

## ARE CREDIT CARD LATE FEES UNCONSTITUTIONAL?

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### ABSTRACT

*State Farm Mutual Automobile Insurance Co. v. Campbell* articulated serious and specific constitutional constraints upon the imposition of punitive damages. Justice Kennedy's majority opinion announced that, apart from exceptional cases, punitive damages should not exceed nine times the amount of the actual losses sustained by the plaintiff and should usually be far lower. Indeed, the opinion observed, they typically should be much lower, citing double, treble, and quadruple multipliers as "instructive" examples. Some commentators have worried that the decision could adversely affect consumer interests by offering insulation for tortious behavior that is difficult to detect or litigate. This Article will explore, however, the decision's unheralded ramifications for contract law, ones that may serve consumer interests.

The constitutional standards articulated in *State Farm* call into question the constitutionality of those statutes and regulations that authorize credit card issuers to charge legally enforceable late penalties but place no significant limitations on their size. Analyzed through the lens of traditional contract law, these penalties are punitive damages for breach that, as such, would typically be invalidated but for positive legislative efforts to override this traditional treatment. Through federal and state statutes and regulations, credit card companies have gained government authorization to levy enforceable penalties that far exceed what the guidelines identified in *State Farm* permit. To be precise, disproportionately high credit card late fees *themselves* are not unconstitutional, but *State Farm* calls into constitutional question their legal enforcement. It also calls into constitutional question the federal and state statutes that authorize and facilitate the imposition of these high late fees, which override both consumer protection statutes to the contrary and traditional contract doctrines that entirely disallow punitive damages.

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## INTRODUCTION

In 2003, *State Farm Mutual Automobile Insurance Co. v. Campbell*<sup>1</sup> imposed serious and specific constitutional constraints on the imposition of punitive damages. The decision, capping a series of cases that developed constitutional limits on punitive damages grounded in procedural and substantive due process,<sup>2</sup> represents the

<sup>1</sup> 538 U.S. 408 (2003) (finding a punitive damage award of \$145 million for a harm worth \$1 million in compensatory damages violated the due process protections of the Fourteenth Amendment).

<sup>2</sup> *Cooper Indus., Inc. v. Leatherman Tool Group, Inc.*, 532 U.S. 424 (2001) (finding the Due Process Clause implicated if fines are grossly excessive); *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559 (1996) (finding a \$2 million punitive damage award excessive on a number of factors including that defendant's conduct was not particularly egregious); *Honda Motor Co. v. Oberg*, 512 U.S. 415 (1994) (striking down a \$5 million punitive damage award that accompanied a compensatory damage award of under \$1 million); *Pac. Mut. Life Ins. Co. v. Haslip*, 499 U.S. 1 (1991) (finding punitive damages did not violate due process when objectively reasonable criteria were met).

most specific articulation of the constitutional limits on punitive damages. Justice Kennedy's majority opinion announced that, apart from exceptional circumstances, punitive damages should not exceed nine times the amount of the actual losses sustained by the plaintiff.<sup>3</sup> Indeed, the opinion observed, punitive damages typically should be much lower, citing double, treble, and quadruple multipliers as "instructive" examples.<sup>4</sup>

Some commentators have worried that the decision could adversely affect consumer interests by offering insulation for tortious behavior that is difficult to detect or litigate.<sup>5</sup> This Article will explore the decision's unrecognized ramifications for contract law that can serve other consumer interests. Specifically, the constitutional standards articulated in *State Farm* call into question the constitutionality of those statutes and regulations that authorize credit card companies to charge late penalties without placing significant limitations on their size.<sup>6</sup> Analyzed through the lens of traditional contract law, these penalties are punitive damages for breach that, as a standard matter, would be invalidated but for positive legislative efforts to override this traditional treatment. Through these federal and state statutes and regulations, credit card companies gain government authorization to levy enforceable penalties that surpass what the guidelines established in *State Farm* permit.<sup>7</sup>

To be precise, disproportionately high credit card late fees *themselves* are not unconstitutional, but *State Farm* calls into constitutional question their legal enforcement. It also calls into constitutional question the federal and state statutes and regulations that authorize and facilitate their imposition, which override both consumer protection statutes to the contrary and traditional contract doctrines that entirely disallow punitive damages.

Part I provides a brief overview of the relevant legal history of credit card late fees and gives a précis of the argument against credit card late fees. Part II argues that *State Farm* applies to the context of credit cards, to contract law more generally, and to legislative authorizations of penalties. Part III establishes that credit card late fees are penalties that transgress the limits established by *State Farm*. Part IV discusses state action. This Article then concludes with a brief discussion of whether limits on credit card late fees would in fact serve the interests of consumers.

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<sup>3</sup> *State Farm*, 538 U.S. at 425.

<sup>4</sup> *Id.*

<sup>5</sup> See, e.g., Catherine M. Sharkey, *Punitive Damages as Societal Damages*, 113 YALE L.J. 347, 400–01 (2003) (suggesting that *State Farm*'s cap may interfere with the use of punitive damages to deter the production of harms on nonpresent plaintiffs that are difficult to detect); Stephen C. Yeazell, *Punitive Damages, Descriptive Statistics, and the Economy of Civil Litigation*, 79 NOTRE DAME L. REV. 2041–42 (2004) (describing litigation incentives *State Farm* may create that may cause a "geographical maldistribution of punitive damages awards"); see also Marc Galanter & David Luban, *Poetic Justice: Punitive Damages and Legal Pluralism*, 42 AM. U. L. REV. 1393, 1418–54 (1993) (criticizing punitive damage caps on deterrence and retributive justice grounds).

<sup>6</sup> See *infra* Part II.

<sup>7</sup> See *infra* Part III.A.2.

## I. THE HISTORICAL BACKGROUND AND THE BASIC ARGUMENT

*A. A Brief Recent History of the Legal Treatment of Credit Card Late Fees*

Credit card late charges have risen exponentially in the last decade. "In eight years, the major card companies have increased the fee charged to cardholders for being even an hour late with a payment to \$39, from \$10 or less."<sup>8</sup> Late charges are assessed in addition to the (typically high) interest charged on outstanding balances. While some companies have tiered structures that vary the size of the late fee according to the outstanding balance, many do not.<sup>9</sup> Some calibrate the size of the late charge in light of the credit rating and credit history of the consumer.<sup>10</sup> Few calibrate the late charge depending on how late the payment is—whether an hour or two weeks.<sup>11</sup> Late fees represent a brisk business. In 2002, it was reported that credit card companies collected \$7.3 billion in late fees annually.<sup>12</sup>

Nationally, credit card late fees began creeping up to very high levels after 1995 when the Comptroller of the Currency issued a regulation interpreting § 85 of the National Bank Act (NBA).<sup>13</sup> The regulation interpreted the NBA to permit credit cards administered by nationally-chartered banks to charge customers in any state whatever late fees are permitted by the home state of the bank.<sup>14</sup> Nearly twenty years before,

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<sup>8</sup> Patrick McGeehan, *Soaring Interest Is Compounding Credit Card Woes for Millions*, N.Y. TIMES, Nov. 21, 2004, at A1; *see also* U.S. GOVERNMENT ACCOUNTABILITY OFFICE, CREDIT CARDS: INCREASED COMPLEXITY IN RATES AND FEES HEIGHTENS NEED FOR MORE EFFECTIVE DISCLOSURES 18 (2006) (reporting exponential rise in late fees since the 1990s); Cardweb.com, Late Fees (Jan. 28, 2005), <http://www.cardweb.com/cardtrak/news/2005/January/28a.html> (reporting that Citigroup, MBNA, Bank of America, and Provident levy a \$39 late fee and that the other major credit card companies charge \$35).

<sup>9</sup> *See 2005 Credit Card Survey: Card Companies Use Common 'Risk Factors' to Impose Unfair Rate Hikes, Finds CA*, CONSUMER ACTION NEWS (San Francisco Consumer Action, San Francisco, Cal.), Summer 2005, at 1, 2, *available at* [http://www.consumer-action.org/archives/English/CANews/2005\\_Credit\\_Card\\_Survey/CC\\_Issue\\_2005.pdf](http://www.consumer-action.org/archives/English/CANews/2005_Credit_Card_Survey/CC_Issue_2005.pdf) [hereinafter *2005 Credit Card Survey*] (detailing the number of credit cards whose late fee plans are tiered and those that are not).

<sup>10</sup> *See id.*

<sup>11</sup> *See id.*

<sup>12</sup> *See* Cardweb.com, Late Fee Bug (May 17, 2002), <http://www.cardweb.com/cardtrak/news/2002/may/17a.html>; *see also* U.S. GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 8, at 72 (reporting that the six largest credit card issuers charged a combined \$7.4 billion in late fees and overlimit fees in 2005); ELIZABETH WARREN & AMELIA WARREN TYAGI, THE TWO-INCOME TRAP: WHY MIDDLE-CLASS MOTHERS AND FATHERS ARE GOING BROKE 141 (2003) (citing a \$7 billion figure for late fees charged in 2003); McGeehan, *supra* note 8 (reporting \$11.7 billion in penalty fees of all kinds in 2003); Cardweb.com, Fee Party (Jan. 13, 2005), <http://www.cardweb.com/cardtrak/news/2005/january/13a.html> (reporting that consumers were assessed \$14.8 billion in late fees and overlimit fees in 2004).

<sup>13</sup> The National Bank Act, 12 U.S.C. § 85 (2000).

<sup>14</sup> 12 C.F.R. § 7.4001 (2006) (interpreting 12 U.S.C. § 85).

*Marquette National Bank v. First of Omaha Service Corp.*<sup>15</sup> affirmed that § 85 of the NBA authorizes a nationally-chartered bank to apply its home state's *interest rate* to those transactions occurring in other states in which standard, percentage-based interest rates are charged on outstanding principal.<sup>16</sup> The unanimous Court in *Marquette* held that a Nebraska bank's credit card solicitations and credit transactions in Minnesota did not locate the bank's credit card program in Minnesota.<sup>17</sup> Rather, for purposes of the NBA, a nationally-chartered bank and its credit card programs are located where the bank designates its operations of discount and deposit.<sup>18</sup> The *Marquette* decision, in essence, permitted nationally-chartered banks to navigate around state usury laws that imposed more restrictive regulations on standard interest rates and to substitute, or *export*, the higher interest rates allowed by their more permissive home states.<sup>19</sup> As a consequence, many banks relocated to states such as Delaware and South Dakota that offered permissive legal environments.<sup>20</sup> The permission to "export" home state interest rates also reached federally-insured state-chartered banks through the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDA).<sup>21</sup> DIDA extends the same powers to federally-insured state-chartered banks that the NBA extends to nationally-chartered banks.<sup>22</sup>

The comptroller's 1995 regulation took a new step beyond permitting the exportation of interest rates on principal. It classified *late charges* as forms of "interest" for the purposes of the NBA.<sup>23</sup> Thereby, the common and statutory laws of the states in which these charges were imposed were effectively pre-empted by the laws of the banks' home states. Banks covered by the NBA (and by extension, those covered by DIDA) were now permitted to impose late charges in accordance with the laws of their home state rather than the state in which the charges were incurred.<sup>24</sup>

By no coincidence, the major credit card issuers have chosen to locate in those states that passed statutes regarding consumer and/or credit contracts that override the common law presumption that penalty clauses in contracts are typically unenforceable. Except in special circumstances, such as fraud, the common law of contract does

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<sup>15</sup> 439 U.S. 299 (1978).

<sup>16</sup> *Id.* at 310–11.

<sup>17</sup> *See id.* at 310.

<sup>18</sup> *Id.* at 309–10.

<sup>19</sup> *See id.* at 318–19.

<sup>20</sup> *See* Samuel Issacharoff & Erin F. Delaney, *Credit Card Accountability*, 73 U. CHI. L. REV. 157, 160–61 (2006).

<sup>21</sup> 12 U.S.C. § 1831d (2000).

<sup>22</sup> *See id.*

<sup>23</sup> 12 C.F.R. § 7.4001. This regulation was presaged by the result in *Greenwood Trust Co. v. Massachusetts*, 971 F.2d 818, 829 (1st Cir. 1992) (interpreting relevant portions of the NBA and DIDA as adopting the home state's full law of usury and applying this result to late charges), *cert. denied*, 506 U.S. 1052 (1993).

<sup>24</sup> *See, e.g., Greenwood Trust*, 971 F.2d 818 (finding DIDA pre-empted state law on the issue of credit card late fees).

not permit the imposition of punitive damages, whether directly by a court or indirectly through the mechanism of prior agreement by the parties, in the form of liquidated damages clauses.<sup>25</sup> Usually, the damages available in contract law are those that represent actual losses or, when liquidated damages are appropriate, those that provide a reliable, agreed upon approximation of actual losses.<sup>26</sup> These common law presumptions, however, can be overridden by state statutes. Many states have statutes exempting credit card charges from standard restrictions on penalty assessments, permitting the imposition of late charges that do not represent an approximation of actual losses.<sup>27</sup> A credit card program run by a bank that falls under the scope of the NBA or DIDA that is headquartered in such a state may therefore charge high late penalties nationally, irrespective of the common law and the consumer protection law of the customer's home state or the state in which the transaction occurred.<sup>28</sup> In an "if you can't beat them, join them" concession, many states altered their consumer protection laws to draw the business of banks after it became clear that these federal regulations eviscerated their ability to protect consumers through consumer protection statutes.<sup>29</sup>

<sup>25</sup> See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 355 (1981); 22 AM. JUR. 2D *Damages* § 500 (2003); E. ALLAN FARNSWORTH, *CONTRACTS* § 12.8 (3d ed. 1999).

<sup>26</sup> RESTATEMENT (SECOND) OF CONTRACTS § 356 (1981). Liquidated damages clauses are usually permitted only when actual losses would be difficult to calculate at the time of breach. It is doubtful that this condition is met in the case of late payments on credit cards, but that issue is left aside here. See also U.C.C. § 2-718 (2003).

<sup>27</sup> See, e.g., DEL. CODE ANN. tit. 5, § 950 (2001) (allowing delinquency charges to be assessed under Delaware law without specifying a limit and declaring that no such charge "shall be deemed void as a penalty or otherwise unenforceable under any statute or the common law"); 205 ILL. COMP. STAT. 675/6 (2000) (allowing any late fees or delinquency charges articulated in credit plan); NEV. REV. STAT. §§ 97A.090, 99.050 (1994 & Supp. 1999) (stating that the term "interest" includes late fees and that parties may agree to any interest rate and fees); N.H. REV. STAT. ANN. § 384-G:10 (2002) (stating banks may set late charges on revolving credit accounts and that no such charge "shall be deemed void as a penalty or otherwise unenforceable under any statute or the common law"); R.I. GEN. LAWS § 6-26.1-9(a)(b) (2004) (using language virtually identical to Delaware and New Hampshire); S.D. CODIFIED LAWS §§ 54-3-1, -1.1 (2006) (classifying late charges as interest and declaring there to be no maximum interest rate in South Dakota); UTAH CODE ANN. § 70C-2-102(1)(b) (1997) (permitting late charges without limitation under Utah Law after 1999); VA. CODE ANN. § 6.1-330.63(A) (2001) (permitting imposition of late fees under Virginia law notwithstanding any statute or other law to the contrary).

<sup>28</sup> See 12 U.S.C. § 85; 12 C.F.R. § 7.4001.

<sup>29</sup> New Jersey once had strong consumer protections against high late charges. In light of *Marquette National Bank v. First of Omaha Service Corp.*, 439 U.S. 299 (1978), and *Smiley v. Citibank*, 517 U.S. 735 (1996), it elected to try to compete for bank business instead. Compare *Sherman v. Citibank*, 668 A.2d 1036, 1040, 1049 (N.J. 1995) (holding, under pre-*Smiley* analysis of New Jersey law, late payment fees at first illegal and then limited to \$10 and denying that NBA and DIDA pre-empted such a holding), *vacated*, *Greenwood Trust Co. v. Hunter*, 517 U.S. 1241 (1996), *rev'd*, *Sherman v. Citibank*, 679 A.2d 652 (1996) (on the grounds of *Smiley* pre-emption), with N.J. STAT. ANN. § 17:3B-29(4)(b) (West 2000) (legislative findings

The 1995 regulation was challenged on the grounds that late charges are not really forms of interest, and therefore, do not fall under the scope of the NBA's exportation doctrine. This challenge was unanimously rejected in 1996 in *Smiley v. Citibank*, a case involving a California consumer and a national bank headquartered in South Dakota.<sup>30</sup> After *Smiley* resolved the uncertainty of the exportation doctrine involving late charges in favor of the credit card companies, higher credit card late fees proliferated nationally.<sup>31</sup>

The litigation in *Smiley*, however, *solely* concerned issues of statutory interpretation. The case addressed the question of whether the comptroller's regulatory interpretation of the term "interest" in the NBA to encompass late fees was reasonable, and concluded that the comptroller's regulatory interpretation was entitled to *Chevron* deference.<sup>32</sup> It did not grapple with the constitutionality of the regulation.<sup>33</sup> In particular,

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and declaration), and N.J. STAT. ANN. § 17:3B-39 (West 2000) (authorizing late charges without any guidelines or amount limits). See generally DAVID S. EVANS & RICHARD SCHMALENSEE, *PAYING WITH PLASTIC: THE DIGITAL REVOLUTION IN BUYING AND BORROWING* 70 (2d ed. 2005) (reporting that states modified usury laws after *Marquette* to attract credit card companies); WARREN & TYAGI, *supra* note 12, at 235 n.71 (citing pressure on state legislatures to relax usury laws because of interstate competition); Issacharoff & Delaney, *supra* note 20, at 164 (reporting Maine's legislature gave up on legislation designed to protect consumers on the grounds that its only effect would be to harm or drive away Maine banks); Mark Furletti, Comment, *The Debate Over the National Bank Act and the Preemption of State Efforts to Regulate Credit Cards*, 77 TEMP. L. REV. 425, 442, 450 (2004) (discussing the changes in state law after *Marquette* and *Smiley*).

<sup>30</sup> *Smiley*, 517 U.S. at 739-47 (according deference to the comptroller's statutory interpretation). *Smiley* held that the late charges levied by Citibank against California residents could be set by Citibank at whatever rate was permitted by South Dakota law. *Id.* This decision permitted Citibank to take advantage of S.D. CODIFIED LAWS §§ 54-3-1 to -1.1 (1990 & Supp. 1995) (classifying late charges as forms of interest and declaring there to be no maximum interest rate in South Dakota).

<sup>31</sup> See U.S. GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 8, at 18 (reporting exponential rise in late fees since 1995); Issacharoff & Delaney, *supra* note 20, at 163 (reporting late fees have tripled in the last ten years and now account for a major proportion of credit card company revenue); see also Cardweb.com, *Late Fee Bug*, *supra* note 12 (reporting that between 1996 and 2002, late fees rose from an average of \$13.28 to an average of \$29.84); Cardweb.com, *Late Fees*, *supra* note 8 (reporting an immediate spike in late fees in 1997 after *Smiley*, from an average of \$14.21 to \$19.24, a 35.4% increase).

<sup>32</sup> *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984) (holding that a reasonable agency interpretation of a statute is entitled to deference even if it does not seem to the court to be the best statutory interpretation).

<sup>33</sup> *Smiley*, 517 U.S. 735. The petitioner raised a different constitutional question, concerning the delegation of federal pre-emption power to the states, that the Court specifically distinguished and declined to address: whether the meaning of "interest" could mean one thing for pre-emption purposes (to activate the permissions of 12 U.S.C. § 85), but could be defined by the home bank's state law in a different way that had an impact on the scope and effect of that pre-emption on other states. *Id.* at 747.

it did not consider the claim that the regulation authorizes the collection of punitive damages that are unconstitutionally disproportionate to the underlying damage.<sup>34</sup> The recent ruling in *State Farm* now brings that issue to the fore.<sup>35</sup>

*B. Why State Farm v. Campbell May Render Legally Enforceable Credit Card Late Fees Unconstitutional: A Précis*

*State Farm v. Campbell* invalidated a punitive damages award of \$145 million on the grounds that it was unreasonable and disproportionate relative to the \$1 million compensatory award.<sup>36</sup> Mr. Campbell's reckless driving on an interstate highway caused a crash resulting in the death of one party and the significant injury of another.<sup>37</sup> His insurance company, State Farm, refused a \$50,000 settlement (representing the policy limit) on his behalf and decided to contest liability, against its own investigator's recommendation.<sup>38</sup> Despite the company's own findings that Campbell was at fault, State Farm assured Campbell that it would represent his interests at trial, that Campbell would not be found liable, that he need not retain separate counsel, and that his assets were entirely safe.<sup>39</sup> Although "State Farm's employees altered the company's records to make Campbell appear less culpable,"<sup>40</sup> Campbell nonetheless lost at trial and was assessed \$185,849 in damages.<sup>41</sup> For some time, State Farm refused to pay for any amount above the \$50,000 policy limit and advised Campbell to sell his property and to move.<sup>42</sup> Campbell, in conjunction with the original plaintiffs against him, sued State Farm for bad faith, fraud, and intentional infliction of emotional distress.<sup>43</sup> The jury awarded him \$2.6 million in compensatory damages, later reduced to \$1 million by the trial court, and \$145 million in punitive damages, which was also reduced by the trial court to \$25 million.<sup>44</sup> The punitive damages award of \$145 million was later reinstated by the Utah Supreme Court, after reviewing its size in light of the U.S. Supreme Court's earlier disproportionality decision in *BMW of North America, Inc. v. Gore*.<sup>45</sup>

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<sup>34</sup> *Smiley*, 517 U.S. 735.

<sup>35</sup> *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408 (2003).

<sup>36</sup> *Id.* at 429.

<sup>37</sup> *Id.* at 412–13.

<sup>38</sup> *Id.* at 413.

<sup>39</sup> *Id.*

<sup>40</sup> *Id.* at 419.

<sup>41</sup> *Id.* at 413.

<sup>42</sup> *Id.* After five years and Campbell's unsuccessful appeal of the wrongful death claims himself, State Farm eventually paid the full judgment. *Id.* at 414.

<sup>43</sup> *Id.*

<sup>44</sup> *Id.* at 415.

<sup>45</sup> 517 U.S. 559 (1996); see *State Farm*, 538 U.S. at 415–16 (reviewing the holding of the Utah Supreme Court).



The U.S. Supreme Court granted certiorari and, in a 6–3 decision, overturned the punitive damages award.<sup>46</sup> In reaching this result, the Court applied the three criteria announced in *Gore* to assess the constitutionality of a punitive damage award: (1) the degree of reprehensibility of the defendant's misconduct, (2) the disparity between the harm suffered by the plaintiff and the punitive damages award, and (3) considerations of horizontal equity.<sup>47</sup> In its discussion of the second factor, the Court declined "to impose a bright-line ratio which a punitive damages award cannot exceed."<sup>48</sup> Nevertheless, one sentence later, it issued a prediction far more specific than the guidelines offered in prior cases: "Our jurisprudence and the principles it has now established demonstrate, however, that, in practice, few awards exceeding a single-digit ratio between punitive and compensatory damages, to a significant degree, will satisfy due process."<sup>49</sup>

*State Farm* has, thus far, mainly been interpreted as articulating a limit on tort litigation and a shield for the defense.<sup>50</sup> Its potential as an offensive tool on behalf of consumers has not yet been explored or appreciated. *State Farm* may serve consumer interests in those contexts in which consumers are levied penalties, i.e., punitive damages, for breach of contract that are significantly disproportionate to the harm caused by breach, such as credit card late charges.

In brief, the implications of *State Farm* for credit card late charges are as follows. The collection of credit card late charges involves the imposition of penalties for contractual breach, namely the failure to render payment by an agreed-upon date. Punitive damages for contractual breach are typically disallowed by the common law of contract (and the Uniform Commercial Code (UCC)), even when mutually agreed on by both contracting parties in the form of contractual penalties for breach.<sup>51</sup> This bar has been

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<sup>46</sup> *State Farm*, 538 U.S. at 411, 416, 429.

<sup>47</sup> *Id.* at 418 (citing *Gore*, 517 U.S. at 575).

<sup>48</sup> *Id.* at 425.

<sup>49</sup> *Id.*

<sup>50</sup> See *supra* note 5.

<sup>51</sup> See RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (1981) ("Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss. A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty."); see also *MCA Television Ltd. v. Pub. Interest Corp.*, 171 F.3d 1265, 1271 (11th Cir. 1999) ("Unlike tort law, which permits the imposition of punitive damages as a means to deter disfavored conduct, contract law does not allow for punitive damages unless the breach of contract is also a tort for which punitive damages are recoverable. . . . Parties may not, however, use . . . stipulated damages provisions as a way to secure for themselves greater damages in the event of a breach than contract law would normally allow. If a court finds the damages stipulated to be out of all proportion to the reasonably anticipated loss from nonperformance, it will conclude that the provision was intended to impose a penalty for breach. . . ." (citations omitted)); *Lawyers Title Ins. Corp. v. Dearborn Title Corp.*, 118 F.3d 1157, 1161 (7th Cir. 1997) (finding that when it was not a "bona fide estimate of the likely damages," a 100% liquidated damages clause for bounced checks was an unenforceable penalty); *Lake River*

specifically applied to penalties for late payment.<sup>52</sup> Under the common law of contract, these charges would be unenforceable penalties.<sup>53</sup> Because the companies make no attempt to calibrate the late charges to the losses they incur from late payment and because these charges do not in fact represent even rough approximations of their losses, absent statutory authorization, the late charge clauses in credit card contracts should be analyzed as unenforceable penalty clauses that masquerade as liquidated damages clauses. Credit card late fees have recently become immune from this general rule

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Corp. v. Carborundum Co., 769 F.2d 1284, 1290 (7th Cir. 1985) (finding that liquidated damages clause was a penalty when "[t]he formula . . . is invariant to the gravity of the breach"); Thorsen v. Iron & Glass Bank, 476 A.2d 928, 932 (Pa. 1984) ("The law is clear that punitive damages are not recoverable in an action for breach of contract."); Wolin v. Walker, 830 P.2d 429, 433 (Wyo. 1992) (holding unenforceable liquidated damages that are "punitive in nature," that is, "when the damages provided bear no reasonable relationship to the actual damages sustained"); U.C.C. § 2-718(1) (2003) ("Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, [and, in a consumer contract,] the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy."); 11 ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS § 1057 (interim ed. 2002); FARNSWORTH, *supra* note 25, § 12.18, at 843; JOHN EDWARD MURRAY, JR., MURRAY ON CONTRACTS § 125(A)(1) (4th ed. 2001).

<sup>52</sup> See, e.g., *Ridgley v. Topa Thrift & Loan Ass'n*, 953 P.2d 484, 490 (Cal. 1998) (finding that when a loan prepayment charge of six months' interest was contingent upon a late payment, such a charge was really a penalty for late payment and unenforceable because it was unrelated to the actual injury suffered from the late payment); *Dist. Cablevision Ltd. P'ship v. Bassin*, 828 A.2d 714, 725 (D.C. 2003) (affirming jury verdict that when actual loss from a late payment of a cable television subscription was \$2.43, a \$5.00 late fee was an unenforceable penalty under the common law); *Graves v. Cupic*, 272 P.2d 1020, 1025 (Idaho 1954) (finding contractually stipulated damages to be a penalty because the amount was arbitrary and bore no reasonable relation to foreseeable damages from contractual breach); *Highgate Assocs., Ltd. v. Merryfield*, 597 A.2d 1280 (Vt. 1991) (finding that when the loss from a late rent payment was readily calculable, the amount of liquidated damages was not reasonably related to the actual loss sustained as a result of the late payment, and the provision was intended to discourage and not compensate for losses resulting from late payment, liquidated damages clause in a residential lease was an unenforceable penalty).

<sup>53</sup> See Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373, 1424-25 (2004). Bar-Gill argues that late fees are disproportionate to the credit card company's cost and that this violates the common law prohibition against penalty damages. *Id.* at 1424. He incorrectly concludes that they are perforce illegal, ignoring the pre-emptive effect of the NBA, DIDA, and the exportation of the laws of more permissive states endorsed by *Smiley v. Citibank*. For this reason, he incorrectly attributes the reluctance of courts to invalidate late fees on common law contracts grounds to the difficulty courts would have in "conduct[ing] the comprehensive analysis of an issuer's cost structure that would be required to separate illegal penalties from reasonable liquidated damages." *Id.* at 1425. Because of the pre-emptive effect of NBA and DIDA, only congressional action, uniform and coordinated legislative action in all fifty states, or a constitutional challenge of the sort discussed in this Article could reinstate the applicability of the common law doctrine to late fee charges for credit card payments.

of contract through a combination of state and federal statutes that override these legal presumptions.<sup>54</sup> Although the common law and statutory presumptions against contractual penalty damages may be overridden or modified by another statute, any statute that authorizes the imposition of punitive damages must still meet constitutional limits. No statute may authorize legally enforceable punitive damages that are excessively disproportionate to the underlying loss. Disproportionately high damages violate the constitutional constraints freshly specified by *State Farm*.

*State Farm* directed that punitive damages should not exceed nine times the amount of the actual losses sustained by the plaintiff.<sup>55</sup> The federal and state statutes that override the common law presumption against contractual penalties have authorized levying and enforcing penalty damages that transgress this guideline. Most major credit card companies impose penalty charges for late payment that range from \$15 to \$39.<sup>56</sup> These penalties may be assessed even when payment is only an hour<sup>57</sup> or a day overdue and even if the balance is quite low, sometimes lower than the fee assessed. As is argued at greater length in Part III, these charges exceed the costs credit card companies incur by a factor that typically far surpasses the 9:1 *State Farm* ratio.<sup>58</sup> Nor does the situation giving rise to these damages have features that meet the conditions that *State Farm* recognized as exceptional, features that might justify a departure from the 9:1 upper limit.<sup>59</sup> Therefore, governmental authorization and enforcement of such late charges violates the Due Process Clause of the Fifth and Fourteenth Amendments.

In the following Parts, this argument will be unpacked in stages. First, it will be argued that *State Farm* applies to this aspect of contract law and to legislative authorizations of penalty damages. Then, an extended argument will be offered to support the contention that state and federal statutes and regulations authorize the enforcement of penalties for breach of contract that violate the constitutional constraints on punitive damages articulated in *State Farm*. This challenge does not involve revisiting the statutory interpretation question resolved by *Smiley*,<sup>60</sup> although the argument of this Article has implications for the regulation considered in *Smiley*. As applied, either the exportation regulations interpreted in *Smiley* in conjunction with relevant state statutes are unconstitutional for reasons not considered by the *Smiley* Court, or, in the alternative, the exportation regulation of the NBA (and its analogous counterpart in

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<sup>54</sup> See *supra* text accompanying notes 25–29.

<sup>55</sup> *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 425 (2003).

<sup>56</sup> See U.S. GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 8, at 20 (calculating that the average late fee charged in 2005 was about \$37); see also *supra* notes 8–9 and accompanying text.

<sup>57</sup> Cf. *Discover Bank v. Superior Court*, 113 P.3d 1100, 1104 (Cal. 2005) (discussing Discover Bank's practice of assessing late fees if payment was received after 1:00 p.m. on the due date).

<sup>58</sup> See *infra* Part III.

<sup>59</sup> *State Farm*, 538 U.S. at 425.

<sup>60</sup> *Smiley v. Citibank*, 517 U.S. 735 (1996).

DIDA) should be interpreted as implicitly incorporating restraints on the size of permissible late fees to avoid the constitutional question. In either case, these penalty charges should be declared invalid because they are disproportionately large punitive damages, because the applicable common law in the absence of the statute would void them as penalties for mere contractual breach, and in some cases, because the otherwise applicable statutory law would invalidate them as usury or unauthorized charges.<sup>61</sup>

## II. THE APPLICATION OF *STATE FARM* TO THE CREDIT CARD CONTEXT

To pursue the argument sketched in Part I, two preliminary issues must be addressed about the extension of *State Farm* to credit card late fees. First, *State Farm* arose in the tort context, not the contracts context.<sup>62</sup> Some may suggest that the *State Farm* protections do not clearly extend to contractors. Second, the *State Farm* constraint arose with respect to jury assessments, not statutes.<sup>63</sup> This Part investigates *State Farm*'s implications in contexts other than jury awards pursuant to tort actions. It argues that *State Farm* limits the penalties legislatures may levy, and that legislatures may authorize private parties to levy in a variety of situations, in a variety of other contexts.

### A. Does *State Farm* Apply to the Contracts Context?

One may question whether *State Farm* limits apply to the credit card context because the line of cases giving rise to the constitutional limitation on punitive damages had tortfeasors in mind, not contractors. Actually, *State Farm v. Campbell*,<sup>64</sup> *BMW of North America v. Gore*,<sup>65</sup> and *Cooper Industries, Inc. v. Leatherman Tool Group, Inc.*<sup>66</sup> were all hybrid cases that involved elements of contract and tort. The bad faith

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<sup>61</sup> For example, Massachusetts's law authorizes creditors of open-end credit accounts to levy late charges no greater than \$10 or ten percent of the outstanding balance, whichever is less. MASS. GEN. LAWS ch. 140, § 114B (2006). Maine's statute authorizes creditors, after fifteen days of delinquency, to assess either late charges of five percent of the outstanding balance, not to exceed \$10 or a highly regulated deferral charge. ME. REV. STAT. ANN. tit. 9-A, § 2-502(1) (2005). For cards that do not charge annual fees, Minnesota permits "delinquency and collection" charges after ten days in arrears for five percent or \$5, whichever is greater, plus capped attorney's fees if an attorney is hired for collection purposes. MINN. STAT. ANN. § 48.185(4)(d)(1) (West 2005) (incorporating ceiling from MINN. STAT. ANN. § 168.71(c) (West 2005)). California sets limits on late fees depending on how long the account has been in arrears. See CAL. FIN. CODE § 4001 (West 1999); see also *infra* notes 184-96 and accompanying text.

<sup>62</sup> See *State Farm*, 538 U.S. at 413.

<sup>63</sup> See *id.*

<sup>64</sup> 538 U.S. 408.

<sup>65</sup> 517 U.S. 559 (1996).

<sup>66</sup> 532 U.S. 424 (2001).

and fraud in *State Farm* arose within an effort to evade payment on an insurance contract.<sup>67</sup> *Gore* involved a failure to disclose minor damage and prior repair in a sales context.<sup>68</sup> *Cooper Industries* concerned fraudulent advertising.<sup>69</sup> Still, in these cases, the punitive damages arose from the tortious element of the conduct.

The focus on tortfeasors in the jurisprudence and commentary on punitive damages does not mean that punitive damages assessed in contract are exempt from the standards articulated in *State Farm*. Lower courts have applied the *State Farm* framework to other causes of action, including § 1983 actions, copyright, and unauthorized credit card charges.<sup>70</sup> The Supreme Court's specific mention of tortfeasors was natural because tort cases are the common civil context in which punitive damages are assessed. Given the general ban on punitive damages in contract,<sup>71</sup> it would have been peculiar for the Court to mention explicitly the applicability of these standards to the contracts context.

This natural focus on tort law does not carry greater import, however. In particular, it does not suggest that the *State Farm* protection does not extend to contractors. If anything, the standards governing punitive damages in contract should be stricter than they are in torts, both because punitive damages awarded in tort actions are more traditional and because they are consequent to clear and serious wrongdoing. By contrast, late fees are triggered by actions (late payments) that the law typically does not regard as a serious form of wrongdoing but rather as merely contractual breach.<sup>72</sup> It would be perverse if a substantive due process protection extended to tortfeasors who had engaged in serious wrongdoing but did not protect contractors whose wrong was rather slight.

Yet, it might be argued that punitive damages in contract differ because contracts (and the late fee agreements in them) involve voluntary, private relationships. This fact has questionable significance. Although their victims have not typically entered into a voluntary relationship, tortfeasors—the ones subject to punitive damages—have often acted voluntarily. Their voluntary behavior and their knowledge that it may

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<sup>67</sup> *State Farm*, 538 U.S. at 413–14.

<sup>68</sup> *Gore*, 517 U.S. at 563–64.

<sup>69</sup> *Cooper Indus.*, 532 U.S. at 428.

<sup>70</sup> See *Siggers-El v. Barlow*, 433 F. Supp. 2d 811, 817–18 (E.D. Mich. 2006) (applying *State Farm* framework in case alleging § 1983 violation for retaliation against use of First Amendment rights); *Lowry's Reports, Inc. v. Legg Mason, Inc.*, 302 F. Supp. 2d 455, 460 (D. Md. 2004) (finding *State Farm* disproportionality analysis applicable in a copyright cause of action, although finding no violation); *Votto v. Am. Car Rental, Inc.*, No. CV010456354S, 2003 WL 21716003, at \*4–5 (Conn. Super. June 16, 2003) (applying *State Farm* framework to case involving unauthorized credit card charges and violation of Connecticut Unfair Trade Practice Act).

<sup>71</sup> See *infra* note 143 and accompanying text and *supra* notes 25–26 and accompanying text.

<sup>72</sup> See *supra* text accompanying notes 25–26; see also Seana Shiffrin, *The Divergence of Contract and Promise*, 113 HARV. L. REV. 708 (2007) (discussing contract law's attitude toward breach as reflected in its stance on punitive damages).

subject them to punitive damages does not exempt them from the constitutional protections afforded by the *State Farm* line of cases. As is illustrated by the treatment of voluntary behavior by tortfeasors who are aware of their susceptibility to punitive damages, what matters from the constitutional point of view in assessing the constitutionality of punitive damages is not whether the conduct subject to punitive damages is knowing and voluntary; what matters is how the state treats this voluntary conduct and whether it authorizes and enforces punishments that are disproportionate to the losses imposed by the behavior.

Still, it might be argued that torts involve public wrongs and that punitive damages represent official state recognition and reaction to this public wrong. The constitutional limitations articulated in *State Farm* govern the governmental reaction to this public wrong. Contractual breach, by contrast, is not standardly considered a public wrong.<sup>73</sup> Punitive damage agreements within contracts, when allowed at all, merely represent an agreement between private parties and do not represent or emerge from the state's recognition of and reaction to a public wrong. Hence, *State Farm*'s limits on the state's imposition of punitive damages are inapt in this context.

Against this objection, it might be pressed that the state does not merely allow these private arrangements but takes an active role in enforcing them. This enforcement role in turn permeates and motivates the background environment of voluntary compliance. Some, however, may object that this degree of state involvement with voluntary agreements, so described, is sufficiently neutral and pale as to render it different in kind from its enforcement activity in the torts domain. Considerations of this kind may lend credence to the position that at least some elements of contract doctrine should not be subject to the same constitutional scrutiny that might be apposite in other domains of law.<sup>74</sup>

The case of credit card late fees, however, has special features that implicate the state to a greater degree than is captured by the standard story of contract as a purely private relation.<sup>75</sup> First, credit card transactions are not *sui generis* private arrangements but are an aspect of the highly regulated banking industry meant to serve national purposes and to underwrite the national economic system.<sup>76</sup> Second, as previously

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<sup>73</sup> See Shiffrin, *supra* note 72.

<sup>74</sup> See, e.g., Kent Greenawalt, *Religious Law and Civil Law: Using Secular Law to Assure Observance of Practices with Religious Significance*, 71 S. CAL. L. REV. 781, 817-18 (1998) (discussing state enforcement of civil contracts that have religious significance and require actions with religious significance); cf. *Jones v. Wolf*, 443 U.S. 595 (1979) (holding that the Establishment Clause did not bar a court from resolving a property dispute between churches so long as neutral principles of law were invoked and not interpretation of internal church doctrine).

<sup>75</sup> Further related considerations addressing the state action dimensions of this concern are offered in Part IV.

<sup>76</sup> See *Marquette Nat'l Bank v. First of Omaha Serv. Corp.*, 439 U.S. 299, 314-18 (1978). In upholding the exportation doctrine with respect to interest rates, the Court made extensive

mentioned, punitive damages in contract are typically disallowed by the common law (and the UCC).<sup>77</sup> The bar is so strong that private parties are not usually permitted to contract around this remedies rule; liquidated damage agreements that contain penalties are invalidated. This strong default presumption has been overcome in the case of credit card late fees, not by any general evolution in the common law but by affirmative legislative action.<sup>78</sup> State and federal legislatures enacted statutes and regulations to overcome the standard ban against punitive damages and punitive damage agreements for contractual breach in order to facilitate the business of banks, to attract their business to particular states, and in the case of the NBA, to promote nationally-chartered banks.<sup>79</sup> The government's aim was to remove the hindrances posed by state common law and state consumer protection law so as to facilitate the use of late fees.

In light of this history, the governmental stance cannot be properly understood as that of a neutral observer. Instead, through legislative and agency activity, the government has actively endorsed and encouraged the use of credit card late fees, a specific sort of punitive damage agreement.<sup>80</sup> Its actions in support of such punitive damages, through authorization meant to encourage and facilitate their imposition, and also through the promise of enforcement, are therefore properly subject to the standards articulated in *State Farm*.

#### *B. Does State Farm Apply to Legislative Action?*

*State Farm* capped a line of cases that assessed the validity of jury impositions of large punitive damage assessments.<sup>81</sup> Although the Court was prompted in some measure by specific concerns about the arbitrariness of jury awards, the vagaries of jury deliberation, and variations between cases,<sup>82</sup> the holding of *State Farm* cannot be limited to the context of jury awards. The underlying issue in the line of cases culminating in *State Farm* is not how a certain agent, namely the jury, calculates punitive damages. If the issue exclusively concerned *the agent* who imposed damages and *how*

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appeal to the significance of the national banking system to the economy and the intention behind the NBA and § 85 to facilitate a national banking system and regional interdependence. *Id.*

<sup>77</sup> See *supra* text accompanying notes 51–54.

<sup>78</sup> See *supra* text accompanying notes 25–31.

<sup>79</sup> In *Beneficial National Bank v. Anderson*, 539 U.S. 1 (2003), the Court described §§ 85–86 of the NBA as allowing for uniform rules for national banks that provide “an integral part of a banking system that needed protection from ‘possible unfriendly State legislation.’” *Id.* at 10; see also *supra* Part I.A.

<sup>80</sup> Cf. *Reitman v. Mulkey*, 387 U.S. 369 (1967) (finding California referendum repealing law against private discrimination did not merely permit private discrimination but, in context, encouraged it, and therefore, was subject to constitutional review).

<sup>81</sup> See, e.g., *supra* note 2 and accompanying text.

<sup>82</sup> *State Farm v. Campbell*, 538 U.S. 408, 417–18 (2003).

they were determined, the matter would sound exclusively in procedural due process, but it does not, as the Court recognized.<sup>83</sup>

Rather, the central issue is how harshly civil wrongs may be punished. Substantive due process requires legally cognizable punishments and penalties to bear a proportionate relationship to the underlying wrong.<sup>84</sup> Whether arrived through settlements, through the agency of a judge, through the agency of a jury, or through the agency of the legislature, punitive damages for a civil wrong must not be disproportionately large relative to the wrong at issue.

A few thought experiments help to illustrate this claim. First, judge-awarded punitive damages must be subject to the same strictures. It defies credulity to think that, after *State Farm*, a judge could directly award the same level of punitive damages relative to compensatory damages that were invalidated when provided by a jury.<sup>85</sup> Furthermore, it is dubitable that a judge could approve a settlement agreement in a class action suit that explicitly included an agreement for punitive damages just like the one invalidated in *State Farm*.<sup>86</sup> If so, it is highly significant to the case at hand. Credit card late fee agreements are agreements to pay punitive damages that are not only explicitly authorized by legislatures but also expected to be judicially enforced against those who do not pay them. In this latter respect, they resemble settlement agreements.

Just as it seems settlement agreements cannot circumvent *State Farm*'s strictures, it is likewise illegitimate for a legislature, whether federal or state, to attempt to override the *State Farm* ruling through a statute that explicitly authorized the very same amount of punitive damages relative to compensatory damages. Nor does it seem compatible with the holding and reasoning of *State Farm* for a legislature to pass a statute explicitly authorizing another agent to set and enforce punitive damage awards that were unconstrained and had no upper boundaries. Likewise, a legislature could not cure the defects of unconstrained jury awards merely by passing a statute explicitly providing juries authorization to award whatever punitive damages they thought appropriate.<sup>87</sup>

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<sup>83</sup> *Id.* at 422–23.

<sup>84</sup> *Id.*

<sup>85</sup> Three cases, one unreported, scrutinize judge-awarded punitive damages for compliance with *State Farm*. None portray any difference between the application of *State Farm* to the judge-awarded damages and to jury-awarded damages; in each case, however, the awards passed muster. *See In re Wright*, No. SA–03–CV–932, 2004 WL 569517, at \*8 n.60 (W.D. Tex. Mar. 8, 2004) (holding that bankruptcy judge awarded punitive damages in accord with *State Farm*); *Austin v. Specialty Transp. Servs., Inc.*, 594 S.E.2d 867, 877 (S.C. App. 2004) (directly applying *State Farm* to judge-awarded punitive damages but finding award met single digit multiplier rule); *Bright v. Addison*, 171 S.W.3d 588, 603–05 (Tex. Ct. App. 2005) (assessing punitive damages awarded in bench trial for compliance with *State Farm*).

<sup>86</sup> *Cf. O'Flaherty v. Belgum*, 9 Cal. Rptr. 3d 286, 335–36 (Ct. App. 2004) (declaring that de novo standard of review for punitive damages does not apply to arbitration awards but also noting, in dicta, that arbitration award met *State Farm*'s substantive standards).

<sup>87</sup> “The *Gore* guideposts may apply to punitive damages awards under federal statutes.”



The *State Farm* Court's concern was not merely with horizontal equity or the unpredictability of juries; only the third factor of the Court's test, the one pertaining to horizontal equity, refers specifically to juries and the relative size of the awards they generate.<sup>88</sup> The other two factors, reprehensibility and size relative to compensatory damages, should equally govern legislative authorizations of punitive damages. Indeed, the Court explicitly emphasized that while "[s]tates possess discretion over the imposition of punitive [damages]," that discretion is limited by procedural *and* substantive constitutional limits.<sup>89</sup> Indeed, the Supreme Court drew the connection itself. In its discussion of the substantive upper limit on punitive damage awards, it drew on the history of legislative enactments of double and treble damages as examples of permissible authorizations of penalties.<sup>90</sup> Not only did the Court articulate the constitutional constraint in terms of the agency of the states and not merely that of juries, but its articulation of the substantive due process concern would apply equally to other state actors.<sup>91</sup> Grossly excessive awards, the Court reasoned, "further[] no legitimate purpose and constitute[] an arbitrary deprivation of property."<sup>92</sup> The context of the decision—that it was a jury award—heightened but was not the crux of the concern in *State Farm*.<sup>93</sup> A substantive constitutional objection to a penalty cannot arise only when that penalty is imposed by a jury. Substantive constitutional restrictions must be respected by juries, judges, legislatures, and executives alike.

True, one of *State Farm*'s objections was procedural, dealing with the absence of fair notice of the size of the penalty that might be imposed for wrongful conduct.<sup>94</sup> This procedural concern, addressed by the horizontal equity factor mentioned above, often has special force against jury awards. This consideration might well be overcome if a statute carefully delineated a narrowly constrained penalty range applicable in response to wrongful conduct.<sup>95</sup> The legislative authorization of credit card late fees

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Lowry's Reports, Inc. v. Legg Mason, Inc., 302 F. Supp. 2d 455, 460 (D. Md. 2004) (citing *Cooper Indus., Inc. v. Leatherman Tool Group, Inc.*, 532 U.S. 424, 430 n.3 (2001)); *see also* *St. Louis, Iron Mountain & S. Ry. Co. v. Williams*, 251 U.S. 63, 66–67 (1919) (holding that statutorily imposed penalties that are "wholly disproportioned to the offense and obviously unreasonable" violate substantive due process) (cited in *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559, 575 (1996)); *Parker v. Time Warner Entm't Co.*, 331 F.3d 13, 22 (2d Cir. 2003) (contemplating application of *State Farm* in case involving violation of privacy provisions of the Cable Communications Act but not reaching the issue).

<sup>88</sup> *See State Farm*, 538 U.S. at 418.

<sup>89</sup> *Id.* at 416 (emphasis added).

<sup>90</sup> *Id.* at 425.

<sup>91</sup> *Cf. id.* (noting that complying with due process through single-digit multipliers of punitive awards would "still achiev[e] the State's goals of . . . retribution" (emphasis added)).

<sup>92</sup> *Id.* at 417.

<sup>93</sup> *See id.* at 417–18.

<sup>94</sup> *Id.* at 417.

<sup>95</sup> *See Lowry's Reports, Inc. v. Legg Mason, Inc.*, 302 F. Supp. 2d 455, 460 (D. Md. 2004) (affirming punitive damages award for copyright violation when punitive damages were based

is not, however, so constrained. The relevant state statutes, NBA, and DIDA neither define a range of permissible penalties nor demand that the penalty size be responsive to the underlying harm caused by breach. Rather, the statutes that the NBA and DIDA select as the governing law simply authorize the banks to charge what they wish<sup>96</sup> so long as there is disclosure to the customer.<sup>97</sup>

The requirement of disclosure of the late fee and the uniform application of the late fee to all customers of a particular card partly, but do not fully, allay the procedural concerns. Forms of legislative authorization that provide no guidelines for the size of the appropriate fee permit private agents who are not accountable to the public to determine the size of legally enforceable penalties and to vary them at will provided they disclose the fee to consumers. One should not overestimate the significance of this disclosure. Many cardpayers do not read the long print of their credit card agreements whose text does not easily submit to comprehension in any case.<sup>98</sup> Fewer still read the updates and amendments that arrive in the mail. Further, many cardpayers significantly discount the likelihood that they will be subject to a late penalty. Many consumers are surprised by the size and conditions of the fee, and their ignorance suggests that they do not force sharper market competition.<sup>99</sup>

Moreover, the penalties announced need not bear a close relationship to the harm caused by breach nor need they manifest horizontal equity with penalties assessed by other companies for similar forms of breach. Competition between credit cards *might* generate some forms of horizontal equity in late fees between credit cards if the notice were sufficiently transparent and salient to consumers. Market competition would not be likely, however, to generate horizontal equity in penalties for late payment between non-competing companies, such as those for credit cards and cell phones, although the wrong of late payments is the same. If the heart of the procedural concern about jury awards is that they are not accountable and not responsive to considerations of horizontal equity, these concerns largely hold true of the broad and limitless legislative authorizations to private companies to levy enforceable penalties.

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on statutory authorization from a "carefully crafted and reasonably constrained statute" and when compensatory losses were difficult to measure); *see also infra* note 132.

<sup>96</sup> See, for example, the South Dakota statute at issue in *Citibank*, which provides no guidelines about the size of charges. S.D. CODIFIED LAWS §§ 54-3-1, -1.1 (2006). It explicitly states there is no maximum to what may be charged. *Id.* § 54-3-1.1.

<sup>97</sup> See Truth in Lending Act, 15 U.S.C. § 1637(c)(1)(B)(ii) (2000) (requiring "clear[] and conspicuous[]" disclosure of late fees, defined as "[a]ny fee imposed for a late payment").

<sup>98</sup> See U.S. GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 8, at 51. The Government Accountability Office found that "the disclosures in the customer solicitation materials and cardmember agreements provided by four of the largest credit card issuers were too complicated for many consumers to understand." *Id.* at 6.

<sup>99</sup> "Most people never anticipate they will pay late, so they do not shop around for better late fees." Robin Stein, *The Ascendancy of the Credit Card Industry*, FRONTLINE, Nov. 23, 2004, <http://www.pbs.org/wgbh/pages/frontline/shows/credit/more/rise.html>.

### III. ARE CREDIT CARD LATE CHARGES PUNITIVE DAMAGES THAT WOULD TRANSGRESS *STATE FARM*'S CONSTRAINTS?

As a matter of statutory interpretation, *Smiley v. Citibank*<sup>100</sup> clearly affirmed the comptroller's regulation under the NBA. That regulation authorized nationally-chartered credit card companies to rely on their home state law to levy charges authorized by their home state statutes.<sup>101</sup> The issuers' home state statutes overrode the default contract rule invalidating penalty charges as well as any other relevant consumer protection statutes from the consumer's home state. *Smiley* only addressed the interpretative question of whether late charges were "interest" in the context of the statutory scheme.<sup>102</sup> It did not address whether a statutory scheme encouraging the unconstrained assessment of punitive damages in contract satisfied constitutional limits on punitive damages. *State Farm* calls into question whether this statutory blanket exemption meets constitutional standards. This Part applies the *State Farm* constitutional standards in greater detail to the legal framework facilitating the imposition of late fees.

#### *A. Applying State Farm's Three-Factor Test*

*State Farm* explicitly recognized both procedural and substantive limitations on punitive damages awards.<sup>103</sup> Elaborating upon its prior decision in *BMW of North America, Inc. v. Gore*,<sup>104</sup> the Court articulated three factors to review punitive damages for constitutional soundness: (1) the reprehensibility of the conduct giving rise to the punitive damages; (2) disparity between the actual loss suffered and the punitive damages; and (3) "the difference between the punitive damages awarded by the jury and the civil penalties authorized or imposed in comparable cases."<sup>105</sup> As the Court declared, these factors need not all be present to render a damage award unconstitutional. "The existence of any one of these factors weighing in favor of a plaintiff may not be sufficient to sustain a punitive damages award; and the absence of all of them renders any award suspect."<sup>106</sup> Applying these factors to credit card late charges casts doubt upon their constitutionality.

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<sup>100</sup> 517 U.S. 735 (1996).

<sup>101</sup> *Id.* at 744-47.

<sup>102</sup> *Id.* at 745.

<sup>103</sup> "While States possess discretion over the imposition of punitive damages, it is well established that there are procedural and substantive constitutional limitations on these awards." *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 416 (2003).

<sup>104</sup> 517 U.S. 559 (1996).

<sup>105</sup> *State Farm*, 538 U.S. at 418 (citing *Gore*, 517 U.S. at 575).

<sup>106</sup> *Id.* at 419.

### 1. Reprehensibility

The Court has identified reprehensibility as the most important factor in a punitive damages analysis.<sup>107</sup> In the case of late payments on credit card bills, there is rarely any *reprehensible* wrongdoing involved in merely making a late payment. In any case, the imposition of late charges does not follow any particularized effort to assess whether the consumer has engaged in any culpable behavior. Even the transparently bad faith behavior of the State Farm Mutual Automobile Insurance Company was nevertheless thought to be consistent with invalidating the punitive damages levied against it.<sup>108</sup> If the degree of reprehensibility involved is, as the Court states, the “most important indicium of the reasonableness of a punitive damages award,”<sup>109</sup> then it is difficult to see how credit card late charges of current magnitudes can be reasonable. Running down the Court’s articulated subfactors, the harm of late payment is economic as opposed to physical; it does not evince indifference or disregard for the health or safety of others; the target is not financially vulnerable; and, in many cases, the conduct may be isolated.<sup>110</sup> Finally, the harm, whether understood as the tardiness or the costs associated with the tardiness, is rarely the result of malice, trickery, or deceit by the late payer.<sup>111</sup> Many late payers are poorly organized, negligent, or just strapped for cash. Few are attempting to hobble the credit card companies. Some late payers may be playing the float and attempting to keep money owed as long as possible in their own accounts for interest and other purposes. They may miscalculate the optimal time to send payment to make it just on time. But it is questionable whether this

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<sup>107</sup> *Id.* (citing *Gore*, 517 U.S. at 575).

<sup>108</sup> Part of the Court’s concern in *State Farm* was that the size of the penalty might have reflected evidence of the company’s pattern of avoiding settlements through like practices. *Id.* at 422–23. The Court objected to the introduction of evidence of State Farm’s practices, both legal and illegal, in other states on the grounds that penalizing practices in other states was beyond Utah’s jurisdiction. *Id.* at 421–23. It further criticized basing penalty assessments on insufficient evidence of the defendant’s actions towards other parties (even in-state) as well as on the defendant’s other, dissimilar forms of malfeasance. *Id.*

<sup>109</sup> *Id.* at 419 (quoting *Gore*, 517 U.S. at 575).

<sup>110</sup> *Id.*

<sup>111</sup> Compare the discussion of reprehensibility in *Williams v. Philip Morris, Inc.*, 127 P.3d 1165 (Or. 2006), *cert. granted in part*, 126 S. Ct. 2329 (2006). To justify a punitive damage award exceeding *State Farm* guidelines, the Oregon Supreme Court noted that “[o]f the five reprehensibility factors listed in *Gore* . . . , four certainly are met here.” *Id.* at 1177 (emphasis added) (finding the harm was physical, defendants showed indifference and reckless disregard for their victims, the behavior was not isolated, and the behavior was not accidental because trickery and deceit were involved, but not finding that the victims were financially vulnerable). The Oregon opinion stressed the physical harms of smoking on the plaintiff and the defendant’s decades-long misconduct involving “trickery and deceit.” *Id.* Whether even this level of reprehensibility justifies a departure is at issue in the current case pending at the Supreme Court. *Petition for a Writ of Certiorari at I., Philip Morris USA v. Williams*, 126 S. Ct. 2329 (2006) (No. 05–1256), available at 2006 WL 849860.

effort and the miscalculation of its limits rise to the level of *reprehensible*, intentional wrongdoing. Of course, a small minority may be evading payment entirely. Perhaps their conduct is reprehensible. The current practice of late charges, however, does not distinguish between these categories of late payers. Late charges are typically assessed without any particularized effort to assess the purposes or quality of the late payer's breach, by looking for instance at the length of delay or the pattern or history of like behavior.

## 2. Disparity Between Compensatory and Punitive Damages

Second, there is an enormous disparity between the actual loss suffered by the credit card company for late payments and the late charges it imposes. While the Court declined "to impose a bright-line ratio which a punitive damages award cannot exceed," in the past, it regarded 4:1 ratios as coming "close to the line of constitutional impropriety."<sup>112</sup> It cautioned that "[o]ur jurisprudence and the principles it has now established demonstrate . . . that, in practice, few awards exceeding a single-digit ratio between punitive and compensatory damages, to a significant degree, will satisfy due process."<sup>113</sup> Many credit card late charges may reasonably be thought to exceed the company's actual costs by a multiple of greater than ten.<sup>114</sup>

Why "ten" rather than "nine"? *State Farm* regards punitive damages in excess of a nine-digit multiplier of actual losses as constitutionally suspect.<sup>115</sup> Suppose the late charge represents an effort to recoup some losses from late payments. If that charge exceeds the amount of actual losses, it is only the excess that serves as a penalty. That is, taking the credit card company's best arguments into account, the late charge should be analyzed as an amalgam of compensatory damages and punitive damages. Most compensatory damages are already supplied by the interest charged on outstanding principal, which compensates for the lost-time value of money. But suppose there are further losses associated with the late payment that are not addressed by that interest rate. To assess what part of the late fee may run afoul of *State Farm*, one should subtract the actual loss from the late charge and then assess whether the excess exceeds the actual loss by a factor greater than nine or, in other words, assess whether the entire late charge exceeds the actual loss by a factor greater than ten.

Most credit card late charges cannot represent realistic approximations of the losses sustained by credit card companies for late payments. Although discovery would be required to substantiate fully that claim, it defies credibility to imagine that information could be supplied to render it credible that credit card companies suffer \$15 to \$39 worth of losses from the range of late payments that evoke these fees. Credit card companies recoup the lost-time value of the money from tardiness through the

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<sup>112</sup> *State Farm*, 538 U.S. at 425.

<sup>113</sup> *Id.*

<sup>114</sup> See *infra* text accompanying notes 116–27.

<sup>115</sup> *State Farm*, 538 U.S. at 425.

interest charged on the outstanding balance. Indeed, late payments also often prompt credit card companies to increase substantially the interest rate they charge on outstanding balances, further insuring compensation for the lost-time value of the money as well as other expenses incurred.<sup>116</sup>

It might be thought that the late charges represent an effort to recoup further costs associated with collection efforts, but there are significant difficulties with this suggestion. In many states, collection costs are often independently recoverable, especially for those individuals whose account is referred to an attorney or a collection agency.<sup>117</sup> Bankruptcy courts *disallow* secured creditors to collect both default interest rates and late fees, on the grounds that collecting both would be a form of double charging.<sup>118</sup> As one court put it, the interest charge is "reasonable compensation, but a second charge [(the late fee)] . . . is a penalty and not reasonable."<sup>119</sup>

Putting aside the issue of double charging, the late charge far exceeds the collection costs, if there are any at all, in most cases.<sup>120</sup> Usually, the only action the credit card

<sup>116</sup> See McGeehan, *supra* note 8; see also U.S. GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 8, at 24 (reporting that late payments often trigger higher "penalty" interest rates on the entire balance that may exceed thirty percent and that may be in force for six months or more); Cardweb.com, Card Changes (Mar. 18, 2005), <http://www.cardweb.com/cardtrak/news/2005/march/18a.html> (discussing reactions of major credit card companies to late payments in addition to late charges, including the discontinuation of promotional rates, the imposition of higher cash advance rates, and the general imposition of interest rates over twenty percent for outstanding balances and future charges).

<sup>117</sup> See, e.g., MINN. STAT. ANN. § 48.185(4)(d)(1) (West 2002) (incorporating ceiling from MINN. STAT. ANN. § 168.71(c) (West 2002) (permitting attorney's fees in addition to restricted late charges when an attorney is hired for collection purposes)); 7 PA. STAT. ANN. § 322(d)(v) (West 1994) (authorizing creditors to recover collection costs in addition to late penalties not to exceed \$20 or ten percent of outstanding balance); R.I. GEN. LAWS § 6-26.1-10 (2004) (authorizing creditors to recover collection costs for referred accounts); see also Geoffrey L. Berman & Peter M. Gilhuly, *Recovering Attorneys' Fees and Costs in Bankruptcy Cases*, 19 AM. BANKR. INST. J. 32, 32-33 (2000) (stating that the majority rule in bankruptcy is that attorneys' fees and collection costs are recoverable for both secured creditors and unsecured creditors if based on contract enforceable under state law and citing cases involving New York, Tennessee, and Florida). See generally James Chareq & Anne Fortney, *An Argument for Retaining the Uniform Commercial Code*, 51 CONSUMER FIN. L.Q. REP. 315, 320-21 & nn.43-50 (1997) (detailing states where collection costs are recoverable and where not).

<sup>118</sup> See *In re Dixon*, 228 B.R. 166, 177 (Bankr. W.D. Va. 1998) ("[T]he case law is settled [that] 'oversecured creditors may receive payment of either default interest or late charges, but not both.'" (citation omitted)); *In re Vest Assocs.*, 217 B.R. 696, 701 (Bankr. S.D.N.Y. 1998) (reporting as "uniform" law that oversecured creditors may not collect both default interest and late charges); *In re Consol. Props. Ltd. P'ship*, 152 B.R. 452, 458 (Bankr. D. Md. 1993).

<sup>119</sup> *In re Consol. Props.*, 152 B.R. at 458.

<sup>120</sup> *In United Cable Television of Baltimore Ltd. Partnership v. Burch*, 732 A.2d 887 (Md. 1999), *superseded by statute*, MD. CODE ANN., COM. LAW § 14-1315(f)(i)(1) (LexisNexis 2003), *as recognized in* *Plein v. Dep't of Labor*, 800 A.2d 757 (Md. 2002), a late fee of \$5 on a late cable bill payment was invalidated as a penalty charge. *Id.* at 887. The trial court heard

company takes is to print the late charges on the next statement. The company takes virtually no action to collect the payment that is late and often does not need to, as when payment is merely delayed. For payments that are an hour to a couple of days late, credit card companies are unlikely to take any action at all. Their only costs are the lost-time value of the money, which is already compensated for by the (typically very high) interest rate on the balance.<sup>121</sup> For this class of late payments, the late fee is purely punitive. It not only exceeds actual losses but exceeds them by far more than the 9:1 ratio outlined in *State Farm*. In such cases, the penalty would represent punitive damages in excess of a 100:1 ratio to compensatory damages.

Even in those cases in which the company does take some action to collect, the late fee often represents a disproportionate charge that exceeds the *State Farm* guidelines. Consider the range of possibilities. A longer period of delinquency may prompt the company to make a call or generate a letter. These activities, of course, do not cost much. They certainly do not cost the company \$39 or even \$15. Under standard contract law, the charge would represent an unenforceable penalty.<sup>122</sup> The letter will be computer generated. It will cost the company very little above the cost of postage, paper, ink, and the marginal cost of the development and operation of the computer program. Suppose that cost rises to \$1. If *State Farm*'s 9:1 ratio applies, even the lesser \$15 penalty would exceed the ratio quite handily. Suppose a phone call occurs. Such calls typically result in messages or short conversations. Assuming the company pays their operators the federal minimum wage, a twelve-minute conversation urging payment (a generous temporal assumption) would represent \$1.03 in labor costs. Suppose the costs associated with phone equipment, the computer dialing program, and supplies are factored in to the equation. Even if that were to raise the price to

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detailed evidence from economists and concluded that a reasonable approximation of the costs incurred by the company from late payments would not exceed 50¢ a month. *See id.* at 891. The collection efforts taken by the cable company were more extensive than those typically undertaken by credit card companies. The appellate court upheld the trial court's finding but also expressed skepticism whether anything above simple interest, including collection costs, could be included at all within the components of valid liquidated damages and that the interest charged could not exceed Maryland's constitutional cap of six percent. *See id.* at 891–902. *United Cable*'s result was repealed by a state statute that permits the imposition of late charges in consumer contracts for the greater of \$5 or ten percent of the amount past due and that declares such charges are not liquidated damages or penalties. MD. CODE ANN., COM. LAW § 14–1315(f)(i)(1) (LexisNexis 2003).

<sup>121</sup> *See* U.S. GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 8, at 24 (reporting that most accounts charge interest rates under fifteen percent but that in addition to late fees, late payments trigger higher “penalty” interest rates that may exceed thirty percent and that may be in force for six months or more); *see also* Statistical Release, Federal Reserve, Consumer Credit (Nov. 7, 2006), <http://www.federalreserve.gov/releases/g19/current/g19.pdf> (reporting the average annual percentage rate in 2005 for credit cards at commercial banks was 14.54% for all accounts against which finance charges were assessed).

<sup>122</sup> *See* FARNSWORTH, *supra* note 25, § 12.8, at 787.

\$1.50 per call, this would still represent a 26:1 ratio if the late charge is \$39. So long as the late charge exceeds \$15, the *State Farm* stricture would be violated.

Even many cases that involve multiple phone calls and letters will still fail to represent collection costs that are one-tenth the size of those late charges that run to \$30 or more. At some point, of course, the collection costs may rise to a level that would be unenforceable under ordinary contract law, but the statutory authorization of which would not run afoul of the ceiling imposed by *State Farm*.<sup>123</sup> It is difficult to know exactly where this line falls without information from the credit card companies about their actual collection costs. Still, one may safely surmise that there is a massive class of people who have paid late charges within at least the first month of their being past due on their accounts and for whom the late fee represents more than 1,000% of the actual costs to the credit card company. This is likely to represent a great deal of money. Using a conservative estimate of the revenue credit card companies collect from late fees, if even a hundredth of that figure represents late fees violating the *State Farm* strictures, for one year alone it would represent at least \$73 million in punitive damages whose authorizing legal authority is subject to constitutional challenge.<sup>124</sup>

The one exception the Court contemplated to the single-digit guideline does not fit the circumstances of credit card late penalties—namely, those cases in which “a particularly egregious act” results in only minimal economic damages.<sup>125</sup> While the economic damages incurred by credit card companies from late payments are small, the cause is not an egregious act, much less a *particularly* egregious act. Furthermore, unlike some of the situations punitive damages are meant to address, the comprehensive difficulties of detection and enforcement of the compensatory harm are absent.<sup>126</sup> Credit card companies have the power and resources to easily detect every particular case of breach and to initiate targeted collection efforts (although they may face other enforcement difficulties).

It might be objected that the methodology just rehearsed is inapt. Instead of asking the size of collection costs in a single case and that figure’s relationship to the late fee, one should instead consider the general collection costs the industry faces and then perhaps the costs of default, and assess their relationship to the general system of charging late fees, the average size of which is \$27.46.<sup>127</sup> This suggested methodology does not, however, fit the constitutional framework imposed by *State Farm* and its predecessors. *State Farm* required a fairly particularized analysis of how the imposed penalty related to the particular wrongful action perpetrated by the insurance

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<sup>123</sup> The third factor in the test used in *State Farm* acknowledges authorized civil penalties. *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 418, 428 (2003).

<sup>124</sup> See Cardweb.com, Late Fee Bug, *supra* note 12. The overall revenue companies collect for penalty fees (late fees and overlimit fees combined) has risen; this figure may be substantially higher. See *supra* note 12. And, as I argue in the text, it is likely that substantially more than a hundredth of these fees, and perhaps all of them, exceed *State Farm* strictures.

<sup>125</sup> *State Farm*, 538 U.S. at 425.

<sup>126</sup> Cf. *supra* note 5 and accompanying text.

<sup>127</sup> See 2005 Credit Card Survey, *supra* note 9, at 2.



company. For both reasons of federalism and, independently, “more fundamental” due process, the decision expressly disallowed any court to take into account in setting the size of the penalty the insurance company’s behavior in other states and the costs this behavior imposed on consumers and other companies more broadly.<sup>128</sup> If, on due process grounds, the *very same company’s* behavior cannot be taken into account to justify punitive damages in excess of the 9:1 ratio, then surely *other parties’* behavior cannot be taken into account to justify disproportionate damages. The Court’s recent jurisprudence rules out this sort of aggregative, systematic approach.

Moreover, the costs credit card companies incur for collection actions and for defaulters lie substantially within their control. Credit card companies have been permissive, some might say promiscuous, in extending credit to vulnerable, fragile borrowers.<sup>129</sup> Given the Court’s insistence that punitive damages be a response to the actual wrong done by the defendant and not a surcharge to recoup more systematic costs imposed by the general behavior of the defendant or other similar parties, the appropriate question to ask is whether, in particular circumstances, the late fee is a disproportionate punitive measure relative to the specific costs imposed by a particular late payment.

### 3. Horizontal Equity

The third factor to consider is the disparity between the penalty and the “civil penalties authorized or imposed in comparable cases.”<sup>130</sup> If the concern is with horizontal equity across particular cases of credit card late fees, credit card late charges may not run afoul of this guidepost. They are applied across the board as a matter of policy by the company.

But if the comparison is made to penalties authorized in similar situations, then the disparity is great. Most other forms of penalty damages in contract are disallowed.<sup>131</sup> Other statutorily permitted late charges are usually accompanied by carefully delineated size and time limitations. They do not involve, as credit card late fees do, blanket and unconstrained authorizations for powerful private parties to set the size of the penalty through contracts of adhesion.<sup>132</sup>

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<sup>128</sup> *State Farm*, 538 U.S. at 422–24 (“A defendant should be punished for the conduct that harmed the plaintiff, not for being an unsavory individual or business. Due process does not permit courts, in the calculation of punitive damages, to adjudicate the merits of other parties’ hypothetical claims against a defendant under the guise of the reprehensibility analysis . . .”).

<sup>129</sup> See WARREN & TYAGI, *supra* note 12, at 139.

<sup>130</sup> *State Farm*, 538 U.S. at 428 (quoting *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559, 575 (1996)).

<sup>131</sup> See FARNSWORTH, *supra* note 25, § 12.8, at 787.

<sup>132</sup> Many states permit penalties for late mortgage payments, but the penalties are explicitly constrained in size. Many statutes also institute a significant grace period before late penalties may be assessed. See CAL. BUS. & PROF. CODE § 10242.5 (West 1987) (allowing charge for late payment on loan secured by mortgage not to exceed greater of \$5 or ten percent of what

All told, credit card late charges do not fare well under the three-part test outlined in *State Farm*. The conduct at issue is not reprehensible in the slightest; these punitive damages are excessively disproportionate to the loss occasioned by the breach. The authorization for these charges permits late fees to be of an unconstrained size, even though comparable wrongs are either immune from punitive damages in other areas of contract or, when permitted, are usually much smaller and constrained in size by statute.

### *B. Are Late Charges Really Punitive Damages?*

It might be suggested, however, that credit card late charges are not punitive damages at all but are in fact interest charges. Indeed, the interpretation of the NBA affirmed in *Smiley* and many of the complementary relevant state statutes have involved a reclassification of late charges as “interest” rather than as penalties or punitive damages.<sup>133</sup> Therefore, it may be suggested that their legal authorization need not conform to *State Farm*’s declared limits.

The characterization of late charges as interest was endorsed—as a matter of statutory interpretation of the NBA—by the Supreme Court in *Smiley v. Citibank*.<sup>134</sup> The Court’s decision in *Smiley*, however, preceded the *State Farm* decision. Further,

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is overdue); CAL. CIV. CODE § 2954.4 (West 1993) (permitting late payment on mortgage for single family home no more than the greater of \$5 or six percent of unpaid balance and only after payment is more than ten days overdue); DEL. CODE ANN. tit. 5, § 2231 (2001) (allowing a charge not exceeding five percent of what is due); IDAHO CODE ANN. § 28-42-301 (2006) (permitting an agreed-upon charge for payments fifteen days past due but not to exceed the greater of \$15 or five percent of what is due); MASS. GEN. LAWS ANN. ch. 183, § 59 (2006) (permitting late charge not to exceed three percent of what is overdue); MISS. CODE ANN. § 75-17-27 (West 1999) (allowing late charge only after fifteen days overdue not to exceed the greater of \$5 or four percent of delinquency); N.J. STAT. ANN. § 46:10B-25 (West 2004) (allowing charge not to exceed five percent of payment); N.Y. REAL PROP. LAW § 254-b (McKinney 2006) (allowing delinquent charge not to exceed two percent of installment); N.C. GEN. STAT. § 24-10.1 (2006) (permitting charge not to exceed four percent of what is due); OR. REV. STAT. ANN. § 86.165 (West 2005) (allowing late charge not to exceed five percent of overdue installment); *see also* CAL. GOV’T CODE § 53088.7 (West 1997) (permitting late fees for delinquent payment of cable bill not to exceed \$4.75 or 1.5% of balance); ME. REV. STAT. ANN. tit. 30-A, § 3010(6-B) (2006) (allowing late fees for cable not to exceed 1.5% of monthly bill); OKLA. STAT. ANN. tit. 11, § 22-107.2 (West 2006) (allowing cable late fees on balances greater than \$12, which may not exceed the greater of five percent of balance or \$6); OR. REV. STAT. ANN. § 646.649 (West 2005) (permitting cable late fees not to exceed greater of five percent or \$6 and only levied on balances greater than \$10); R.I. GEN. LAWS § 39-2-1.3 (2005) (disallowing late charges for cellular service unless payment more than thirty days overdue); R.I. GEN. LAWS § 39-19-13 (2005) (disallowing late charges on cable bill unless payment more than forty-five days overdue).

<sup>133</sup> *Smiley v. Citibank*, 517 U.S. 735 (1996).

<sup>134</sup> *Id.* (holding that the comptroller’s interpretation of “interest” under the NBA to include late fees was reasonable).

the issues presented in *Smiley* solely concerned questions of deference to an agency's statutory interpretation.<sup>135</sup> The standard the Court applied investigated the reasonableness of the agency's interpretation.<sup>136</sup> The opinion's emphasis was on the historical meaning of "interest" that was likely to be implicit within the NBA's use of the term in the nineteenth century.<sup>137</sup> In finding that late charges were "interest" for the purposes of the NBA, the Court did not confront the constitutional question of the disproportionality of the punitive damages whose imposition it authorized and facilitated.<sup>138</sup>

Since *Smiley*, the Court has recognized a rather specific constitutional due process constraint upon the imposition of punitive damages.<sup>139</sup> If it is a constitutional matter, a statutory label cannot suffice to exempt what is in essence a penalty from a constitutional constraint. Analogously, contracting parties cannot evade the common law rule against penalty damages merely by declaring that agreed upon liquidated damages are not penalties.<sup>140</sup> The NBA directs which state's law should apply—that of the bank's home state or that of the state in which the consumer lives or the transaction occurs.<sup>141</sup> Finding that a late charge is "interest" for that choice-of-law purpose, though, does not resolve whether it is interest or a penalty for constitutional purposes. If late charges are in fact penalties, a statutory label cannot transform the underlying function of the late charge as a penalty for breach into an interest charge just by declaration. By analogy, neither the legislature nor the Utah Supreme Court could cure the defects in *State Farm*'s punitive damage award, or in similar awards generally, by relabelling it as "interest" on the compensatory damages award.

Under traditional contracts analysis, the late charges authorized by the various state statutes, in conjunction with the NBA, would be viewed as penalties, notwithstanding labels and statutory classifications to the contrary.<sup>142</sup> Indeed, in *Smiley* itself, the Supreme Court did not contest that under traditional principles of contract, these charges would be invalid as punitive damages. The Court explicitly acknowledged

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<sup>135</sup> *Id.* at 744.

<sup>136</sup> *Id.* at 744–45.

<sup>137</sup> *Id.*

<sup>138</sup> *Id.* at 744–47.

<sup>139</sup> *See supra* notes 46–49.

<sup>140</sup> California may present a complex case. The California Civil Code marks a departure from the common law by presuming in favor of the enforceability of liquidated damages, but it incorporates a plethora of exceptions including many concerning consumers and late charges. CAL. CIV. CODE § 1671 (West 1985); *see also* *Garrett v. Coast & S. Fed. Sav. & Loan Ass'n*, 511 P.2d 1197, 1200-01 (Cal. 1973), *superseded by statute*, CAL. CIV. CODE § 1671 (West 1985), *as recognized in* *Weber, Lipshie & Co. v. Christian*, 53 Cal. Rptr. 2d 468, 472 (Ct. App. 1996) (emphasizing that the determination of whether a clause is a penalty must involve ignoring form and labels and analyzing substance).

<sup>141</sup> The National Bank Act, 12 U.S.C. § 85 (2000); 12 C.F.R. § 7.4001 (2001).

<sup>142</sup> *See, e.g.,* *Perez v. Capital One Bank*, 522 S.E.2d 874, 876 (Va. 1999) (finding on behalf of Capital One that Virginia Code § 6.1–330.63(A) abrogates Virginia common law doctrine that would otherwise find credit card late fees to be unlawful liquidated damages).

that these charges may well be penalties, even as they are labeled interest by the Act.<sup>143</sup> “In § 85 [of the NBA], the term ‘interest’ is *not* used in contradistinction to ‘penalty,’ and there is no reason why it cannot include interest charges imposed for that purpose.”<sup>144</sup>

The substantive considerations supporting the classification of late charges as penalties, and of late charge clauses in credit card contracts as punitive liquidated damages clauses, are located in theoretically sticky terrain. Contract law doctrine holds that the equity of exchanges may not be assessed for adequacy or invalidated for disproportionateness unless the exchange is so disproportionate (and often that the formation process is so flawed) as to be unconscionable.<sup>145</sup> Liquidated damages clauses, however, are treated differently and will be invalidated as penalty clauses if they do not represent a reasonable approximation of the actual damages suffered.<sup>146</sup> For these two doctrines to coexist comfortably, a clear line should distinguish contractual terms that represent the consideration, the primary objects of the exchange, and the liquidated damages in response to breach. Unfortunately, there is no such clear line and much depends on how the contract is written. Graduated payment schedules in the main body of the contract may present alternative performances, and thereby, appear to be complex articulations of contractual duties that are enforceable although they achieve the same result as clauses worded as liquidated damages that overreach and are invalidated as penalties.<sup>147</sup>

Classifying a term as a penalty clause requires analysis of the form of the contract, its wording, and its primary function. Although the absence of clear rules of decision poses a difficult theoretical problem, in this context, the classification of late charges as punitive damages is straightforward. Before the NBA preemption took effect, credit card late fees were found to be punitive damages and those holdings rested on solid ground.<sup>148</sup>

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<sup>143</sup> *Smiley*, 517 U.S. at 746–47.

<sup>144</sup> *Id.*; see also *Nicolas v. Deposit Guar. Nat'l Bank*, 182 F.R.D. 226, 232 (S.D. Miss. 1998) (discussing 12 C.F.R. § 7.4001(c), which clarifies that the definition of “interest” for purposes of the NBA’s § 85 preemption of state law does not dictate the definition of “interest” for purposes of state law).

<sup>145</sup> See U.C.C. § 2–302 (2003); RESTATEMENT (SECOND) OF CONTRACTS §§ 79, 208 (1981).

<sup>146</sup> See U.C.C. § 2–718; RESTATEMENT (SECOND) OF CONTRACTS § 356.

<sup>147</sup> See FARNSWORTH, *supra* note 25, § 12.18, at 316–18.

<sup>148</sup> See, e.g., *Smiley v. Citibank*, 900 P.2d 690 (Cal. 1995) (distinguishing *Beasley* because it did not address § 85 of the NBA); *Hitz v. First Interstate Bank*, 44 Cal. Rptr. 2d 890, 900 (Ct. App. 1995) (upholding a finding that credit card late fees and overlimit fees were penalties, not reasonable liquidated damages, although adjusting calculation of award to plaintiff); *Beasley v. Wells Fargo Bank*, 1 Cal. Rptr. 2d 446 (Ct. App. 1991) (finding in favor of plaintiff’s challenge to Wells Fargo credit card \$3 late fees as penalties and not reasonable approximations of loss even taking into account administrative costs); see also *Perez v. Capital One Bank*, 522 S.E.2d 874, 876 (Va. 1999) (finding on behalf of Capital One that Virginia Code § 6.1–330.63(A) abrogates Virginia common law doctrine that would otherwise find credit

First, the semantics: “late” suggests that the payment was due at an earlier time, and the charge is an imposed consequence for the failure to meet this contractual requirement. The charge is levied in response to a partial breach. Its payment does not represent the discharge of any primary contractual duty.

Second, the ostensible purpose of this contractual relationship is to facilitate a mode of payment (and to loan money on a short term basis) in exchange for a timely monthly payment for at least part of the balance, for any relevant interest payments, and in some cases, for an annual fee. Failure to make this monthly payment on time is a breach of this primary duty and hence the late charge is an assessment occasioned by breach. The late charge cannot plausibly be understood as part of the primary purpose of the contractual exchange. It is not the reason to enter into the relationship but is a consequence of the failure to meet the terms of the relationship.

Third, late payments trigger other adverse consequences, suggesting that the company regards late payment not as another option for payment but rather as a failure to meet the primary contractual requirement to pay by a particular date. Late payments often trigger the imposition of higher “penalty” interest rates, sometimes provide the basis for termination of the relationship, and often are reported to credit agencies.<sup>149</sup>

Fourth, structurally similar charges and structurally similar clauses in other contexts and contracts are recognized as penalty damages.<sup>150</sup>

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card late fees to be punitive damages and therefore unlawful liquidated damages).

<sup>149</sup> See U.S. GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 8, at 5, 24; see also Kathleen Lynn, *Don't Fall into Credit Cards' Late-Payment Traps*, THE RECORD (Hackensack, N.J.), June 15, 2005, at B2. Credit reports of late credit card payments may then be the basis of universal default interest rate hikes in which other credit card issuers raise interest rates in reaction to a late payment made to a different credit card issuer. See *Annual Credit Card Survey 2004: Good Credit Is Your Shield Against Unfair Risk Policies*, CONSUMER ACTION NEWS (San Francisco Consumer Action, San Francisco, Cal.), May 2004, at 1, available at [http://www.consumer-action.org/archives/English/CANews/2004\\_May\\_CreditCard/?English/CANews/2004\\_May\\_CreditCard](http://www.consumer-action.org/archives/English/CANews/2004_May_CreditCard/?English/CANews/2004_May_CreditCard). Automatic rate increases for behavior with other creditors have become more rare, but many companies still change interest rates in reaction to reports of late payments on other cards. See U.S. GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 8, at 25–26.

<sup>150</sup> See *supra* notes 52–54 and accompanying text, and cases cited in 24 WILLISTON ON CONTRACTS § 65:1, at 222–24 nn.6–8 (4th ed. 2002); see also *AT & T Capital Leasing Servs., Inc. v. Brasch*, 912 F. Supp. 395 (N.D. Ill. 1996) (holding an invariant ten percent late penalty on lease payment unenforceable as against Illinois public policy); *Garcia v. Canan*, 851 F. Supp. 327 (N.D. Ill. 1994) (holding a fixed late charge of ten percent is an unenforceable penalty); *In re Hein*, 60 B.R. 769 (Bankr. S.D. Cal. 1986) (holding that a \$500-a-day late fee on a loan was an unenforceable penalty); *In re Bryant*, 39 B.R. 313 (Bankr. D. Nev. 1984) (holding that late charges disproportionate to actual damages sustained by injured party were an unenforceable penalty); *United Cable Television of Balt. Ltd. P'ship v. Burch*, 732 A.2d 887, 901–02 (Md. 1999), *superceded by statute*, 2000 MD. LAWS 59, *as recognized in* *Plein v. Dep't of Labor*, 800 A.2d 757 (Md. 2002) (holding that a \$5 late fee was an unenforceable penalty when standardized actual damages were 10¢); *Stroh v. Omni Arabians, Inc.*, 748 A.2d

Whether contract law has a theoretically sustainable account of the difference among consideration, liquidated damages, and penalty clauses, it is doctrinally committed to the difference. If anything is to count as a liquidated damages clause, these charges would fall pretty squarely in that category. These charges do not represent the point of the exchange; they are framed as responses to a failure to perform another duty that is the point of the contractual relationship, and prior to the preemptive combination of the NBA and permissive state statutes, they were found by courts to be penalties.<sup>151</sup> Thus, if *State Farm* does apply to the credit card context, it would place substantive limits on the size of the late fees that states could authorize as responses to late payment in breach of contract because these late fees represent forms of punitive damages.

### C. Other Examples

This Article focuses on late charges levied by credit card companies because they represent a prominent example of disproportionately large penalty damages imposed on consumers that are in tension with the constitutional guarantees announced in the line of cases culminating in *State Farm v. Campbell*. The theory of the Article may have further implications and extensions, a few of which are discussed here.

Over-limit fees charged by credit cards and other sorts of late charges levied in different contexts—by cable companies, phone companies, etc.—may also be vulnerable to attack, although the case against them is more complex. Over-limit fees are imposed when a customer spends an amount that exceeds his or her credit limit. These are also exorbitant fees that are not calibrated to the amount by which the limit is exceeded or to any losses suffered by the credit card issuer.<sup>152</sup> Unlike late payments, however, credit card companies have some control over whether consumers charge above their limit. When the credit charge is processed electronically (as opposed to a manual imprint being made and later sent to the credit card company), the credit card issuers are in the position to permit or to deny authorization for a charge that exceeds the consumer's credit limit. Issuers keep track of charges and can refuse to authorize charges that exceed the credit limit or come close to the ceiling. Their authorization of overcharges that trigger over-limit fees without notifying the consumer at the point

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1015, 1019–20 (Md. Ct. Spec. App. 2000) (holding that any late charges above six percent of debt were unenforceable penalties because Maryland fixed statutory late payment fees at six percent per annum).

<sup>151</sup> See *supra* cases discussed in note 148. Although *Mattvidi Associates Ltd. Partnership v. NationsBank of Virginia*, 639 A.2d 228, 238 (Md. App. 1994), argued late charges are valid under Virginia law because administrative costs from late payment are too difficult to approximate, this view seems to have been rejected in *Perez*, which held Virginia common law doctrine would find credit card late fees to be unlawful penalty damages but that the common law was abrogated by statute. See *Perez v. Capital One Bank*, 522 S.E.2d 874, 876 (Va. 1999).

<sup>152</sup> See U.S. GOVERNMENT ACCOUNTABILITY OFFICE, *supra* note 8, at 20–21 (reporting most over-limit fees were between \$35 and \$39 in 2005).

of the charge may show credit card companies to be particularly shameless from a moral perspective. Legally, the companies might contend that the over-limit fee is a form of consideration required for more credit, rather than a penalty for breach of payment. The company will authorize the extra charge in exchange for a fee.<sup>153</sup> This characterization has some difficulties, though. This structure is not made explicit to the consumer at the time the overcharge occurs, and the consumer is often entirely unaware that she has charged over her limit.<sup>154</sup>

Late charges are also levied in other consumer contexts—on utility bills, cable bills, cell phone bills, etc. They might also be subject to challenge but tend to be lower in many jurisdictions,<sup>155</sup> in part because they do not fall under the protection of the NBA and its exportation doctrine. Hence, they are still subject to a state's common law doctrine invalidating punitive damages, or subject to other forms of state regulation protecting consumers.

#### IV. DO LATE FEES INVOLVE STATE ACTION? STATE ACTION AND THE STRUCTURE OF A CONSTITUTIONAL CHALLENGE TO LATE FEES

Credit card companies are not directly subject to constitutional limitations.<sup>156</sup> To challenge disproportionate late charges as unconstitutional, there must be state action.<sup>157</sup> Typically, private parties contract for late charges and the consumer voluntarily pays the charges without any sort of formal enforcement action or direct state involvement. This private action between private parties is not directly subject to constitutional scrutiny.<sup>158</sup>

While the private agreement itself is not state action, the law or the state action that authorizes, facilitates, or enforces the collection of punitive damages is subject to constitutional scrutiny. For instance, if in litigation, a party invokes a statute to enforce the collection of punitive damages or to defend its charges or its collection activity, then

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<sup>153</sup> Overdraft or insufficient funds charges in the checking context have been found by some courts not to be liquidated damages. *See, e.g.,* *Perdue v. Crocker Nat'l Bank*, 702 P.2d 503, 516 (Cal. 1995) (holding that insufficient funds charges are not liquidated damages or penalties because writing a bad check was not a breach of contract given the absence of a specific agreement not to write an overdraft); *Jacobs v. Citibank*, 462 N.E.2d 1182 (N.Y. 1984) (holding the same and emphasizing that the U.C.C. explicitly contemplates overdrafts).

<sup>154</sup> In the 1990s, two California cases invalidated over-limit fees on the grounds that they were penalties. *See Hitz v. First Interstate Bank*, 44 Cal. Rptr. 2d 890, 899 (Ct. App. 1995) (finding late fees and over-limit fees to be penalties and that consumers often accidentally exceeded their limit); *Beasley v. Wells Fargo Bank*, 1 Cal. Rptr. 2d 446 (Ct. App. 1991) (finding late fees and over-limit fees to be penalties).

<sup>155</sup> *See supra* note 52.

<sup>156</sup> *Cf. Shelley v. Kraemer*, 334 U.S. 1, 13 (1948) (stating that the Fourteenth Amendment does not prohibit wrongful or discriminating conduct by private parties).

<sup>157</sup> *Id.*

<sup>158</sup> *See id.*

that statute is subject to constitutional challenge. If it is invalidated, then the relief or defense may be unavailable. Subpart A below explores the general approach to state action that would undergird a constitutional challenge to the legal authorization and enforcement of disproportionately large credit card fees. In the subparts that follow, different strategies for litigation are identified that highlight the relevant form of state action.

*A. The General Doctrinal Argument That State Action Is Implicated in Enforceable Late Fees*

The theory of this Article is that those federal and state statutes that override or abrogate the common law rule against the enforcement of punitive damages in contract, may be challenged as unconstitutional, at least as applied. They directly authorize the imposition of enforceable punitive damages for late payment of credit card bills without imposing any guidelines on the size of these damages. Thus, they make no effort to ensure that the penalty damages they authorize stay within constitutional guidelines. Furthermore, the NBA enacts a choice-of-law rule that permits companies to charge what is allowed under the state law of their headquarters.<sup>159</sup> It, thereby, authorizes a method of setting enforceable penalty damages that is insensitive to constitutional mandates.

Late fees collected pursuant to statutes insensitive to *State Farm* strictures might be challenged indirectly by subjecting the underlying legal authority that authorized the charges to constitutional scrutiny. Further, when significant forms of state action are implicated, such as when wage garnishment and liens are sought as modes of enforcement, a § 1983 counter-claim might be asserted against credit card companies (or collection agencies) on the grounds that their efforts to enlist and collaborate with state officials to impose unconstitutional punitive damages place their actions "under color of state law."<sup>160</sup> If successful, a § 1983 action makes attorneys' fees available.<sup>161</sup>

This approach to state action is supported by cases such as *New York Times Co. v. Sullivan*.<sup>162</sup> *New York Times* involved a private cause of action: a suit by one private party against another for the tort of libel.<sup>163</sup> The invocation in litigation, however, of the state law of libel and the prospect of its enforcement was sufficient state action

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<sup>159</sup> 12 U.S.C. § 85 (2000).

<sup>160</sup> *Lugar v. Edmondson Oil Co.*, 457 U.S. 922, 942 (1982) (permitting § 1983 action against a private creditor for due process violation involved when creditor, acting jointly with state officials, wrongfully attached property).

<sup>161</sup> 42 U.S.C. §§ 1983, 1988(b) (2000).

<sup>162</sup> 376 U.S. 254 (1964); see also *Shelley*, 334 U.S. 1 (finding state action in judicial enforcement of racially restrictive covenants). The general approach to state action defended here follows Stephen Gardbaum, *The "Horizontal Effect" of Constitutional Rights*, 102 MICH. L. REV. 387 *passim* (2003).

<sup>163</sup> *N.Y. Times*, 376 U.S. at 256.



to permit the underlying law to be challenged for its inconsistency with the First Amendment.<sup>164</sup> A like theory was affirmed more recently in *Cohen v. Cowles Media Co.*<sup>165</sup> In that case, the Court considered a First Amendment challenge to a promissory estoppel action in which a source sued a reporter for breach of a confidentiality agreement.<sup>166</sup> The reporter argued in reply that enforcement of a promissory estoppel action in these circumstances would violate the First Amendment.<sup>167</sup> While the reporter lost the substantive issue concerning the First Amendment, the Court did not hesitate in finding state action.<sup>168</sup> "Our cases teach that the application of state rules of law in state courts in a manner alleged to restrict First Amendment freedoms constitutes 'state action' under the Fourteenth Amendment."<sup>169</sup> Notably, even though the law of promissory estoppel in general was not alleged to be unconstitutional, its potential application to the particular enforcement action being litigated was sufficient for the Court to find state action.<sup>170</sup>

Two factors might distinguish these cases from constitutional challenges of the enforcement of credit card late fees. First, both *New York Times* and *Cowles* pertain to First Amendment challenges, not due process challenges.<sup>171</sup> While the language in *Cowles* emphasizes the First Amendment nature of the claim,<sup>172</sup> it is unclear what the argument would be as to why this difference should be dispositive. No argument is given in either case to suggest that the recognition of state action in those cases depends on the constitutional clause at issue being the First Amendment.

*Cowles* might be read, however, to suggest that it does matter that the cause of action is one created by the state. In that case, the reporter was subject to a duty he had not agreed to undertake but was imposed on him through the rules of promissory estoppel.<sup>173</sup> It might be suggested that in the case of credit card late fees, the obligations have been explicitly assumed by the parties and are not especially imposed by the state.<sup>174</sup> However, the case of contractual late penalties does not in fact pose a sharp contrast with the structure of the situation addressed in *Cowles*. While it is

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<sup>164</sup> *Id.* at 265 (holding that court application of statute or common law in civil suit renders statute or common law open to constitutional scrutiny).

<sup>165</sup> 501 U.S. 663 (1991).

<sup>166</sup> *Id.*

<sup>167</sup> *Id.* at 668.

<sup>168</sup> *Id.*

<sup>169</sup> *Id.* (citing *Phila. Newspapers, Inc. v. Hepps*, 475 U.S. 767, 777 (1986); *NAACP v. Claiborne Hardware Co.*, 458 U.S. 886, 916 n.51 (1982); *N.Y. Times*, 376 U.S. at 265).

<sup>170</sup> *Id.*

<sup>171</sup> *N.Y. Times*, 376 U.S. at 264 n.4; *Cowles*, 501 U.S. at 667.

<sup>172</sup> *Cowles*, 501 U.S. at 667 ("We granted certiorari to consider the First Amendment implications of this case.").

<sup>173</sup> *Id.* at 670-71.

<sup>174</sup> To hold that this difference is dispositive is not, however, consistent with the underlying theory of *Shelley v. Kraemer*, 334 U.S. 1 (1948). This will not trouble those who regard *Shelley* as having been limited to its context over time.

true that in the credit card context, the contracting parties assume the obligations to pay late fees for late payment, the ability to contract in this way is, as argued above, unusual from a common law perspective. The enforcement of high penalties for late payment does not represent the standard application of private law norms. The standard private law approach would invalidate these charges as arising from illegitimate penalty clauses. For these obligations to exist, affirmative state action—in the form of state statutes, the NBA, and DIDA—had to be taken to override the background baseline and to provide explicit permission for charges of this kind. These forms of state action were taken to further the national banking system and to further particular state's interests.<sup>175</sup> In this respect, the legal context surrounding credit card late fees closely resembles, while exceeding in degree, the positive state action recognized in *Cowles*.

To show that state action underlies legally enforceable credit card late fees, *Flagg Brothers, Inc. v. Brooks* should be distinguished.<sup>176</sup> *Flagg Brothers* found no state action in a sale by a private warehouse of another's goods entrusted to the warehouse for storage, although such sales were explicitly authorized by the New York Uniform Commercial Code (N.Y.U.C.C.).<sup>177</sup> The state authorization of a private party's sale (according to methods that might not satisfy due process were they the actions of the state) did not make the private sale itself state action.<sup>178</sup> So, too, it might be asked: how does the state authorization of a private party's charging high late fees, subject to another party's consent, make those charges state action?

In *Flagg Brothers*, the issue was whether the private party's sale pursuant to the authorizing statute was state action.<sup>179</sup> The relevant portion of the statute, Section 7–210 of the N.Y.U.C.C., was not directly challenged. All the Supreme Court found was that the private party's sale itself was not state action, although it was pursuant to an authorizing statute.<sup>180</sup> No skepticism was evinced that the underlying statute itself represented state action.<sup>181</sup>

There is a further distinction between *Flagg Brothers* and a challenge mounted against the legal structure authorizing disproportionately high late fees. *Flagg Brothers* involved a sale pursuant to a lien.<sup>182</sup> Arguably, the lien already effected a transfer of property (conditional on the failure to meet the conditions to clear title). An agreement

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<sup>175</sup> See *supra* text accompanying notes 75–80; see also *Reitman v. Mulkey*, 387 U.S. 369 (1967) (finding California referendum repealing law against private discrimination did not merely permit private discrimination but, in context, encouraged it, and therefore, was state action).

<sup>176</sup> 436 U.S. 149 (1978).

<sup>177</sup> *Id.* at 164–65.

<sup>178</sup> *Id.*

<sup>179</sup> *Id.* at 155.

<sup>180</sup> *Id.* at 165.

<sup>181</sup> *Id.*

<sup>182</sup> *Id.* at 151.

to pay a late charge does not already effect a transfer of property but rather requires further action—either voluntary compliance or state enforcement.

As was noted at the outset, credit card late fees themselves are not directly subject to constitutional challenge. Two forms of state action enable credit card late fees to be subject to constitutional assessment: (1) the state and federal statutes themselves that authorize enforceable penalties of any size, without clear guidelines; and (2) the actual enforcement of these penalties pursuant to state authorization. There is no question that statutes are themselves forms of state action. Should these forms of state action, which authorize and enforce disproportionately large late fees, be found unconstitutional, the charges would no longer be enforceable given the underlying traditional principles of contract law. While the main aim of this Article is to explore the constitutional status of the legal structure that gives support to and enforces credit card late fees, a brief discussion of three different ways litigation against credit card late fees could be framed will help to illuminate the presence of state action.

### *B. Recoupment Actions*

One way to frame a constitutional challenge against credit card late fees is to begin with a straightforward common law or statutory action to recoup a charge that is not legally authorized. The defenses that could be offered by the credit card company that levied the fee would appeal to those previously mentioned statutes and regulations that authorize collection of the fees. That is, federal and state statutes would emerge as defenses to the common law or statutory recoupment claim. If the arguments of Parts II and III above are correct, those authorizing statutes are themselves unconstitutional legislative action. So, the plaintiff's counter to this statutory defense would be that the statutes themselves are unconstitutional under *State Farm*. The underlying common law action to invalidate penalty damages would thereby be revived.<sup>183</sup>

Whether the cause of action for recoupment would be a common law or statutory cause of action is slightly complex in the case of credit cards covered by the NBA. Charges imposed by a card owned by a non-federally-insured, state-chartered bank are subject to whatever common law recoupment action and usury claims are applicable under state law. Federally-insured, state-chartered banks may also be liable under standard state causes of action under the laws of their home states.<sup>184</sup> The situation is less clear with respect to cards issued by nationally-chartered banks, the majority of credit cards.<sup>185</sup> *Beneficial National Bank v. Anderson* suggests that 12 U.S.C. §§ 85

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<sup>183</sup> See Gardbaum, *supra* note 162, at 421.

<sup>184</sup> Further, although DIDA pre-empts state regulation of interest rates charged by federally-insured, state chartered banks, including usury laws, it does not provide such banks with protection from other common law claims. 12 U.S.C. § 1831(d) (2000).

<sup>185</sup> Furletti, *supra* note 29, at 425 (reporting nationally chartered banks underwrite the majority of credit card loans in the United States).

and 86 offer the exclusive avenues of relief for allegations of overcharging for cards covered by the NBA.<sup>186</sup> If so, this would render the cause of action subject to federal question jurisdiction.

Although *Anderson* uses expansive language in its declaration that the NBA creates “a federal remedy for overcharges that is exclusive,”<sup>187</sup> *Anderson* concerned usury and the federal pre-emption of state usury laws only.<sup>188</sup> The majority opinion uses “remedy for overcharges” and “remedy for usury” interchangeably.<sup>189</sup> One may question whether “usury” is meant to cover *all* cases in which excessive interest is charged, or whether it covers only those sorts of cases typically regulated by usury law and consumer protection statutes in which ceilings on permissible charges are articulated. For instance, accidental overcharges of interest may fall under the broader former designation but not the latter; that is, they may be overcharges but they are not traditional forms of usury because there is no usurious intent. It may be argued that the NBA pre-empts traditional state usury laws but not all state causes of action that remedy bread and butter forms of overcharging. Some support for this interpretation may be gleaned from a recent regulation of the Office of the Comptroller of the Currency.<sup>190</sup> It declares that NBA pre-emption over the law of the consumer’s home state does not extend so far as to pre-empt those state laws that only “incidentally affect” lending practices, such as those regulating contracts, torts, recollection of debts, and the criminal law.<sup>191</sup> This may suggest that general efforts to remedy accidental and un-“knowing” overcharges, or charges that are otherwise simply not authorized by law, are not pre-empted by these sections and can be pursued through standard state law means. Their pursuit would then trigger the assertion of § 85 exportation doctrine as a defense, against which the plaintiffs would argue that an unconstitutional statute cannot be invoked to defend a charging practice.

The structure of §§ 85 and 86 provides some evidence that the NBA pre-empts only traditional usury regulations. While the language of § 85 is broad in stating limits as to what interest a national bank may charge, the language of § 86, the attached remedy provision, is circumscribed. It only explicitly provides for a (rather generous) remedy for *knowing* overcharges.<sup>192</sup> It is unclear whether the “knowing” requirement is

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<sup>186</sup> 539 U.S. 1 (2003) (holding a challenge to H & R Block’s interest charges based on common law usury claims and an Alabama statute limiting the amount of permissible interest was pre-empted by the NBA, and therefore, federal question jurisdiction was appropriate).

<sup>187</sup> *Id.* at 11.

<sup>188</sup> *Id.* at 9.

<sup>189</sup> *See id.* at 10 (using both “action for usury” and “remedies for . . . overcharges”).

<sup>190</sup> *See* 12 C.F.R. § 7.4008(e)(1), (4)–(5) (providing that state law governing contracts, property, and collection of debts are not pre-empted by the NBA so long as it is not inconsistent with and only incidentally affects the exercise of national banks’ non-real estate lending powers).

<sup>191</sup> *See* Furletti, *supra* note 29, at 439.

<sup>192</sup> 12 U.S.C. § 86 (remedying overcharges that are “knowingly done”). It provides for larger remedies than standard recoupment actions, although it carries a two-year statute of limitations.

satisfied just by intentionally levying a charge, by stating clearly the illegal charge as a charge on a bill (as opposed to an overcharge resulting from individual graft or corruption)<sup>193</sup> or whether the bank must be aware the charge is illegal.<sup>194</sup> The NBA provides no explicit remedy for overcharges that are not “knowing,” i.e., that do not fall under § 86. Perhaps § 85 implies a standard recoupment remedy as a matter of federal common law. Some language in *Panos v. Smith*<sup>195</sup> provides support for this view. Discussing § 85, the Sixth Circuit said, “When a national bank takes more interest than is permitted by the law of the state in which it is located, it violates the law of the United States. It is that law that creates the borrower’s right and provides his remedy.”<sup>196</sup> Were § 85 not to imply a remedy for overcharges that are not knowing, it may be argued that state common law is not pre-empted and that a standard state recoupment action could be pursued.

In sum, recoupment actions for overcharges based on state law may be available for cards issued by state and nationally chartered banks. If they are not available for nationally chartered banks on the grounds that the NBA pre-empts *all* other causes of action relating to credit card transactions, then there are two alternatives. The NBA may be read to imply a federal common law cause of action for recoupment. In addition, the requirements for a § 86 overcharge may be met, making double damages available. On any of these theories, a non-constitutional recoupment cause of

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If a higher rate of interest is charged than is allowed by § 85, then under § 86 *all* of the interest due on the debt is forfeited. If the excessive interest has been paid already, then twice the interest paid is recoverable as punitive damages.

<sup>193</sup> Some support for this second interpretation—that an overcharge is “knowing” if the charge is made as a matter of policy—can be gleaned from *American Timber & Trading Co. v. First Nat’l Bank of Oregon*, 511 F.2d 980 (9th Cir. 1973), *cert. denied*, 421 U.S. 921 (1975). That court held that the knowledge requirement was met in a case in which a bank did not know its charge was illegal, although it knew its method would yield a higher rate than alternatives. *Id.* at 983. If this view of knowledge is sustainable, then a § 86 action may be available that would provide a remedy of twice the excess late fees already paid.

<sup>194</sup> See, e.g., *Walters v. First Tenn. Bank*, 855 F.2d 267, 272 (6th Cir. 1988), *cert. denied*, 489 U.S. 1067 (1989) (dismissing a § 86 claim and finding that “an honest mistake of fact, e.g., a mistake in computation, is not usurious”). Only some jurisdictions distinguish between mistakes of fact and law, regarding the former but not the latter as a defense to a claim of usury or usurious intent. See 11 A.L.R. 3d 1498 § 4 (collecting cases and statutes from eight states that make the distinction). In some jurisdictions, an honest mistake of law is not a defense to a charge of usury for service charges in particular, including late fees. See *id.* § 8(b). But see RICHARD A. LORD, 9 WILLISTON ON CONTRACTS, § 20:35, at 116 (4th ed. 1999) (reporting that in some jurisdictions “a willful purpose to transgress the law is essential” to a claim of usury). Because the explanation of why late fees are legally excessive involves the application of a novel theory, one might argue the requisite intent is not present so that usury is not at issue; with respect to this issue, banks may have levied the fees in legal good faith. If usury is not at issue, then the NBA may not pre-empt other state causes of action to recoup the excessive fees.

<sup>195</sup> 116 F.2d 445 (6th Cir. 1940).

<sup>196</sup> *Id.* at 446.

action would be filed to reverse an overcharge. The credit card companies would defend by citing the relevant permission of the state statute or, for an out of state bank, by citing the permission of DIDA or § 85 to export home state rules on late fees. That defense would then invoke either one or two forms of state action, both of which this Article has argued are subject to constitutional challenge. The essence of the theory of this strategy is that an overcharge cannot be defended by appeal to an unconstitutional statute.

There are two other options for framing litigation against credit card late fees based on *State Farm*, both of which satisfy state action requirements.

### *C. Injunction or Declaratory Judgment*

An injunction or a declaratory judgment might be sought to declare the relevant regulations and statutes unconstitutional and to reinstate statutory and common law limits on penalty damages and late charges in consumer contracts. Or, in the alternative, one might seek a declaratory judgment to interpret the NBA and other relevant statutes to render them constitutional. Applying canons of constitutional avoidance, they may be interpreted as implicitly incorporating substantive limitations on penalty damages that would bring it in line with *State Farm*. Under this interpretation, the late charges currently assessed would outstrip the authority granted by the NBA. Such measures might support restitutionary measures and might activate the provisions of § 86 of the NBA against further late charges. As discussed in Subpart B above, that provision provides for the forfeiture of the “entire interest” of the debt when the issuer knowingly charges interest in excess of that permitted by 12 U.S.C. § 85 plus that amount again in punitive damages.<sup>197</sup>

Any offensive litigation based on the theory of this Article would have to resolve a number of other strategic issues and obstacles. These include whether a federal court would be available and desirable whether the choice of forum, choice of law, and arbitration clauses within many credit card agreements are binding and what effect they would have and whether particular states (and particular state statutes) are particularly friendly places to initiate suits of this kind, states such as Massachusetts, Minnesota, and California that still have consumer protective statutes that are preempted by the NBA.<sup>198</sup>

The choice of state versus federal court may be determined partly by the criteria of composition of the litigant class. If the class encompasses charges made by national banks and if §§ 85 and 86 of the NBA apply to this case, then federal question jurisdiction may be established by the underlying cause of action;<sup>199</sup> this would facilitate suit in federal court or removal by defendants to federal court. The Class Action Fairness Act would also facilitate removal by defendants to federal court unless the class composition was carefully controlled so that residents of a particular

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<sup>197</sup> See 12 U.S.C. § 86; *supra* text accompanying notes 192–96.

<sup>198</sup> See *supra* note 61.

<sup>199</sup> 28 U.S.C. § 1331 (2005).

state predominated and at least one of the defendant banks was located in the state.<sup>200</sup>

The arbitration clauses common in credit card agreements pose an obstacle to litigating in court,<sup>201</sup> although these clauses may be subject to challenge.<sup>202</sup> Unconscionability challenges against the substance of the clause have met with some success. For instance, in *Armendariz v. Foundation Health Psychcare Services*,<sup>203</sup> California recognized circumstances in which mandatory arbitration clauses are unconscionable. The California Supreme Court also recently recognized circumstances in the consumer credit context in which mandatory waivers of access to class action were unconscionable, whether the waiver applied to class action litigation or to class-wide arbitration.<sup>204</sup> The California court found “an element of procedural unconscionability” in the waiver because it appeared in an adhesive contract and, in particular, because the waiver at issue was added to the agreement through a bill insert.<sup>205</sup> It also found the waiver itself to be substantively unconscionable because given the small amount of money

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<sup>200</sup> See 28 U.S.C. § 1332 (d)(4) (2005) (declining federal court diversity jurisdiction when more than two-thirds of the plaintiff class and at least one defendant are citizens of the state where the action was originally filed provided certain other conditions are met, or when two-thirds or more of the plaintiff class and all primary defendants are citizens of the same state).

<sup>201</sup> See generally Johanna Harrington, Comment, *To Litigate or Arbitrate? No Matter—The Credit Card Industry Is Deciding for You*, 2001 J. DISP. RESOL. 101 (noting that many credit card agreements now contain mandatory arbitration clauses that prevent people from seeking redress from a court).

<sup>202</sup> “Generally applicable contract defenses, such as fraud, duress, or unconscionability, may be applied to invalidate arbitration agreements . . . .” *Doctor’s Assocs., Inc. v. Casarotto*, 517 U.S. 681, 687 (1996).

<sup>203</sup> 6 P.3d 669 (Cal. 2000) (finding mandatory arbitration clause in employment contract contrary to public policy and unconscionable). *But see* *Bischoff v. DirecTV, Inc.*, 180 F. Supp. 2d 1097, 1111 (C.D. Cal. 2002) (distinguishing *Armendariz* because the customer agreement in question was not so one-sided as to render it unconscionable and economic pressure on customer was not high).

<sup>204</sup> *Discover Bank v. Superior Court*, 113 P.3d 1100 (Cal. 2005).

<sup>205</sup> *Id.* at 1108. Some other courts have also found the introduction of arbitration agreements through bill inserts an improper form of contract modification. See, e.g., *Stone v. Golden Wexler & Sarnese*, 341 F. Supp. 2d 189 (E.D.N.Y. 2004) (analyzing Virginia contract law); *Perry v. FleetBoston Fin. Corp.*, No. Civ. A. 04-507, 2004 WL 1508518, at \*3 (E.D. Pa. July 6, 2004) (analyzing Rhode Island contract law); *Myers v. MBNA Am.*, No. CV00-163-M-DWM, 2001 WL 965063 (D. Mont. Mar. 20, 2001); *Badie v. Bank of Am.*, 79 Cal. Rptr. 2d 273 (Ct. App. 1998) (analyzing California law); *Discover Bank v. Shea*, 827 A.2d 358, 360, 365 (N.J. Super. Ct. Law Div. 2001) (disallowing unilaterally added arbitration clause and finding a clause precluding class-wide arbitration unconscionable); *Sears Roebuck & Co. v. Avery*, 593 S.E.2d 424 (N.C. Ct. App. 2004) (analyzing Arizona law on contracts of adhesion). *But see* *Discover Bank v. Superior Court*, 129 Cal. Rptr. 2d 393 (Ct. App. 2003) (finding unilateral addition permissible under Delaware law), *superseded by* *Discover Bank v. Superior Court*, 113 P.3d 1100 (Cal. 2005); *Hutcherson v. Sears Roebuck & Co.*, 793 N.E.2d 886 (Ill. App. Ct. 2003) (finding unilateral addition of arbitration clause permissible under Arizona law).

at stake for each individual consumer, the ban on class actions worked to permit the credit card company to evade responsibility for illegal activity—in this case, charging a late fee for a payment received after 1 p.m. but still on the due date.<sup>206</sup> The California court emphasized, however, that allegations were made that Discover Card was deliberately cheating individual consumers.<sup>207</sup> That particular allegation may not be apt in a more general challenge against high credit card fees. Nonetheless, for the more general case that this Article suggests could be made against most credit card late fees, an unconscionability challenge against arbitration agreements that threaten to preclude judicial assessment of late fees might be further enhanced by the fact that the protection and adjudication of constitutional rights and values is at issue. Further, at the time of assent, this was not apparent.<sup>208</sup>

Even if the arbitration clauses themselves are not vulnerable to challenge, class-wide *arbitration* may be available in some jurisdictions. Although credit card companies have attempted to evade class-wide arbitration through the use of waivers, these efforts have not been uniformly successful.<sup>209</sup> The California Supreme Court found a clause banning class-wide arbitration in a Discover Card agreement unconscionable under California law.<sup>210</sup> Courts in Connecticut, Florida, Illinois, Missouri, New

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<sup>206</sup> *Discover Bank*, 113 P.3d at 1103, 1110; *see also* *Leonard v. Terminex Int'l. Co.*, 854 So. 2d 529, 538 (Ala. 2002); *Powertel, Inc. v. Bexley*, 743 So. 2d 570, 576 (Fla. Dist. Ct. App. 1999); *State ex rel. Dunlap v. Berger*, 567 S.E.2d 265, 279 (W. Va. 2002), *cert. denied*, 537 U.S. 1087 (2002). *But see* *Blaz v. Belfer*, 368 F.3d 501, 504 (5th Cir. 2004), *cert. denied*, 543 U.S. 874 (2004); *Johnson v. W. Suburban Bank*, 225 F.3d 366, 369 (3d Cir. 2000), *cert. denied*, 531 U.S. 1145 (2001); *Champ v. Siegel Trading Co.*, 55 F.3d 269, 277 (7th Cir. 1995); *Strand v. U.S. Bank Nat'l Ass'n N.D.*, 693 N.W.2d 918, 926 (N.D. 2005).

<sup>207</sup> *Discover Bank*, 113 P.3d at 1103.

<sup>208</sup> *Cf. Green Tree Fin. Corp.-Ala. v. Randolph*, 531 U.S. 79, 90–92 (2000) (making a similar claim concerning the ability to vindicate statutory rights effectively in the face of high arbitration costs).

<sup>209</sup> *See* Robert S. Safi, Note, *Beyond Unconscionability: Preserving the Class Mechanism Under State Law in the Era of Consumer Arbitration*, 83 TEX. L. REV. 1715, 1715, 1726–28 & *passim* (2005) (discussing class-wide arbitration, efforts to evade it through contract, and challenges that have been and may be made to such efforts).

<sup>210</sup> *Discover Bank*, 113 P.3d 1100 (finding class action waiver and class-wide arbitration waiver unconscionable and the California rule against class action waivers was not federally preempted); *see also* *Ingle v. Circuit City Stores, Inc.*, 328 F.3d 1165, 1175 (9th Cir. 2003), *cert. denied*, 540 U.S. 1160 (2004); *Szetela v. Discover Bank*, 118 Cal. Rptr. 2d 862 (Ct. App. 2002), *cert. denied*, 537 U.S. 1226 (2003); *Discover Bank v. Shea*, 827 A.2d 358 (N.J. Super. Ct. Law Div. 2001); *Eagle v. Fred Martin Motor Co.*, 809 N.E.2d 1161 (Ohio Ct. App. 2004). *But see, e.g.,* *Discover Bank v. Superior Court*, 129 Cal. Rptr. 2d 393 (Ct. App. 2003) (finding addition of class-wide arbitration waiver permissible under *Delaware* law and resolving choice of law issue for Delaware because no specific violation of California law was part of the pleading); *Edelist v. MBNA Am. Bank*, 790 A.2d 1249 (Del. Super. Ct. 2001); *Rosen v. SCIL, LLC*, 799 N.E.2d 488 (Ill. App. Ct. 2003); *Ranieri v. Bell Atl. Mobile*, 759 N.Y.S.2d 448 (App. Div. 2003).



Jersey, and other states have arrived at similar conclusions.<sup>211</sup> However, even if the clauses are unconscionable, it is still unsettled whether the choice of law provisions in the contracts apply to these clauses or whether the choice of law provisions only apply to “substantive claims.” If the former, the California finding of unconscionability may be rendered moot if the waivers are instead governed by the law of Delaware or South Dakota, states especially friendly to bank interests. However, at least in California, prior cases have indicated a reluctance to allow choice of law provisions to nullify state policy favoring access to class actions.<sup>212</sup>

#### *D. Defenses Against Collection Actions*

A final alternative approach would invoke a significantly more conservative, defensive theory of state action. It would assert the theory of this Article as a defense to a collection action by the credit card companies (or the collection agency to whom the credit card company assigns the debt).<sup>213</sup> In this scenario, the state action would

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<sup>211</sup> Powertel, Inc. v. Bexley, 743 So. 2d 570, 576 (Fla. Dist. Ct. App. 1999); Kinkel v. Cingular Wireless, LLC, 828 N.E.2d 812, 818 (Ill. App. Ct. 2005) (holding class-wide arbitration ban in contract unenforceable because unconscionable); Whitney v. Alltel Commc'ns, Inc., 173 S.W.3d 300 (Mo. Ct. App. 2005) (finding anti-class action provision in a wireless contract unconscionable); Muhammad v. County Bank of Rehoboth Beach, 912 A.2d 88, 100–01 (N.J. 2006) (finding class-wide arbitration waiver clause unconscionable); Lytle v. CitiFinancial Servs., Inc., 810 A.2d 643 (Pa. Super. Ct. 2002) (holding mortgage anti-class provision unconscionable); Thibodeau v. Comcast, No. 4526, 2006 WL 416863 (Pa. Com. Pl. Jan. 27, 2006); State ex rel. Dunlap v. Berger, 567 S.E.2d 265, 278–79 (W. Va. 2002), cert. denied, 537 U.S. 1087 (2002); see also Luna v. Household Fin. Corp. III, 236 F. Supp. 2d 1166 (W.D. Wash. 2002) (finding arbitration rider unconscionable under Washington law); Lozada v. Dale Baker Oldsmobile, Inc., 91 F. Supp. 2d 1087 (W.D. Mich. 2000) (finding under Michigan law, class action waiver was unconscionable); Leonard v. Terminix Int'l Co., 854 So. 2d 529, 535 (Ala. 2002). See generally Issacharoff & Delaney, *supra* note 20; Safi, *supra* note 209.

For classes whose membership is restricted to residents of a single state, state law may also provide relief against clauses that forbid class action suits. For example, in California, the right to bring a class action under the Consumers Legal Remedies Act is not waivable. CAL. CIV. CODE §§ 1750–1752 (West 1998). It may be argued that this right is not preempted by the NBA in light of 12 C.F.R. § 7.4008, which exempts from pre-emption those state laws that have only an incidental effect on the loaning practices of national banks.

<sup>212</sup> See, e.g., Nedlloyd Lines B.V. v. Superior Court, 834 P.2d 1148, 1155 (Cal. 1992); Am. Online, Inc. v. Superior Court, 108 Cal. Rptr. 2d 699 (Ct. App. 2001) (holding that choice of law agreements will not be given effect when strong state policy or access to a forum for protection would be circumvented).

<sup>213</sup> Collection agencies now handle a very large amount of credit card debt, which includes incorporated late fees. In 2003, credit card companies sold \$57.3 billion of written-off credit card debt to collection agencies. Peter Benesh, *These Debt Collectors Try the Gentle Touch*, INVESTOR'S BUS. DAILY, Apr. 28, 2004, at A8. The agencies often use wage garnishment and liens as methods of collection. See *id*; Suein Hwang, *Asset Acceptance, A New Type of Collector*,

be more evident because a court would be engaged in an enforcement action.<sup>214</sup> If the court were to enforce the credit card company's full claim, including the late charge, it would thereby impose punitive damages that exceed *State Farm* guidelines. A similar approach might be taken in bankruptcy proceedings to challenge the recognition of these late fees as part of the debtor's debt.<sup>215</sup>

#### CONCLUSION: IS IT GOOD FOR THE GANDER?

This Article has argued that the federal and many state statutes that authorize credit card late charges are subject to constitutional challenge because they authorize enforceable penalties that are severely disproportionate to the costs imposed by late payment. The Article's general strategy is to argue that the very same constitutional doctrine that is thought to serve the interests of non-consumer defendants, by placing a cap on the punitive damages for which they may be liable, may also serve the interests of consumers.

This claim raises the question of whether a successful challenge on constitutional grounds of the legal authorization for credit card late fees would actually serve consumer interests in any significant way. If credit card companies were not permitted to charge late fees or were required to constrain the size of those late fees so they did not run afoul of constitutional constraints, they might respond by raising interest rates and charging annual fees on all accounts to make up for this lost revenue.<sup>216</sup> Consumers as a whole might not save any money, but rather the points of charge would just shift. Further, it might be objected that the costs of this relocation would fall on consumers as a general class rather than being visited on late payers who now pay a special premium for their own controllable behavior.<sup>217</sup> Finally, were interest rates

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*Hits Paydirt Suing for Modest Sums*, WALL ST. J., Oct. 25, 2004, at A1.

<sup>214</sup> "[W]hen private parties make use of state procedures with the overt, significant assistance of state officials, state action may be found." *Tulsa Prof'l Collection Servs., Inc. v. Pope*, 485 U.S. 478, 486 (1988) (citing *Lugar v. Edmondson Oil Co.*, 457 U.S. 922 (1982), and *Sniadach v. Family Fin. Corp.*, 395 U.S. 337 (1969), and distinguishing *Flagg Bros., Inc. v. Brooks*, 436 U.S. 149 (1978)).

<sup>215</sup> See 11 U.S.C. § 502(b)(1) (2006) (providing that bankruptcy court should disallow bank's claim to the extent it is not allowable under non-bankruptcy law).

<sup>216</sup> They might do this at the outset, or they might raise interest rates and charge annual fees as a response to late payment. See Caroline E. Mayer, *No Late Fees, But Watch Out for Late Rates: New Credit Card Offers Remove Common Penalty*, WASH. POST, Oct. 13, 2005, at D1 (reporting on new card accounts from Citibank, Commerce Bank, and American Express). Whether the latter maneuver would raise the same constitutional problems as discussed in this Article might depend on whether the higher interest rates were applied to future transactions (in which they might be considered new terms for future contracts), or whether the rates also applied to existing transactions. If it were the latter, there might be an argument that the higher interest rates served as penalties, although there would also be a good argument that they were permissible modifications on the terms of an ongoing loan, rather than penalties.

<sup>217</sup> See Furletti, *supra* note 29, at 444-45 (suggesting that late fees permit card issuers to

to rise and annual fees to increase, consumers of modest means might have a more difficult time gaining and maintaining access to credit lines.<sup>218</sup>

It is difficult to predict whether the invalidation of current late fee charge practices would just shift those charges onto consumers in another guise, whether the loss would be absorbed by the credit card companies, or whether some combination of these two effects would result.<sup>219</sup> (The articulation of these alternatives assumes, of course, that no complementary legislative action is taken to regulate other charges and rates.) If the argument of the Article is correct, late fees do not serve as necessary compensation for the costs of late payments; the costs of late payments are captured through the charging of interest on outstanding principal, among other techniques. They may, however, represent efforts to recoup other business operating expenses while keeping interest rates and annual fees lower. There is some evidence, however, that the 1995 comptroller's regulation, which made way for the exportation of home state policies on late fees, served mainly to increase the income of credit card companies rather than inducing them to shift from blunt forms of seeking revenue to more particularized forms. While many issuers no longer charge annual fees,<sup>220</sup> interest rates on credit card charges have not been as responsive to the decline in costs of money.<sup>221</sup> This is not dispositive evidence, of course, but it gives some reason to think that late fee charges may partly represent windfall payments and not necessary expenses whose cost must be spread in another way.<sup>222</sup> If so, the expense of precluding disproportionate late

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allocate collection costs to late payers specifically and that the alternative is higher interest rates for everyone). Furletti, however, does not discuss the "penalty" interest rates that are triggered by late payments. This practice also permits issuers to allocate additional collection costs with specificity and in ways targeted to the amount owed. It is thus unclear that disproportionate and uncalibrated late fees are essential to this effort.

<sup>218</sup> As a consequence, they might face obstacles to economic activity or they might resort to more disadvantageous methods of borrowing, such as payday loans or loan sharks.

<sup>219</sup> See Bar-Gill, *supra* note 53, at 1376 nn.12–13, 1377 (discussing dispute in literature whether credit card companies enjoy "supra-competitive" profit levels); see also BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE PROFITABILITY OF CREDIT CARD OPERATIONS OF DEPOSITORY INSTITUTIONS 2–4 (2005), available at <http://www.federalreserve.gov/board/docs/rptcongress/creditcard/2005/ccprofit.pdf> (reporting that the credit card industry is highly competitive but that "credit card earnings have been consistently higher than returns on all commercial bank activities").

<sup>220</sup> Bar-Gill, *supra* note 53, at 1391 & n.92.

<sup>221</sup> See *id.* at 1389; see also WARREN & TYAGI, *supra* note 12, at 145–46 & *passim* (arguing the credit card market is not well-functioning and sufficiently competitive). But see EVANS & SCHMALENSEE, *supra* note 29, at 240 (questioning some earlier findings that credit card rates were significantly unresponsive to changes in the cost of money).

<sup>222</sup> See TIM WESTRICH & MALCOLM BUSH, BLINDFOLDED INTO DEBT: A COMPARISON OF CREDIT CARD COSTS AND CONDITIONS AT BANKS AND CREDIT UNIONS 17 (2005), available at <http://www.woodstockinst.org/publications/research-reports> (comparing credit card rates from banks and credit unions and arguing that "the credit union data . . . demonstrate that credit card lending can be done without exorbitant fees and without confusing terms").

fee charges might be borne by the credit card companies, and would thereby, serve to the advantage of consumers.

But suppose annual fees and interest rates were to rise significantly as a consequence of constraining the size of late fees. This might have some modest benefits for consumers if those categories are more salient to consumers than late fees.<sup>223</sup> In that case, consumers' decisions may be more informed. The greater salience may induce more comparison shopping and greater competitive behavior by credit providers than is induced by late fee charges whose likelihood is often discounted by consumers when shopping for cards.<sup>224</sup> The effect would be disadvantageous to consumers if these categories were less salient than late fees and especially if the costs of a higher annual interest rate triggered by constraints on late fees overshadowed the costs of the late fees themselves. The evidence on the subject is mixed. As Oren Bar-Gill has argued, short-term costs such as annual fees are often highly salient to consumers because consumers know they will have to pay them. He argues, however, that consumers tend to discount the significance of interest rates and late fees due to exaggerated optimism about their discipline in spending and ability to pay.<sup>225</sup> A large increase in interest rates could be hazardous for consumers. Although, decreasing the number of different factors that may induce high charges could help to focus consumers' attention on interest rates by introducing greater simplicity and fewer factors to consider. This might introduce both greater prudence by consumers and more competition because of a better informed consumer base.

Limits on late charges might generate more active efforts by credit card providers to limit access to individuals who pose higher credit risks. This, too, is a mixed blessing. While it is important that people of modest means and those with prior difficulties with credit have access to credit, it is not clearly in their interest to gain access to credit lines but be unable to make the payments on them and be subject to penalties for late payment that compound the difficulties they face.<sup>226</sup>

Nonetheless, the question of whether consumers as a whole or those consumers most disadvantaged by high late fees from the invalidation of the current late fee practice is not relevant to the constitutional question of whether these penalties are disproportionately high. If the argument of this Article is correct, these authorizing statutes authorize enforceable penalties in violation of the substantive due process constraints of the Fifth and Fourteenth Amendments, no matter whose interests they serve or frustrate. Sauce for the goose is sauce for the gander, whether it tastes good with either.

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<sup>223</sup> See EVANS & SCHMALENSSEE, *supra* note 29, at 218 (citing survey that annual fees and interest rates on purchases were the main criteria for credit card selection).

<sup>224</sup> See Bar-Gill, *supra* note 53, at 1407–08 & n.145.

<sup>225</sup> *Id.* at 1395–1408; see also EVANS & SCHMALENSSEE, *supra* note 29, at 95.

<sup>226</sup> See WARREN & TYAGI, *supra* note 12, at 138–39, 150–51 & *passim* (arguing credit card companies target financially vulnerable borrowers to make larger profits off their inability to pay in a timely fashion and do not serve well this borrowing population).