Is overdraft safe? (July 2009)

Favorable California appeals court ruling removes a major threat, and could persuade judges in other jurisdictions to follow pro-bank reasoning.

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A favorable ruling in California’s Miller case removes a major threat, and could persuade judges in cases in other state jurisdictions

It’s convenient. Most customers love it. It prevents the embarrassment and potential expense associated with bouncing a check.

And until the California Supreme Court took action last month, it was a potentially massive litigation liability for your bank if you did business in the Golden State.

Hidden danger in overdraft

While virtually all banks offer an overdraft protection product, most give little thought to the source of the funds being deposited into the account. Institutions in California, however, became all-too-aware of an unexpected potential downside associated with overdraft protection. This came after a trial court in San Francisco awarded depositors at Bank of America nearly $1.1 billion in restitution and damages.

Like any other bank with an overdraft program, Bank of America had debited the overdrawn account (and charged an NSF fee) and looked to subsequent deposits into the account to satisfy the indebtedness. The key difference in this instance, however, was that the accounts in question were being used by their customers as repositories for their Social Security or other similar government benefits.

On June 1, after five years of closely-watched litigation, the California Supreme Court ruled in Miller v. Bank of America that overdraft protection programs do not violate state law that normally shields funds such as Social Security or other similar benefit programs from collection actions by creditors. While the decision has, at least for the moment, settled the issue in California, the decision in Miller may do little to dampen a growing national debate over how best to protect government benefits, and balance the burden that is often placed on banks to determine whether or not a customer’s account contains protected funds.

Understanding the Miller case

The Miller litigation was filed in 2004 in the San Francisco County Superior Court on behalf of 1.1 million Bank of America account holders who had overdrawn accounts containing Social Security and other government benefits. The plaintiffs argued that the practice of debiting overdrafts from benefit payments that were subsequently deposited into the account (usually via automatic electronic payment from the benefit provider) violated state law protecting such benefits from normal collection efforts.

Banking law practitioners recognized from the start that the case had the potential to be very significant; an adverse ruling would impose large monetary liability on virtually all banks doing business in California.

Equally daunting were the likely operational and customer-relations problems that would have been created by an adverse decision. According to Leland Chan, General Counsel for the California Bankers Association, a decision in favor of plaintiffs “would have required banks to develop the capability to detect the presence of benefit funds in transaction accounts on an automatic basis and systematically withhold overdraft services from those accountholders.”

Chan found that most banks that have considered this option “found it to be either impossible or prohibitively expensive to develop.” Adopting a policy of categorically refusing to honor overdrawn items of benefit recipients was not a palatable option because, as Chan notes, it “would hurt customers and likely result in greater costs to them in the form of retailer bounced check fees, late fees, cancelled services, and negative credit reports.”

The litigation also attracted the interest of the federal Social Security Administration. The agency saw a ruling against Bank of America as posing a threat to the government’s preferred mechanism for delivering Social Security benefits–automatic direct de- posit. The Social Security Administra-tion recognized that if the California courts ruled that banks could not automatically debit an account that receives Social Security payments or other protected government benefits when an overdraft occurs, many banks would restrict the types of products available to accept direct deposit, making it a less-attractive option for benefit recipients.

After defeat, victory, then victory

Despite these strong operational and policy considerations, the Superior Court for San Francisco County ruled in March of 2005 that Bank of America’s overdraft protection program did violate state law. The trial court eventually awarded class plaintiffs in excess of $1 billion dollars in restitution and damages.

The trial court’s decision was appealed to the California Court of Appeals where, in 2006, it was overturned. Undeterred, the plaintiffs asked the California Supreme Court to take their case. And to the surprise and concern of many observers, the Court agreed to review the Court of Appeals’ dismissal in 2007.

On June 1, 2009, the California Supreme Court unanimously affirmed the Appellate Court’s decision to dismiss the case. The court ruled that an overdraft program that allows a bank to balance overdrafts, collect NSF fees, and correct bank errors against subsequent deposits into the affected account—even deposits of protected benefit payments—does not violate California law. This ruling came after a lengthy and rigorous briefing involving many amici (“friends of the court”) including the American Bankers Association, the California Bankers

Association, and the Solicitor General of the United States on behalf of the Social Security Administration, the Comptroller of the Currency, and the Department of the Treasury.

This positive result for the industry required the court to distinguish one of its own long-standing precedents regarding the protection of benefit payments, a case dating from 1974—Kruger v. Wells Fargo Bank.

In Kruger, the California Supreme Court ruled that an attempt by a bank to offset a customer’s credit card debt with protected funds held in a savings account violated state law protecting such funds. Bank of America and its amici argued in the Miller case that the court should recognize a distinction between the situation in Kruger—where a bank used a depositor’s funds to set off an independent, past debt external to the depositor’s savings or checking account—and the situation in Miller—where a bank attempted to recoup an indebtedness created by overdrawing an account from funds subsequently deposited into that same account.

The California Supreme Court ultimately agreed with this analysis, buttressing its decision with support from California Financial Code section 864, which governs the manner in which banks may exercise the right to set off debts in California. Financial Code Section 864 places limitations on the ability of a bank to exercise “any setoff for a debt” owed to the bank by a customer. Significantly, “debt” is defined in the statute as excluding “a charge for bank services or a debit for uncollected funds or for an overdraft of an account imposed by a bank on a deposit account.” The court concluded that because the California Legislature saw fit to expressly exclude overdrafts and bank charges from the protections of section 864, “the recovery of overdraft policy concerns about the setoff of independent debt—at issue in Kruger—are not present here, where the credits and debits occur in a single account.”

That is not to say that the Justices were not mindful of the policy behind the protection that is accorded to benefit payments. In the end, however, the court found that it is “far from clear” that the policy of protecting government benefit payments is undermined when banks offer their customers overdraft protection. The court noted that “an overdraft may be the result of the bank honoring, rather than bouncing, a rent or utility payment made prior to the deposit of benefit funds,” and that requiring banks to dishonor checks for their customers who deposit their government benefit payments “can harm the customer’s credit rating, result in the customer’s incurring fees, and affect the customer’s relationship with merchants.”

Is the issue settled? Not quite …

The good news is, of course, that the California Supreme Court has settled the overdraft issue in one of the largest banking markets in the United States. The bad news is that the decision may not prevent consumer advocates from trying their luck in other jurisdictions.

The larger question of Miller’s significant in jurisdictions outside of California remains an open question. While the legal analysis in Miller isn’t binding outside of California, it should provide persuasive authority in similar litigation that may be brought in other states. California is one of the largest markets for banking products in the United States. It is also home to one of the largest concentrations of recipients of Social Security and other government benefits. Courts taking up the issue will certainly recognize the significance of the decision, if only in terms of economic impact.

It is also worth noting that the California Supreme Court certainly didn’t exhaust all of the possible legal arguments that can be used to defend against this type of suit.

For example, the Miller decision left untouched arguments offered by the United States and other amici that federal law preempts extending state law protections in a way that affected a bank’s overdraft products, at least with respect to national banks and other federally chartered institutions.

Nor did the Miller court necessarily disagree with the approach taken by the United States Court of Appeals for the Ninth Circuit in a case decided in 2002, Lopez v. Washington Mutual. The Lopez decision held that a customer’s agreement to the terms of a bank’s overdraft protection product constitutes a “voluntary payment of a debt incurred” that trumps any statutory protection that may be accorded to the funds that a customer chooses to deposit.

In the end, the question of whether and to what extent protected benefit payments should be carved out from a bank’s overdraft products may be settled legislatively.

The counsel who filed the Miller litigation is publicly calling upon state and federal legislators to, in his words, “stop these predatory practices.” Members of Congress such as Carolyn Maloney (D.-N.Y.) have proposed curbs on overdrafts in federal legislation. A similar bill was introduced earlier this year in the California legislature, where it subsequently died. The federal regulators have become involved as well; the Federal Reserve Board recently issued an amendment to Regulation DD to enhance the disclosure of overdrafts and is considering a requirement to allow customers to opt out of certain overdrafts under Regulation E. BJ

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