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New Developments in Overdraft and Account Processing

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NEW DEVELOPMENTS IN OVERDRAFT AND ACCOUNT PROCESSING

Wells Fargo Overdraft Litigation

On August 10, 2010, Judge William Alsup, United States District Judge for the Northern District of California, ordered Wells Fargo Bank to pay damages in the amount of $203 million to California consumers who were part of a class affected by Wells Fargo's practices with regard to overdrafts.

What Were Wells Fargo's Overdraft Practices?

The Court found that Wells Fargo made a conscious business decision, with the goal of increasing profits generated from overdraft fees, to commingle ACH, check and debit card transactions and post the entire group from highest-to-lowest dollar amount to customers' accounts. Typically, the check and ACH items were larger dollar amounts than the debit card items, which resulted in the consumption of the customers' account balances faster than if all of the debit card items were deducted first. The end result was that instead of a customer incurring one or two overdraft charges, the customer incurred eight or ten overdraft charges. Internal Wells Fargo documents were admitted during the trial and reflected that Wells Fargo estimated that the commingling coupled with high-to-low posting order would generate an additional $40 million in annual revenue.

Wells Fargo also decided to extend overdraft protection, what the Court referred to as a "shadow line" of credit, to debit card transactions, where previously it declined debit card transactions for customers that did not have sufficient funds to cover the transaction. The Court found that Wells Fargo's sole motivation for changing its practice was to generate an additional $40 million in annual revenue.

Wells Fargo's Disclosures, Advertising, and Deposit Account Agreement

Wells Fargo's deposit account agreement was approximately 60 pages long, printed in a small font, and contained the following posting order disclosure:

> We <u>may</u> pay Items presented against your account in any order we choose, unless a particular order is either legally required or prohibited. In particular, we <u>may choose</u> to pay Items in the order of highest dollar amount to lowest dollar amount (unless such a practice is specifically prohibited by any applicable state or federal law, rule or regulation). We may change the order of posting Items to your account anytime without notice to you. [emphasis added]

The Court found that this language did not adequately disclose Wells Fargo's practices to customers because the disclosure used the term "may" when it was undisputed that Wells Fargo was

actually posting all transactions in order from highest-to-lowest dollar amount. The Court reasoned that this language suggested to customers that Wells Fargo would either exercise discretion or that it had not yet implemented a high-to-low posting scheme, when in fact it already had.

Subsequently, Wells Fargo amended its disclosure language and added the following disclosure:

> If more than one Item is presented to the Bank for payment on a day the Bank determines there are sufficient funds to pay one or more but not all of the Items, the number of Items paid and the overdraft and returned Item fees assessed may be affected by the order that the Bank <u>chooses</u> to pay those Items . . . . For example, <u>if</u> the Bank pays Items in the order of highest-to-lowest dollar amount, the total number of overdraft and returned Item fees you are charged <u>may be larger</u> than if the bank were to pay the Items in the order of lowest-to-highest dollar amount. [emphasis added]

Although this language provided a better description of what Wells Fargo "may" do, the Court found that it compounded the deception to customers because it still did not adequately disclose that the bank was already posting transactions in high-to-low order. The Court also took issue with the fact that the disclosure was buried within the 60-page document, and "no reasonable depositor could be expected to read the entire document or locate the 'disclosure'". . . . Further, the Court found that even if a customer found the disclosure, no reasonable depositor could be expected to understand what the bank's practices were.

The Court also found it misleading that Wells Fargo used advertising language that indicated debit transactions would be "immediately withdrawn" from a customer's account. Moreover, the online banking service displayed pending transactions in chronological order when in reality, the debit transactions were never actually posted in this order. Therefore, the Court determined that even if a customer kept an accurate register of his or her transactions, the register balance, which would be recorded in chronological order, would never match up to the actual balance, where transactions were posted in high-to-low order.

Furthermore, the Court found that the only time Wells Fargo actually explained to customers the high-to-low posting practice was when a customer made a written or oral complaint to Wells Fargo regarding the number of overdrafts that hit his or her account. The Court determined that an after the fact explanation further highlighted the deficiency of Wells Fargo's before-the-fact disclosures.

Also at issue was the fact that Wells Fargo did not disclose that it offered a "shadow line of credit" to customers; rather it disclosed to customers that it "may" pay the item and create an overdraft and customers "may" be charged a fee. Again, the Court found this misleading because in reality, Wells Fargo would pay the overdraft and as many as ten overdraft fees could hit a customer's account in a day.

Wells Fargo's Arguments

One of Wells Fargo's defenses was that its customers wanted and benefitted from a high-to-low posting order. However, the Court found that no credible evidence was presented to indicate that the high-to-low posting practice was deployed for this purpose. The Court reasoned that because a vast majority of debit card transactions are "must pay" items, there is no benefit to customers when a large

dollar item clears first because there is no risk that the bank would reject the large debit card item even if it posts last.

Wells Fargo also argued that it decided to commingle all transaction types because commingling would increase customer migration away from checks, that posting the transactions separately had become increasingly confusing to customers, and that consumers wanted their high dollar transactions paid first, regardless of the transaction type. The Court rejected these arguments because Wells Fargo could not produce adequate evidence reflecting these motivations.

Wells Fargo also argued that its posting-order practices are preempted under 12 C.F.R. 7.4002, applicable to national banks. The regulation allows a national bank to establish non-interest fees and charges in accordance with safe and sound banking principles provided the bank employs a decision-making process that considers the following factors: 1) the bank's cost in providing the service; 2) the deterrence of misuse of a service by customers; 3) the increase in competitive position of the bank; and 4) the maintenance of safe and sound banking principles. The Court found, however, that Wells Fargo did not actually consider any of the above four factors when making its decision to switch to commingling of all transactions and the high-to-low posting order of transactions.

The Court's Conclusions and Damages Awarded

Based on Wells Fargo's commingling of transactions and posting of transactions in high-to-low order, the Court held that Wells Fargo violated Section 17200 of the California Business and Professions Code, which prohibits business acts or practices that are unlawful, unfair, or fraudulent. In its analysis, the Court discussed California's version of Section 4-303 of the Uniform Commercial Code, which states that items may be paid to the account of a customer in any order. However, the statue contains a legislative comment, similar to the legislative comment included in Texas' version of Section 4-303, which requires a bank act in good faith when determining the posting order. The Court reasoned that a bank's discretion to determine posting order may not be exercised solely to drive up overdraft fees. Accordingly, the Court found that Wells Fargo did not act in good faith.

The Court noted that the changes to Regulation E regarding overdraft practices would remedy the issue that Wells Fargo had not adequately disclosed to customers that a "shadow line of credit" existed and did not award damages based on this practice. In addition to injunctive relief, the Court, based on an expert's calculation of the actual impact of commingling and high-to-low posting order, ordered that Wells Fargo restore overdraft fees paid by class members that were wrongfully extracted by Wells Fargo's unfair practices. To calculate the refund, transactions would be posted in the following sequence: 1) credits; 2) priority debit transactions (cash withdrawals and equivalents, such as wire transfers, ATM withdrawals, and money orders); 3) debit-card transactions with date/time information in chronological order; 4) debit-card transactions without date/time information in low-to-high order; and 5) checks and ACH transactions in high-to-low order. The amount is estimated to be around $203 million dollars.

Recommendations

This high profile case is likely to result in questions from local bank customers. Therefore, banks need to develop a communication plan to address questions and complaints. The first step is to understand the specific facts that underlie this decision. The commingling of all transactions (debit cards, checks, and ACH) with a re-sequencing then from largest to smallest played a huge role in the judge's opinion.

The next step is for bankers to clearly understand their own overdraft programs and how items are paid. It is quite likely that electronic transactions are paid first and then paper ones. In other words, the Wells Fargo method simply may not be used in their bank. Customer service representatives need to be able to explain this clearly. It may be helpful to develop a script for CSRs and to make sure that tellers and other employees with customer contact direct complaints and questions only to the CSRs who are prepared to respond.

All bankers should be reviewing their own overdraft protection programs. In addition to this case, the FDIC has proposed rules that would further restrict overdraft protection practices. Although the comment period does not close on these until September 27, it is highly likely that most of the requirements proposed in the new Overdraft Payment Supervisory Guidance—or some form of them—will be implemented. Here are key points for bankers to consider as they review programs:

- Be sure that disclosures are clear and meaningful. Don't bury them in the fine print!
- Honor opt-out requests with regard to check coverage. Give customers choices.
- Cap the number of daily transactions and fees.
- Monitor accounts and contact customers who abuse overdraft coverage.
- Develop alternatives, like sweeps between accounts and open end lines of credit (for credit worthy customers).
- Establish reasonable order of payment systems and clearly disclose them. It is likely that the FDIC will attempt to mandate chronological payment of debit cards and electronic payments before paper.

While the ultimate requirements in this Guidance may change after comments, banks clearly need to begin their review of overdraft programs sooner rather than later.