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The California Usury Law and the Non-Exempt Lender

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With the proliferation of exemptions from the California Usury Law, it is surprising to find lenders who are not exempt. However, they still exist. And they still take the risk of unintentionally making an interest-free loan, with limited possibility of acceleration, and with all free or under-priced warrants, equity kickers or other consideration for the loan being voided. A recent case underscores the risk of not having an exemption.

In *WRI Opportunity Loans II LLC v. Cooper*, 2007 DJDAR 12930 (Aug. 23, 2007), the lender made a loan to the borrower who planned to build residential townhouses and condominiums in West Hollywood. The loan was guaranteed by the two principals of the borrower. In addition to the regular interest on the loan (a spread over Bank of America's reference rate), the loan documents entitled the lender to receive additional interest according to a fixed schedule if other “contingencies” were to occur. For instance, the lender was to receive a percentage of the sales price of any units sold and was also to receive a specified sum in case the project was not completed. The borrower filed for bankruptcy, and the lender sued the guarantors. The guarantors responded with the defense of usury.

Because the guarantors were individuals, the usury exemption under California Corporations Code Section 25118 was not available. Also, the lender was not a licensed lender in California and did not have available one of the many exemptions from the California Usury Law applicable to various categories of licensed lenders. Hence, the lender first tried to shoehorn itself into the “interest contingency rule” under California common law. Under that rule, interest that exceeds the legal maximum is not usurious when its payment is “subject to a contingency so that the lender's profit is wholly or partially put in hazard,” provided “the parties are contracting in good faith and without intent to avoid the statute against usury.” Under this common law rule, the non-contingent part of the interest must be materially less than the amount of interest that could have been charged at the highest permissible rate.

Unfortunately for the lender, the “contingencies” in the *Cooper* case were not true contingencies. No matter what happened to the project, except in some unlikely scenarios, the lender was entitled to an amount of additional interest that would have put the lender over the usury limit.

The lender then tried to shoehorn itself into the statutory exemption for shared appreciation loans under California Civil Code Sections 1917 through 1917.006. That

statute permits additional interest to be collected, regardless of the usury law, from "a share of (1) the appreciation in the value of the security property, (2) rents and profits attributable to the subject property, or (3) both." However, that is not how this lender's additional interest was calculated, and the court found that the statutory exemption for shared appreciation loans was not applicable.

Finally, the lender argued that guarantors had waived the usury defense through the broad suretyship waivers in the guaranty. The court held that, because the usury law voided the interest provision, the suretyship waivers did not apply to the usury defense.

Moral

Investment or private equity funds that lend money frequently overlook or downplay the need for appropriate licenses and usury exemptions. The *Cooper* case underscores the continuing need to observe the restrictions imposed upon lenders by the usury law. While many lenders rely upon the transactional exemption in California Corporations Code Section 25118, that exemption is not applicable if any of the borrowers or guarantors is an individual, a revocable trust having one or more individuals as trustors, or a partnership in which, at the time of issuance of the debt, one or more individuals are general partners.

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