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STATE OF NORTH DAKOTA

IN THE SUPREME COURT

STATE OF NORTH DAKOTA

Supreme Court Case No.: 20100024
Ransom County District Court No.: 08-C-151

Quality Bank and
Timothy Cavett,

Plaintiffs and Appellees,

v.

Lynette Cavett, a/k/a Lynnette Cavett,

Defendant and Appellant.

APPELLANT'S BRIEF

APPEAL FROM THE OCTOBER 14, 2009 MEMORANDUM OPINION AND NOVEMBER 16, 2009 SUMMARY JUDGMENT ISSUED BY JUDGE JOHN T. PAULSON RANSOM COUNTY DISTRICT COURT

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STATEMENT OF ISSUES AND STANDARD OF REVIEW

1. The issues in this matter are as follows:

   A. When a bank honors a check for a customer who has insufficient funds to cover the check, is the bank making an unsecured loan to the customer in amount of the overdraft. This is a question of law and fully reviewable.

   B. Did the Trial Court err in failing to rule that bank overdraft fees or charges in excess of the bank's administrative costs in paying the overdraft, are the equivalent of interest on the money the bank loaned to customer to honor the overdraft. This is a question of law.

   C. Did the Trial Court err in failing to rule that bank overdraft agreements or policies are subject to the same unconscionability limits as are other agreements. This is a question of law

   D. Did the Trial Court err in granting summary judgment for Quality Bank prior to conducting an evidentiary hearing as to whether all or part of the overdraft fees and charges imposed on the Cavett account at Quality Bank were unconscionable. This is an issue of whether the Trial Court failed to abide by state law, and thus is a question of law and fully reviewable.

   E. Based on the documents presented in the record, were a portion of the overdraft fees and charges imposed on the Cavett account at Quality Bank unconscionable. This is a mixed question of law and fact, however as the Trial Court did not issue fact findings, it is fully reviewable.

   F. Should the portion of Quality Bank overdraft fees and charges that were unconscionable be returned to Cavett. This is a question of law.

STATEMENT OF THE CASE

2. Plaintiff/Appellee Quality Bank ("Bank") brought an action against Defendant/Appellant Lynette Cavett ("Cavett") based on promissory notes. Cavett counterclaimed against Bank alleging that the overdraft fees Bank had charged on her checking account from 2004 through 2008 were unconscionable. Bank has been paid in full for all Cavett debts and is no longer a party in the initial action against Cavett. The Trial Court granted summary judgment in favor of Bank and against Cavett on the counterclaim. Cavett appealed the Trial Court's granting of summary judgment against her in the counterclaim.

STATEMENT OF FACTS

3. Cavett was a pig farmer, and a poor money manager. The July 31, 2009 Affidavit of Dan McLeod, formerly President and now Vice President of Bank, In Support of Quality Bank's Motion for Summary Judgment, especially Paragraph 25–43, reveals that Bank was Cavett's banker, her lender, and the entity through which Cavett applied for numerous loans and grants from other entities. Appendix pages 23-33 ("App 23-33"). The McLeod Affidavit and Cavett's Counterclaim in this action, App 15-18, set forth the extensive relationship between the parties and explain why Cavett continued to incur overdraft fees that were not only imprudent, but also financially crushing. On October 6, 2003, Cavett opened with Bank checking account #221858 which she used for her pig farming business. Bank has never revealed what its overdraft charges were when Cavett opened the account, but an examination of the account statements in late 2003 and early 2004 show the

overdraft charges did not exceed $15. App 98-210 includes all monthly statements on the Cavett account. On May 1, 2004, Bank instituted a new schedule of overdraft fees of up to $100 for each day that an overdraft balance remains in the account. App 97. Cavett did not agree in writing to the new fee schedule.

4. Bank sent Cavett monthly statements that set forth the activity in the account and each overdraft charge. These statements show there were two types of fees imposed by the Bank when the Cavett account had a negative balance. App 98-210. One type, the *overdraft charge*, was applied on days when checks that Cavett had written were presented to the Bank, which then decided whether to honor payment of the checks. The other type, the *daily overdraft fee*, was applied on days in which no Cavett checks were presented to Bank and there was no account activity. Cavett alleges these two types of charges are unconscionable. Cavett acknowledges that other types of charges by Bank were reasonable administrative fees, namely the "return item fee," the monthly service fee, and the per item fee.

5. Although Cavett asserts that both the *overdraft charges* and *the daily overdraft fees* were unconscionable, Cavett concedes that a small portion of the *overdraft charge* is valid, in that Bank likely did incur some administrative costs when checks were presented against an account with insufficient funds. During litigation Bank did not reveal what its administrative costs are to process overdrafts. Bank's fee schedule based the amount of the *overdraft charge* on the amount of the negative balance in the account. The administrative costs incurred in processing a check that caused an overdraft would have been the same if the overdraft balance were $50 or $11,000. Yet Bank charged $4 for an overdraft when there was -$50 in the account, and $100

for an overdraft when there was -$10,001 in the account. Because overdraft fees were as low as $4, and in absence of contrary data from Bank, during this litigation Cavett has assumed that Bank's administrative cost for each day when overdrafts were presented was $4.

6. The second type of fees to which Cavett objects, the *daily overdraft fees*, were by definition not to compensate Quality for administrative costs, because no activity took place in the account on days when the *daily overdraft fee* was imposed. They were fees charged solely because Cavett had a negative balance. Bank's written policy was to charge a $100 fee each day that an overdraft of $10,001 or more remains in an account. As there are 365 days in a year, on its face, Bank's fee schedule policy allowed it to collect $100 X 365, or $36,500 in fees if there was a negative balance of $10,001 for a full year, even if not one check was written against the account during the year, and if Bank incurred no administrative costs pertaining to the account during that year.

7. In its Motion for Summary Judgment, Bank provided monthly statements for the duration of the account but summary judgment was granted before submission of a report from Cavett's expert totaling the Bank's *overdraft charges* and *daily overdraft fees* for the duration of the account, and computing what percentage those fees represent of all funds that were paid from the account for the life of the account. Even though an analysis of all four years was not provided before summary judgment hearing, a statement of Cavett's account for one month, May 25, 2004, through June 24, 2004, was provided to the Court prior to summary judgment. App 211. In Memorandum of Law Of Cavett in Opposition to Motion

For Summary Judgment, Cavett provided the Trial Court with an analysis of the month at issue. App 71-82. This analysis showed the account balance on May 25 was negative $9,031.31. The balance on June 24 was negative $17,861.29. The average balance for the month was approximately the average of the high and low, or -$13,446. The *daily overdraft fees* for the month were $600. The *overdraft charges* for the month totaled $1,350, nearly all at $100 per overdraft. As *overdraft charges* could be as low as $4, which presumably represents the administrative cost for overdrafts, 96% of the *overdraft charges,* or $1,296 was not compensation for administrative costs. Therefore, for the month in question, $54 was withdrawn by Bank from the Cavett account for administrative costs for overdrafts, and $1,896 ($600 *daily overdraft fees* + $1,296 *overdraft charges*) was withdrawn by Bank from the Cavett account to compensate Bank for loaning money to cover Cavett overdrafts.

LEGAL ARGUMENTS

A. THE TRIAL COURT ERRED IN FAILING TO RULE THAT OVERDRAFT FEES ARE A FORM OF INTEREST.

8. The Trial Court wrote about a Florida case, but also referring to the case at bar, "charges on the account were not interest. The overdraft charges clearly are used for administrative fees and to ensure the safely and soundness of the institution." App 91. The Trial Court's error in failing to understand that the amount of overdraft fees in excess of administrative costs to process an overdraft is payment to the bank for use of the bank's money, was an error in law which prevented the Trial Court from addressing the primary issues in this matter. When a bank pays a check drawn on an account with a negative balance, the bank advances money to cover the

check and the customer is using the bank's money during the overdraft period. When a bank advances money to cover an overdraft, a loan is created. The North Dakota Supreme Court holds that an overdraft is an unsecured loan to a customer:

> When a bank honors a customer's overdraft, it makes an unsecured loan to that customer,…[citation deleted]. A bank's decision to honor or dishonor a check creating an overdraft but otherwise properly payable is a business decision turning on factors such as the size of the overdraft and the bank's view of its customer. Schaller v. Marine Nat'l Bank of Neenah, *supra;* White & Summers, Uniform Commercial Code § 17-3 (2d Ed. 1980).

Thiele v. Security State Bank of New Salem, 396 N.W.2d 295, 298; (N.D. 1986).

9. The states which have addressed this question concur that when a bank voluntarily pays a check as an overdraft, it makes a loan to its customer. Bryan v. Citizens Nat'l Bank, 628 S.W.2d 761, 763 n. 2 (Tex. 1982). The following cases hold that an overdraft is a loan: Williams v. Cullen Center Bank & Trust, 685 S.W.2d 311, 312 (Tex. 1985) (UCC section 4-401 entitles bank to treat overdraft as loan); United States v. Christo, 614 F.2d 486, 493 (5th Cir. 1980) (bank may enforce overdraft in the same manner as any loan); Sayan v. Riggs Nat'l Bank, 544 A.2d 267, 269 (D.C.App. 1988) (overdraft carries agreement to repay the loan); C & H Farm Serv. Co. v. Farmers Sav. Bank, 449 N.W.2d 866, 876 (Io. 1989) (the effect of the bank's payment of the overdraft was a loan); United States Trust Co. v. McSweeney, 91 A.D.2d 7, 457 N.Y.S.2d 276, 278 (N.Y.S.Ct.App. 1982) (the payment of an overdraft constitutes a loan); Pacenta v. American Sav. Bank, 195 Ill.App.3d 808, 142 Ill. Dec. 535, 552 N.E.2d 1276, 1278 (1990) (payment of overdraft is a loan); Brown v. Lee County Bank, 501 So.2d 702, 703 (Fla.Ct.App. 1987) (overdraft is a loan); Schaller v. Marine Nat'l Bank of Neenah, 131 Wis.2d 389, 388 N.W.2d 645,

648 (Ct.App. 1986) (overdraft is an unsecured loan); Dalton v. First Nat'l Bank of Grayson, 712 S.W.2d 954, 957 (Ky.Ct.App. 1986) (payment of overdraft is in the nature of a loan); Pulaski State Bank v. Kalbe, 122 Wis.2d 663, 364 N.W.2d 162, 163 (Ct.App. 1985) (overdraft check is treated as a loan); Chute v. Bank One of Akron, 10 Ohio App.3d 122, 460 N.E.2d 720, 722 (1983) (payment of overdraft is in the nature of a loan); First Citizens Bank & Trust v. Perry, 40 N.C.App. 272, 252 S.E.2d 288, 290 (1979) (overdraft amounts to a loan); Continental Bank v. Fitting, 114 Ariz. 98, 559 P.2d 218, 220 (Ct.App. 1977) (overdraft carries an implied promise to reimburse); City Bank of Honolulu v. Tenn., 52 Haw. 51, 469 P.2d 816, 818 (1970) (an overdraft is a loan).

10. When a bank takes money from a customer's account and pays itself, the fact that the bank calls the taking of money a "fee" does not necessarily justify the taking. The following cases discuss that the trier of fact must determine how much of the taking was a bank administrative cost, and whether the balance of the money taken was interest the bank paid itself: Eckols v. Sabine Bank, 613 S.W.2d 762-763 (Tex.App.-Beaumont 1981, writ ref'd n.r.e.) (court of appeals held it was a fact issue for jury to decide if $25 fee in connection with car loans to a car dealership was interest); Gonzales County Sav. & Loan Ass'n v. Freeman, 534 S.W.2d 903, 906 (Tex. 1976) (the court held a fact issue was presented whether an up-front "loan fee" was legitimate commitment fee or interest); Greever v. Persky, 140 Tex. 64, 165 S.W.2d 709, 712 (1942), (where there is any dispute in the evidence as to whether a charge in addition to interest is actually for an additional consideration, a fact question is raised for the jury); Dryden v. City Nat'l Bank, 666 S.W.2d 213,

216 (Tex.App.-San Antonio 1984, writ ref'd n.r.e.) (the court of appeals found that a charge for credit life insurance, added to the interest rate, raised a fact issue whether that charge for the loan exceeded the maximum legal interest rate); Withers v. Jefferson Trust Co., 123 N.J. Eq. 113, 196 A. 442-443 (N.J.Ch. 1938) ("[T]he payment of an overdraft by a bank amounts to a loan to its depositor, which is recoverable in the absence of an equitable defense."); Center Cadillac, Inc. v. Bank Leumi Trust Co., 859 F.Supp. 97, 105 (S.D.N.Y. 1994) ("Established precedent suggests that defendants had a legal right to treat plaintiffs' overdraft as a loan and impose terms and conditions upon its repayment, including charging them a reasonable interest rate.").

11. A review of the monthly account statements prepared by Bank from 2003 through 2008, App 99-210, reveals that Cavett had been using overdrafts on its account with Bank as a very expensive source of credit. This practice, while unwise for the customer, is common throughout the country.

> The overdraft has proved to have enormous significance as a credit device. *See* Clark, *The Law of Bank Deposits, Collections and Credit Cards* ¶ 2.4[1] (rev'd ed. 1981) …"In their wildest dreams, the drafters of Article 4 probably never suspected how pervasive overdraft banking, as authorized by Section 4-401(1), would become." *Id.* "[U]se of the bank check as a credit device apart from its payment function" occupies an increasingly important position in the consumer credit market. *Id.* … . The widespread, systematic use of overdrafts as a credit mechanism may be a recent development, but the overdraft has long been used as an adjunct to payment and collection services. Banks have customarily charged interest on these overdrafts and they have been permitted to set off deposits against them … .

In re Frigitemp Corp., 34 B.R. 1000, at 1019, 1020; D.C.N.Y. 1983.

12. A bank is expected to be compensated when it makes an unsecured loan to a customer by honoring an overdraft, as Bank did for Cavett. In North Dakota, any compensation for use of money is referred to as "interest." "Interest is the compensation allowed for the use, … of money … ." N.D.C.C. § 47-14-04. For the monthly statement examined in the Motion for Summary Judgment, May 25 – June 24, 2004, App 211, Bank paid itself from the Cavett account $600 for *daily overdraft fees* on days in which no transactions took place. That amount was purely the Bank's compensation for Cavett's use of Bank money, which N.D.C.C. § 47-14-04 denotes as "interest." The sum of $600 is 4.446% of the average monthly balance of -$13,446, which means that Bank earned 4.446% interest for the month of May 25 – June 24, 2004, on its overdraft "loan" to Cavett. This is equivalent to an annual interest rate of 4.446% x 12 months = 53.55%. App 73.

13. Bank also paid itself *overdraft charges* of $1,350 for the month in question, assessed on days in which checks were presented against the account and paid. Bank failed to reveal what its administration costs were to pay these checks, but its own policy documents show the *overdraft charges* may be as low as $4 per day. Bank did not refute Cavett's assertion that Bank's administration costs were $4 per day, and Bank submitted no evidence to the contrary. As this matter was heard on a Motion for Summary Judgment, all facts must be interpreted most favorably to Cavett. Security State Bank v. Schutz, 350 N.W. 2d. 40 (N.D. 1984). Therefore, for purpose of this appeal, it must be assumed that Bank's administrative costs were $4 for each day of *overdraft charges.* Therefore, of each $100 *overdraft charge*, $4 reflected administrative costs and the remaining $96 was in fact compensation for

use of Bank's money, i.e., interest. Of the $1,350 *overdraft charges* for the month at issue, 4%, or $54 was payment for administrative costs, and $1,296 was interest Bank paid itself for Cavett's use of Bank money for the month. The sum of $1,296 is 9.64% of the outstanding balance of negative $13,446 for the month at issue, which is an annual interest rate of 116% per year of the money Bank had at risk, i.e., the amount the account was overdrawn. App 73.

14. The account statement provided by Bank shows that from May 25–June 24, 2004, Bank paid itself the equivalent of $1,896 interest, representing an annual rate of 116% + 53% = 169%, for the monthly average of $13,446 it had loaned to Cavett to cover the Cavett overdrawn account. App 73. Cavett requests the Supreme Court to affirm that the portion of overdraft charges that are not administrative fees are indeed interest. The next issue is whether general unconscionability doctrine limits how much "interest" a bank may charge in the guise of overdraft fees.

B. <u>ALTHOUGH NOT USURIOUS OR CONTRARY TO BANKING REGULATIONS, OVERDRAFT FEES MAY BE SO EXCESSIVE AS TO BE UNCONSCIONABLE.</u>

15. To enable the Court to focus on the crucial issues, Cavett concedes the following:

A. Overdraft fees charged by Bank were not usurious under North Dakota law, as "usury" has a statutory definition and in general does not appy to banks.

B. North Dakota and Federal banking laws give Bank the authority to impose reasonable overdraft fees, and the laws do not specify a maximum amount which may be charged.

C. Banks may take appropriate measures to discourage customers from borrowing money by writing checks for more money than their account

balance, and thus reasonable overdraft charges are a necessary element of banking. "[A] waiver of overdraft charges … would be contrary to banking practice as it would result in an indefinite interest-free loan since without an overdraft charge there would never be a reason to call for an advance … ." In re Hoge Enterprises, 6 WL 33366970 (page 3) (Bkrtcy.D.N.D. 1996).

D. "[I]t is unrealistic to expect a bank to operate without some sort of ability to profit from the transactions and service fees." Trial Court Opinion, App 91-92.

E. Cavett was liable to repay Bank for the funds Bank loaned to Cavett when Bank paid the Cavett overdrafts, and Bank has been repaid in full.

16. However, notwithstanding the above, bank account agreements, as with all agreements, are constrained by an unconscionability standard. Section 41-02-19, N.D.C.C. (UCC 2-203) provides:

> 1. If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.
>
> 2. When it is claimed or appears to the court that the contract or any clause thereof may be unconscionable the parties shall be afforded a reasonable opportunity to present evidence as to its commercial setting, purpose, and effect to aid the court in making the determination.

17. North Dakota law before the Uniform Commercial Code ("UCC") recognized that contracts may be so one-sided as to be unconscionable. Gage v. Fisher, 65 NW

809, 815, 5 ND 297 (1895). A recent formulation of North Dakota's doctrine of unconscionable agreements after enactment of the UCC is as follows:

> When this Court determines whether a contractual provision is unconscionable, we employ a two-pronged framework….The first prong pertains to procedural unconscionability, "which encompasses factors relating to unfair surprise, oppression, and inequality of bargaining power [citation omitted] … The second prong pertains to substantive unconscionability, "which focuses upon the harshness or one-sidedness of the contractual provision in question." [citation omitted] …To prevail on an unconscionability claim,"a party alleging unconscionability must demonstrate some quantum of both procedural and substantive unconscionability, and courts are to balance the various factors, viewed in totality, to determine whether the particular contractual provision is 'so one-sided as to be unconscionable.' " [citation omitted]

Rutherford v. BNSF Ry. Co., 765 N.W.2d 705, 713, 714, 2009 ND 88, ¶ 20-22.

18. Rutherford holds that the doctrine of unconscionability allows a court to "deny enforcement of a contract because of procedural abuses arising out of the contract's formation and substantive abuses relating to the terms of the contract." Strand v. U.S. Bank Nat'l Ass'n ND, 2005 ND 68, ¶ 4. Rutherford instructs the trial court to "look at the contract from the perspective of the time it was entered into, … whether, under the circumstances presented in the particular commercial setting, the terms of the agreement are so one-sided as to be unconscionable. The principle… is the prevention of oppression and unfair surprise . Rutherford v. BNSF Ry. Co., 765 N.W.2d 705, 713, 714, 2009 ND 88, ¶ 20-22. Determination of unconscionability is a question of law, dependent on the factual circumstances of each case on a case by case basis. Rutherford, *Id.*

19. The Trial Court's Opinion was deficient in that it failed to clarify whether bank account overdraft fees are never subject to the unconscionability tests set forth in Rutherford v. BNSF Ry. Co., or whether there is an unconscionable limit to overdraft fees, but that limit was not reached by the facts in this case. The Trial Court seemed to disregard North Dakota law that all contracts, including those for bank overdrafts could be unconscionable when it wrote: "Cavett needed only to adhere to keeping a positive balance in her account." App 88. By this statement, the Trial Court seems to imply that because Cavett could have refrained from overdrawing her account, there is no unconscionable limit on overdraft fees, and Bank could have charged Cavett an unlimited amount when Cavett did overdraw her account. If there is no unconscionable limit as to overdraft fees, as implied by the Trial Court, a bank fee of, for example, $10,000 for every day an account is overdrawn would be acceptable, because Cavett could avoid the fee by keeping a positive balance in her account. The Trial Court's reasoning leads to an unjust result. If a bank did charge overdraft fees of $10,000 per day an account is overdrawn, and a bank customer made a mistake in computing an account balance, or encountered a temporary financial difficulty and overdrew its account by, say, $10, then the Trial Court's reasoning would justify a $10,000 penalty to be imposed which would create a negative account balance of $10,010. If the customer was unable to pay $10 initially, the customer would almost certainly be unable to pay $10,010 the next day. The failure to pay $10,010 would incur another $10,000 charge the following day, and the penalties would continue to mount up until the balance in the account would be negative $3,650,010 after one year. This example,

although extreme, shows that there is some point at which an overdraft fee is so unreasonably large as to shock the conscience. North Dakota statutory and case law dictate that even though the Trial Court failed to include recognize the unconscionability doctrine in its Opinion, a bank agreement regarding overdraft fees will be void, or will be modified, if the fees shock the conscience, *i.e.*, are unconscionably excessive.

20. The Supreme Court has held that if there is "a substantial inequality in bargaining power, … it is obvious that there is no room for bargaining or negotiation, [and] the facts …demonstrate an actual lack of negotiation coupled with elements of unfair surprise … an element of procedural unconscionability is present … Construction Associates, Inc. v. Fargo Water Equipment Co., 446 N.W.2d 237, 241-244, (N.D. 1989). When some procedural unconscionability is coupled with "the harshness of the particular contractual terms … taking into consideration all of the facts and circumstances of a particular case … Construction Associates, Inc. v. Fargo Water Equipment Co., 446 N.W.2d 237, 241-244, (N.D. 1989), a trial count may find that the offending contract or clause within a contract is unconscionable under the relevant statutory provisions.

21. The substantive and procedural elements on unconscionability operate on a sliding scale such that the more significant one is, the less significant the other need be. Blake v. Ecker, 93 Cal.App.4th 728, 743, 113 Cal.Rptr.2d 422 (2001). Indeed, some jurisdictions hold that in certain fact patterns, only one is necessary. Gillman v. Chase Manhattan Bank, N.A., 73 N.Y.2d 1, 537 N.Y.S.2d 787, 794, 534 N.E.2d

824, 829 (1988). Various fact patterns which may lead to a finding of unconscionablity are as follows:

> Resource Management Co. v. Weston Ranch & Livestock Co., 706 P.2d 1028, 1043 (Utah 1985) ("Gross disparity in terms, absent evidence of procedural unconscionability, can support a finding of unconscionability."); American Home Improvement, Inc. v. MacIver, 105 N.H. 435, 201 A.2d 886, 889 (1964) (relying explicitly on U.C.S. § 2-302 and finding unconscionable, based on price-value disparity, a contract requiring payment of $1,609 for goods and services valued at "far less"); World Enter., Inc. v. Midcoast Aviation Serv., Inc., 713 S.W.2d 606, 610 (Mo.App.1986) ("Unconscionability is defined as either procedural or substantive."); Frank's Maintenance & Eng'g, Inc. v. C.A. Roberts Co., 86 Ill.App.3d 980, 42 Ill.Dec. 25, 31-32, 408 N.E.2d 403, 409-10 (1980) ("Unconscionability can be *either* procedural or substantive or a combination of both.") (emphasis added). Cf. Schroeder v. Fageol Motors, Inc., 86 Wash.2d 256, 544 P.2d 20, 23 (1975) (en banc) (recognizing that cases fall within the two classifications of procedural and substantive unconscionability).

Maxwell v. Fidelity Financial Services, Inc., 907 P.2d 51, 58-60, (Ariz.,1995).

C. THE OVERDRAFT FEES AND CHARGES IMPOSED BY BANK ON THE CAVETT ACCOUNT WERE UNCONSCIONABLY EXCESSIVE.

22. The Trial Court erred in failing to conduct the evidential hearing mandated by N.D.C.C 41-02-19, (2): "When it is claimed or appears to the court that the contract or any clause thereof may be unconscionable the parties shall be afforded a reasonable opportunity to present evidence as to its commercial setting, purpose, and effect to aid the court in making the determination." Supreme Court cases hold that the correct procedure for the Trial Court would have been to first acknowledge that a bank overdraft agreement may be unconscionable, and then to conduct a hearing as to whether the facts in this matter required a finding of unconscionability

of the overdraft agreement, as the overdraft agreement was written, and as implemented:

> [A] determination of unconscionability ... is a question of law for the court…[and] should have been considered, if appropriate, only after reasonable opportunity was afforded to present evidence, preferably at a separate hearing, with adequate notice. "Section 41-02-19(2) requires that the parties be afforded a reasonable opportunity to present evidence as to the contract's commercial setting, purpose, and effect to aid the court in making the determination of unconscionability." Farmers Elevator & Mercantile Co. v. Farm Builders, Inc., 432 N.W.2d 864, 869 (N.D. 1988).

Cook v. Hansen, 499 N.W.2d 94, (N.D. 1993).

23. Although the Trial Court did not conduct a hearing for unconscionability, the May 1, 2004, fee schedule imposed by Bank, and the monthly statements showing how the overdraft policy was implemented, are sufficient for the Supreme Court to find the Trial Court erred in dismissing Cavett's counterclaim without a full evidentiary hearing on unconscionability. The fact that this was a consumer transaction in which the overdraft fees were imposed on Cavett after she had established her account and Cavett needed Bank as a conduit to process loan applications to others, and thus could not abandon her account at Bank, indicates procedural unconscionablity. An adhesion contract imposed as a "take it or leave it" basis against a consumer who did not draft the contract is examined with close scrutiny.

> When one party is in such a superior bargaining position that it totally dictates all terms of the contract and the only option presented to the other party is to take it or leave it, some quantum of procedural unconscionability is established. The party who drafts such a contract of adhesion bears the responsibility of assuring that the provisions of the contract are not so one-sided as to be unconscionable

Strand v. U.S. Bank Nat. Ass'n ND, 693 N.W.2d 918, 923-925; 2005 ND 68 ¶ 15.

24. Courts have held that adhesion is sufficient to show procedural unconscionability:

> The procedural unconscionability analysis begins, and may end, with the question of whether or not the contract is one of adhesion, i.e. a standardized contract, imposed upon the subscribing party without an opportunity to negotiate the terms. Flores v. Transamerica Homefirst, Inc., (2002) 93 Cal.App.4th 846, 853… . There is no question that any proposed agreement or agreement here is a contract of adhesion. The Bank presents the terms of its accounts to its account holders who must accept them if they wish to hold an account.

Comb v. PayPal, Inc., 218 F.Supp.2d 1165 (N.D.Cal., 2002).

25. Where, as in the present case, one party is a large institution which dictates the form of agreements, and the other party is an individual, procedural unconscionability may be presumed, and only substantive unconscionability becomes an issue.

> The distinction between procedural and substantive abuses, however, may become quite blurred; overwhelming bargaining strength or use of fine print or incomprehensible legalese may reflect procedural unfairness in that it takes advantage of or surprises the victim of the clause, yet the terms contained in the resulting contract-whether in fine print or legal "gobbledygook"-would hardly be of concern unless they were substantively harmful to the nondrafting party as well. Thus, the regularity of the bargaining procedure may be of less importance if it results in harsh or unreasonable substantive terms, or substantive unconscionability may be sufficient in itself even though procedural unconscionability is not.

Williston on Contracts, 8 Richard A. Lord, § 18.10 (4th ed. 1998) (footnotes omitted).

26. Substantive unconscionability focuses upon the harshness or one-sidedness of the contractual provision in question. Construction Assocs., 446 N.W.2d at 241. In order to use her checking account, Cavett was subject to payment of $36,500 in fees

to Bank if she maintained a $10,001 overdraft for one year. This represents an annual interest rate of 364.96%. Bank's overdraft terms were such that if Cavett had a negative $10,001 balance, Bank could collect $100 per day, or $36,500 per year from Cavett's account, even if Cavett wrote no checks against the negative balance for the entire year. Bank was not obligated to let Cavett overdraw her account. It permitted the overdrafts as part of its business, which was to make a profit. When Cavett wrote checks in excess of her account, Bank voluntarily paid the checks and voluntarily gave Cavett an unsecured loan. Bank honored the Cavett overdrafts as a business decision and deserves reasonable compensation for doing so. But any agreement by which a more powerful party is permitted to triple its money in a year at the expense of a far weaker consumer is unjust on its face.

27. Any agreement that provides for even the possibility of an interest rate of 364% is unconscionable when made. Documents produced by Bank in its Motion for Summary Judgment indicate that Bank's overdraft agreement not only appeared unconscionable when made, but also was unduly harsh in practice. For the month of June, 2004, Bank paid itself overdraft charges of $100 per day, totaling $1,896 (plus administrative costs of $54) for loaning Cavett $13,446 for her checking account overdraft for one month. Payment of $1,896 for one month loan of $13,466 represents an annual interest rate of 169%.

28. Although unconscionability is determined as a matter of law, its finding depends on the facts of the matter. "The concept of unconscionability must necessarily be applied in a flexible manner, taking into consideration all of the facts and

circumstances of a particular case." Construction Associates, Inc. v. Fargo Water Equipment Co., 446 N.W.2d 237, 244 (N.D. 1989).

29. Other jurisdictions hold that an agreement to pay an excessive price or high financing rates may be unconscionable. For example, a contract to purchase a residential water heater for $6,500, paid over time at 19.5% annual interest rate, gave at least the appearance of being unconscionable, which should have led the trial court to conduct an evidentiary hearing:

> [A] $6,500 price of a water heater for a modest residence, payable at 19.5 percent interest, for a total time-payment price of $14,860.43… present at least a question of grossly-excessive price, constituting substantive unconscionability. [citations deleted]… Certainly, on the present record, before an evidentiary hearing, both contracts appear to be unconscionable. But we do not reach that final conclusion for good reason. The unconscionability finding is for the trial judge to make, after the evidentiary hearing…the final conclusion should abide the taking of evidence.

Maxwell v. Fidelity Financial Services, Inc., 907 P.2d 51, 58-60, 806 (Ariz., 1995).

30. In the matter at hand, Bank imposed upon Cavett potentially devastating overdraft terms after Cavett established her checking account at Bank. The party who drafts such a contract of adhesion bears the responsibility of assuring that the provisions of the contract are not so one-sided as to be unconscionable. *See,* Construction Assocs., 446 N.W.2d at 241. If, as shown by documents Bank itself introduced, the effective interest rate on money Bank was advancing to cover the Cavett overdrafts could exceed 300% per year, and such charges continued for four years, Bank would have reaped a profit of many times the money it permitted Cavett to overdraw, at a minimum risk to itself. Having imposed the checking account fee schedule on Cavett, Bank has the responsibility to assure that the fee policy would

not be so one-sided as to be unconscionable. Because Bank was processing loans for Cavett, Bank knew Cavett had money coming which would be, and was, eventually deposited into the account. Admittedly, Cavett was naïve in financial matters to pay exorbitant overdraft fees for so long. However, Bank could have stopped the process by refusing to pay any more overdrafts at any time. "[I]n order to prove unconscionableness …, there must be a showing, not only that the terms thereof are onerous, oppressive or one-sided, but also that the terms bear no reasonable relation to the business risks … ." Central Ohio Co-op. Milk Producers, Inc. v. Rowland, 29 Ohio App.2d 236, 239, 240, 281 N.E.2d 42 (Ohio App 1972). Bank was reaping handsome benefits from the Cavett overdrafts, and was familiar enough with Cavett's financial situation and pending loan applications to FSA and other potential lenders, to be confident that its loans to Cavett, via overdrafts, would be repaid. The amounts that Bank was receiving as overdraft charges from the Cavett account were far in excess of any risk it was taking in advancing money for the overdrafts. Bank's confidence in Cavett was well placed, as on several occasions, Cavett brought the account into a positive balance. For example, on September 17, 2004, she deposited $384,000, which brought the account to +$289,123.86. App 116-117. On May 23, 2005, she deposited $50,000, which brought the account positive. App 133. On November 9, 2005, she deposited $20,000 to bring the account positive. App 143. In September, 2006 she deposited $116,232.88, $6,020.05, $6,551.14, and $3,825 to bring the account positive. App 163.

31. At any of those occasions, Bank, secure because the Cavett account was then positive, could have explained to Cavett that Cavett had already paid Bank tens of thousands of dollars in overdraft fees, that financing herself via overdraft fees was financially onerous for Cavett, and that for Cavett's own good, Bank would refuse to honor any more overdrafts, even though the rewards Bank was receiving as a result of Cavett paying the overdraft fees were far in excess of the risk Bank was taking in allowing the overdrafts. Bank did not act responsibly in counseling Cavett and terminating overdraft privileges. Rather Bank continued to take advantage of Cavett's naiveté to Bank's substantial financial benefit, even as it purported to help Cavett in applying for various loans and grants.

32. Cavett acknowledges that overdrafts should be discouraged by a combination of overdraft fees, counseling by bank officials, and ultimately by a bank refusing to honor overdrafts. Cavett had an obvious overdraft problem. Instead of helping Cavett understand how detrimental the overdrafts were for her, Bank used Cavett's lack of sophistication to its advantage. If Bank claims that it needs hefty overdraft fees to discourage needless overdrafts, it must produce evidence to the Court of the appropriate amount of its commercial needs:

> A contract may provide a "margin of safety" that provides the party with superior bargaining strength protection for which it has a legitimate commercial need. "However, unless the 'business realities' that create the special need for such an advantage are explained in the contract itself, ... it must be factually established." Stirlen v. Supercuts, Inc., 51 Cal.App.4th 1519, 1536, 60 Cal.Rptr.2d 138 (1997). When a contract is alleged to be unconscionable, "the parties shall be afforded a reasonable opportunity to present evidence as to its commercial setting, purpose, and effect to aid the court in making the determination.

Comb v. PayPal, Inc. 218 F.Supp.2d 1165 (N.D. Cal. 2002).

33. In a major multi-district litigation case pending in federal court in Florida, many account owners allege that over 15 national-scope banks manipulate the order in which charges are assessed against accounts so as to maximize overdraft fees and thus bank profits. The suit also alleges that the amounts of overdraft fees in the various banks have been in excess of the administrative costs and the reasonable risk taken by the banks in paying overdrafts. The court ruled that the portion of the complaint which alleges excessive overdraft fees should not be dismissed, because it is a valid cause of action:

> A term is substantively unconscionable if it is so "outrageously unfair as to shock the judicial conscience," … To make that determination, courts should consider "the commercial reasonableness of the contract terms, the purpose and effect of the terms, the allocation of the risks between the parties, and similar public policy concerns." Jenkins v. First Am. Cash Advance of Ga., LLC, 400 F.3d 868, 876 (11th Cir.2005) (quotations and citations omitted). Plaintiffs argue …. that the amount of overdraft fees is unconscionably excessive because the fees are not reasonably related to the costs or risks associated with providing overdraft protection…. Finally, Plaintiffs argue that this analysis is highly fact dependent and cannot be resolved on a motion to dismiss. The Court finds that Plaintiffs have sufficiently pled substantive unconscionability. The Complaints state that… the fees bear no reasonable commercial relationship to the costs or risks associated with providing the overdraft service. Therefore, having found that Plaintiffs have sufficiently alleged both the procedural and substantive aspects, the Court concludes that Plaintiffs have stated a claim for unconscionability.

In re Checking Account Overdraft Litigation, --- F.Supp.2d ----, 2010 WL 841305 (S.D.Fla., March 11, 2010).

D. AS UNCONSCIONABILITY MUST BE DETERMINED BY THE COURT, CAVETT'S DEMAND FOR JURY TRIAL IS WITHDRAWN.

34. As Strand v. U.S. Bank Nat. Ass'n ND, 693 N.W.2d 918, 923-925; 2005 ND 68, and the other North Dakota cases cited above explain, unconscionability, while dependent on the facts in each matter, is determined by the court, following the guidelines set forth in prior North Dakota and other jurisdiction cases, and in the decision to be drafted in this case. As Cavett has abandoned the other claims in her Counterclaim, which were appropriate for jury, and as her unconscionability claim will either be decided by the Supreme Court in its decision, or by the trial court on remand, Cavett withdraws her demand for jury trial on remand.

CONCLUSION

35. The Trial Court erred in failing to recognize that when Bank allowed Cavett to overdraw her account, Bank made an unsecured loan to Cavett, and that the portion of Bank's fees that exceeded administrative costs for overdrafts were the equivalent to interest on the unsecured loan. Bank was entitled to repayment of any amounts it loaned to Cavett, to reimbursement of its administrative expenses in paying overdrafts, and to reasonable interest for its risk and for Cavett's use of its money. However, an interest rate that according to Bank's own schedule of charges could exceed 300% per year, and in the month examined amounted to 169% per year, is so excessive as to shock the conscience.

36. Banks and customers need the Court's guidance in this important area. The Court must clarify that if bank fees exceed administrative costs and a commercially reasonable rate of return on money advanced, the excess fees may be

unconscionable. As unconscionability will be determined by trial courts on a case by case basis, the Supreme Court must offer tests and guidelines for trial courts to apply. In the case at bar, the record is sufficient to show unconscionability. This matter should be remanded to the Trial Court with instructions to compute all the *overdraft charges* and *daily overdraft fees* that Cavett has paid, subtract a reasonable amount for interest on the amounts loaned by Bank to Cavett, subtract Bank's actual administrative costs in paying Cavett's overcharges, and refund the balance to Cavett.

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Dated this 29th day of March, 2010.

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IN THE SUPREME COURT

STATE OF NORTH DAKOTA

Supreme Court Case No.: 20100024
Ransom County District Court No.: 08-C-151

I hereby certify that a true and correct copy of the foregoing **Appellant's Brief** was served via e-mail and U.S. Mail and **the Appellant's Appendix** was served by placing the foregoing in the U.S. mail on March 30, 2010 to the following:

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