VOLUME 22 FALL 2016

ILLINOIS BUSINESS LAW JOURNAL

IS YOUR BANK ACCOUNT SAFE? FINANCIAL INSTITUTIONS' BAD FAITH MALPRACTICE

❖ NOTE ❖

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Abstract

This Note argues that a poisonous culture in the banking industry, to indiscriminately profit by cutting legal and ethical corners, led to the Wells Fargo scandal in 2016. Wells Fargo had wrongfully profited by incentivizing its employees to meet sales quotas by creating phony accounts using confidential customer information without consent. Although the employees acted alone, liability lies on the employer, Wells Fargo, under the theory of respondeat superior. In doing so, Wells Fargo violated unfair and deceptive financial practices law. Also the scandal raised the issue of whether the mandatory arbitration clause in a financial product purchase agreement should be enforced against consumers or not. This Note proposes a multifaceted solution to address the pandemic of bad faith banking practices.

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I. INTRODUCTION

Moral hazard issues are a common theme in white-collar crimes. There are several notorious white-collar crimes in history such as Bernie Madoff's Ponzi scheme, Enron's deceptive accounting practices in the 2000s, and WorldCom CEO defrauding his own business in order to buoy his other failing business in 1990s.[1] More recently, Wells Fargo has been clouded by a scandal which may represent the most notorious white-collar crime of 2016.[2]

Wells Fargo's 2016 scandal incurred the highest punitive damages enforced since the Consumer Financial Protection Bureau ("CFPB") was established in 2011 to oversee consumer protection in the financial sector.[3] The public was shocked that Wells Fargo committed such a widespread scam of creating unauthorized bank accounts with consumer's personal information that remained unnoticed for several years. [4] This Note will delve into the scandal in detail by providing a background of the scandal in Part II. Part III will analyze who is liable, which relevant laws were violated, and the moral hazards involved in this scandal. Part IV will recommend that systemic change must be brought to banking institutions to dis-incentivize client scamming. Lastly, Part V will conclude with a notion that financial institution should be subject to more stringent regulations than other businesses given the business model of the financial institutions relies on consumer's trust.

II. BACKGROUND

Wells Fargo is one of the largest consumer banks in the United States, boasting the highest market valuation in the United States.[5] In September

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[1] MC, *The 10 Most Notorious White-Collar Criminals*, THE RICHEST (Oct. 18, 2014), http://www.therichest.com/business/the-10-most-notorious-white-collar-crimes.
[2] CONSUMER FINANCIAL PROTECTION BUREAU, *Consumer Financial Protection Bureau Fines Wells Fargo $100 Million for Widespread Illegal Practice of Secretly Opening Unauthorized Accounts* (Sep. 08, 2016), https://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-fines-wells-fargo-100-million-widespread-illegal-practice-secretly-opening-unauthorized-accounts/.
[3] *Id.*
[4] *Id.*
[5] *Wells Fargo Today, 3rd Quarter 2016 Quarterly Fact Sheet*, WELLS FARGO (2016), https://www08.wellsfargomedia.com/assets/pdf/about/corporate/wells-fargo-today.pdf.

2016, Wells Fargo was accused of a national scheme of creating over 1,500,000 phony accounts and more than 500,000 credit card applications since 2011.[6] Wells Fargo profited from charging clients various fees including annual fees, interest charges, and overdraft protection fees on phony accounts created by using confidential customer information without consent.[7] Wells Fargo employees were incentivized to open the unauthorized accounts to meet unrealistically high sales goals for a commission.[8] Subsequently, 5,300 employees who did not meet their quota by engaging in the fraudulent scam were fired.[9] As a result, Wells Fargo was denounced by public outcry, fined $185 million, and ordered to refund $5 million to their affected customers.[10]

III. Analysis

A. Liabilities of the Parties

Wells Fargo employees engaged in tortious and fraudulent activities, but pursuant to agency law they may not be liable if the wrongful acts that were (1) committed within the scope of employment at the workplace while (2) interacting with the customers to serve the employer's interest.[11] Arguably, by creating these unauthorized accounts, the Wells Fargo employees were attempting to serve their own personal interests, which would not fall within the scope of employment. However, the employees would not have engaged in the wrongful acts but for the incentive program imposed by Wells Fargo to maximize the firm's profit.[12] This mixed purpose of personal interest and employer's interest is enough to put employees within the scope of employment because a significant portion of the purpose is attributable to serving the employer's interest.[13] Therefore, Wells Fargo is liable for its

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[6] Matt Egan, *5,300 Wells Fargo Employees Fired over 2 Million Phony Accounts*, CNN: MONEY (Sep. 9, 2016, 8:08 AM), http://money.cnn.com/2016/09/08/investing/wells-fargo-created-phony-accounts-bank-fees/.
[7] *Id.*
[8] Nick Clements, *The Wells Fargo Reminder: Incentives Can Be Dangerous*, FORBES (Sep. 27, 2016, 5:55 PM), http://www.forbes.com/sites/nickclements/2016/09/27/the-wells-fargo-reminder-incentives-can-be-dangerous/#50d8c93d4c49.
[9] *Id.*
[10] Egan, *supra* note 5.
[11] Lisa M. v. Henry Mayo Newhall Mem'l Hosp., 907 P.2d 358, 360–62 (1995). (discussing that employees are not liable for torts committed within the scope of employment under the agency law); RESTATEMENT (SECOND) OF AGENCY § 1 (1958) [hereinafter RESTATEMENT (SECOND)].
[12] Reynolds v. L & L Mgmt., Inc., 492 S.E.2d 347, 350 (1997).
[13] *Id.*

employees creating phony accounts while working within the scope of employment. Furthermore, under corporate agency law, Wells Fargo's board of directors has an agency relationship with Wells Fargo because they (1) work on behalf of the principal, Wells Fargo, and (2) are subject to Wells Fargo's control on how to conduct daily tasks such as providing banking services to customers.[14] The agency relationship means that the directors owe a fiduciary duty to the company as agents to ensure their duty of loyalty and care.[15] Problems arose when the board members breached their fiduciary duty to the company by encouraging its employees to engage in white-collar crimes to meet unrealistically high sales goals.[16] As a result, the scandal tainted the company's reputation through blatantly overcharging its clients. [17]

B. Relevant law

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") was enacted in response to the financial crisis in 2009 to change the financial regulatory system in the U.S.[18] Dodd-Frank specifies that CFPB can only declare acts and practices unfair if, "the act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers, and such substantial injury is not outweighed by countervailing benefits to consumers or to competition."[19]

By engaging in these wrongful acts, Wells Fargo employees violated 12 U.S.C. § 5531(C)(1) which prohibits unfair acts or practices. [20] The employees violated the provision by causing a substantial injury to the customers that is not reasonably avoidable, and it is not outweighed by countervailing benefits to consumers.[21] Also, they materially interfered with the consumers' full ability to understand a term or condition of the financial product by disclosing phony accounts created through identity theft.[22]

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[14] RESTATEMENT (SECOND), *supra* note 11.
[15] Harding Co. v. Sendero Res., Inc., 365 S.W.3d 732, 744 (Tex. App. 2012).
[16] *Id.*; Clements, *supra* note 7.
[17] Egan, *supra* note 5 (quoting "they lost me as a banking customer and I have warned family and friends.").
[18] *Dodd-Frank Act*, U.S. COMMODITY FUTURES TRADING COMMISSION, http://www.cftc.gov/LawRegulation/DoddFrankAct/index.htm (last visited Jan. 26, 2017).
[19] Melissa B. Jacoby, *Dodd-Frank Regulatory Innovation, and the Safety of Consumer Financial Products*, 15 N.C. BANKING INST. 99, 105 (2011) (quoting Dodd-Frank Act § 1031(c), 12 U.S.C. § 5531(c)).
[20] 12 U.S.C. § 5531(C)(1)(a) (2012).
[21] Egan, *supra* note 5 (explaining that the scandal "incurred over $400,000 in fees . . . .").
[22] 12 U.S.C. § 5531(d)(1).

Finally, the firm took unreasonable advantage of the inability of the consumers to protect their interests in making an informed decision to select the right financial product.[23] Although the employees acted wrongly and broke the law, Wells Fargo will be vicariously liable for its employees' wrongdoing under the *respondeat superior* theory.[24] Under the theory of respondeat superior, the firm is vicariously liable for its employees acting on its behalf and subject to its control within the scope of employment. [25] It might be the case that Wells Fargo only provided an incentive for commission for sales quota. However, those who could not meet the sales quota were fired – which may be viewed as compulsory from the employee's perspective. [26] Although employees were not assigned to create phony accounts, the whole scam was to serve the purpose of the incentive program.[27]

Furthermore, the scandal raises a dispute whether a pre-arbitration "gotcha" clause commonly put in a financial product purchase agreement should be enforced or not.[28] The "gotcha" clause is a boilerplate clause waiving consumers' rights to bring a class action lawsuit when there is a legal dispute concerning the purchase of the financial product.[29] Currently facing class action lawsuits respectively brought by the former employees, shareholders, and consumers, Wells Fargo can avoid a class action brought by a number of affected consumers if the mandatory arbitration clause were intact. [30] Firms favor this clause because it prevents private parties from bringing a class action lawsuit against the firm, and the arbitration process usually yields more generous results in favor of firms. [31] Recently, the CFPB

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[23] 12 U.S.C. § 5531(d)(2).
[24] RESTATEMENT (THIRD) OF AGENCY § 7.07 (2006).
[25] *Id.*
[26] Clements, *supra* note 8.
[27] RESTATEMENT (THIRD) OF AGENCY § 7.07 (2006).
[28] *See* W.B. Lytton, *The State of Consumer ADR: Negotiation Ethics, International ADR, and Reparations Claims Facilities*, 21 INT'L INST. FOR CONFLICT PREVENTION & RESOLUTION 79, 86–87 (2003).
[29] CONSUMER FINANCIAL PROTECTION BUREAU, *CFPB Proposes Prohibiting Mandatory Arbitration Clauses that Deny Groups of Consumers their Day in Court*, (May 5, 2016), http://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-proposes-prohibiting-mandatory-arbitration-clauses-deny-groups-consumers-their-day-court/.
[30] *Id.*; Egan, *supra* note 5; Heather Kelly, *Wells Fargo Used by Customers Over Fraudulent Accounts*, CNN: TECHNOLOGY (Sep. 16, 2016, 7:21 PM), http://money.cnn.com/2016/09/16/technology/wells-fargo-lawsuit/.
[31] Michael Hiltzik, *How Wells Fargo Exploited a Binding Arbitration Clause to Deflect Customers' Fraud Allegations*, L.A. TIMES (Sep. 26, 2016, 11:55 AM),

proposed 12 C.F.R. § 1040 to remove the mandatory arbitration "gotcha" clauses because the study showed consumers found the class action provides more effective means for public interest than arbitration does.[32] The study further showed that the class action could be effective in collecting small amounts of money just like the victims of Wells Fargo scandal.[33] Although Wells Fargo already paid out a substantial penalty fee to the CFPB, it might want to minimize the pending class action lawsuits against it by dropping the one brought by the consumers. Not surprisingly, Wells Fargo wants to enforce the mandatory arbitration clause enforcement, and the CFPB's proposal to prohibit such usage of the clause will be considered.[34]

C. Enforcement Action

Soon after the scandal was discovered, Wells Fargo paid full refunds of $5,000,000 to all affected consumers of fees paid on unauthorized accounts and paid $185,000,000 of penalties to the CFPB's Civil Penalty Fund.[35] In an attempt to mitigate a negative public opinion, Wells Fargo hired an independent consultant to conduct a thorough review of procedure.[36] In addition, Wells Fargo employed heightened work ethic training and replaced CEO John Stumpf with Timothy Sloan.[37] Finally, Wells Fargo amended its bylaws in November 2016 to require separation of chairman and CEO roles and appointed Vice Chairman as an independent director to restore the trust of its customers and team members.[38] This separation of two positions of power and the independent audit committee installation are better for Wells

http://www.latimes.com/business/hiltzik/la-fi-hiltzik-wells-arbitration-20160926-snap-story.html.

[32] CONSUMER FIN. PROT. BUREAU, PROPOSED RULE WITH REQUEST FOR PUBLIC COMMENT (2015), http://files.consumerfinance.gov/f/documents/CFPB_Arbitration_Agreements_Notice_of_Proposed_Rulemaking.pdf; Yvette Ostolaza, *Overview of Arbitration Clauses in Consumer Financial Services Contracts*, 40 TEX. TECH L. REV. 37, 37 (2007).

[33] *Id.* at 50.

[34] Hiltzik, *supra* note 30.

[35] Egan, *supra* note 5.

[36] Lucinda Shen, *Wells Fargo's Phony Account Scandal May Not Actually End Up Costing That Much*, FORTUNE: FINANCE (Dec. 6, 2016), http://fortune.com/2016/12/06/wells-fargo-phony-accounts-legal-costs.

[37] Emily Glazer, *Wells Fargo CEO John Stumpf Steps Down*, WALL ST. J.: MARKETS (Oct. 12, 2016, 8:12 PM), http://www.wsj.com/articles/wells-fargo-ceo-stumpf-to-retire-1476306019.

[38] Ross Kerber & Dan Freed, *Wells Fargo Amends Bylaws to Separate Chairman and CEO Roles*, REUTERS: BUSINESS NEWS (Dec. 1, 2016, 5:02 PM), http://www.reuters.com/article/us-wells-fargo-accounts-managementchange-idUSKBN13Q5N7.

Fargo corporate governance because it can effectively police unethical banking practices better than when insiders with conflicts of interest are solely responsible for corporate policy.[39]

The bylaws amendment will hopefully promote not only the transparency of accounting and banking practices but also the moral standards of the board of directors and the employees. When the 2007 subprime mortgage crisis struck Wall Street, declines in residential investment caused global financial institutions to default. [40] However, the institutions were closely interconnected with each other so that one of their failures had a cascade effect on the whole U.S. economic system. [41] In response to this, the federal government intervened and bailed out the lenders, the institutions. [42] The underlying theory of the intervention has been criticized as a moral hazard of 'too big to fail' because the troubled institutions leveraged their intertwined position to enjoy policy preference and kept seeking high-risk high-return investments. [43] The costs of the high risk were left in the hands of consumers who invested in these institutions, and the bailed-out institutions did not pay full restitution.[44] The 2007 subprime mortgage crisis and Wells Fargo scandal are similar in a nutshell because both financial institutions had an incentive to pass off the cost of risky and bad faith practices to their consumers, by leveraging their positions as large institutions which are too intertwined with one another to let fail as a matter of U.S. policy, and also as employers pressuring employees with the problematic incentive programs respectively. [45] It is a moral hazard for firms to make profits by cutting legal and ethical corners through incentivizing employees to breach consumer trust.

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[39] Angie Mohr, *3 Reasons to Separate CEO AND Chairman Positions*, INVESTOPEDIA, http://www.investopedia.com/financial-edge/0912/3-reasons-to-separate-ceo-and-chairman-positions.aspx (last visited Feb. 16, 2017).
[40] John v. Duca, *Subprime Mortgage Crisis*, FEDERAL RESERVE HISTORY (Nov. 22, 2013), http://www.federalreservehistory.org/Events/DetailView/55.
[41] Scott E. Harrington, *The Financial Crisis, Systemic Risk, and the Future of Insurance Regulation*, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS 2 (Sep, 2009), http://www.naic.org/documents/topics_white_paper_namic.pdf.
[42] *Id.*
[43] *Id.* at 21.
[44] Saul Perez, *Must-know: Why "Too-big-to-fail" is Like Moral Hazard in Banks*, MARKET REALIST (Sep. 1, 2014, 11:38 AM), http://marketrealist.com/2014/09/big-fail-moral-hazard-banks/.
[45] *Id.*; Egan, *supra* note 5.

IV. RECOMMENDATION

Similar to the Wells Fargo breach of trust, when large consumer banks engaged in banking malpractice by rearranging debit transactions in order to maximize overdraft fees, the CFPB held this practice to be unfair under Dodd-Frank.[46] These banks tweaked real-time transaction by rearranging them on the books to show a false large transaction to bring the account into a deficit, and then when the bank account holder makes other transactions (e.g. withdrawing money at an ATM), she incurs overdraft fees.[47] In response, the CFPB reinforced an opt-in requirement, mandating consumers' affirmative consent to be charged an overdraft fee, and it awarded a penalty of $7,500,000 million.[48] This case is very similar to the Wells Fargo scandal because it also harmed consumer trust and financial interests by making the fundamental tools to manage people's funds artificially more expensive.

There are a number of recommendations to improve the pandemic moral hazards and bad faith practices in the banking industry. Thomas Curry, one of the chief banking regulators in the United States, testified about the Wells Fargo scandal by stating that all other national and regional banks employ similar borderline unlawful practices and under the similarly immense pressure to engage in bad faith sales tactics.[49] His testimony implies that this is a serious industry-wide problem, not just Wells Fargo's.

From the industrial standpoint, the poisonous culture to indiscriminately sell dangerous financial products to customers must be addressed. The regulatory agencies' continuing role as watchdogs in the banking industry will be helpful. From an institutional level, the heightened transparency in banking practices and the deterrence of risky incentive practices must be sustained through independent audit committees. Finally, from the judiciary's standpoint, punitive damages should be high enough to deter future anti-consumer conduct from bankers. Indeed, in the Wells Fargo case, the harsh punitive damages assessed against Wells Fargo sent an important

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[46] Regions Bank, CFPB No. 2015-CFPB-0009, http://files.consumerfinance.gov/f/201504_cfpb_consent-order_regions-bank.pdf (Apr. 28, 2015).

[47] *Id.*

[48] *Id.*; Kathy Kristof, *Nearly Half of Banks Still 'Reorder' Checks, Boosting Overdraft Fees*, CBS: MONEY WATCH (Apr. 9, 2014, 4:00 PM), http://www.cbsnews.com/news/nearly-half-of-banks-still-reorder-checks-boosting-overdraft-fees/.

[49] CNN Wire, *Wells Fargo is Not the Only One: Other Bank Workers Describe Intense Sales Tactics*, FOX (Sep. 22, 2016, 11:02 AM), http://fox43.com/2016/09/22/wells-fargo-isnt-the-only-one-other-bank-workers-describe-intense-sales-tactics/.

message to the whole financial industry to strictly regulate their sales culture and financial products.

After systemic changes are implemented, from the consumer standpoint, there will be wide public awareness of potential fraud, which should result in caution when purchasing financial products. Consumers are also recommended to take an active role such as consulting with an external financial consultant when in doubt, although this may be an impossibility for many consumers who cannot afford third party advice. This will help consumers safeguard their financial interests and make informed financial decisions.

V. CONCLUSION

To avoid bad faith malpractice and moral hazards in the banking industry and to better safeguard consumers, changes need to be made from both the consumer and corporate standpoints. Financial institutions need to reconsider the defective system of managing, training, supervising, hiring, rewarding, and punishing their employees. A more stringent standard should be enforced especially against trust institutions such as consumer banks because the core of their business model relies on consumer trust. Problematic incentive programs need to be closely regulated internally and externally by the CFPB. On the consumer side, the consumers should make an informed decision when entering into a purchase contract with a bank by regularly reviewing bank statements.