

Real Estate Update

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Can a Usury Savings Clause Save the Lender?

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Usury savings clauses are commonly found in loan agreements. These clauses attempt to negate the effect of interest payable under a financing arrangement that may result in the imposition of usurious charges. The usury savings clause basically recharacterizes as principal interest payments made by a borrower, should such payments exceed the permissible rate set by state law. Lenders often assume that the use of such a clause "saves" the lender from liability arising from the imposition of interest charges ultimately determined to exceed the maximum allowed under applicable law. However, courts have varied in their interpretation of the validity and enforceability of the usury savings clauses, with many unwilling to uphold them.

In *In Re Global Outreach SA*, a 2010 New Jersey decision, the court held that the following usury savings provision contained in a note evidencing a \$41 million construction loan was not enforceable: "This Note is subject to the express condition that, at no time shall Borrower be obligated or required to pay interest at a rate that could subject Lender to either civil or criminal liability . . . as a result of such rate exceeding the maximum rate that Borrower is permitted by law to contract to agree to pay. If, by the terms of this Note or any other instrument, Borrower is at any time required or obligated to pay interest at a rate exceeding such maximum rate, interest payable hereunder shall be computed (or recomputed) at such maximum rate, and the portion of all prior interest payments exceeding such maximum shall be applied to payment of principal hereunder."

This article explores the enforceability of the usury savings clause under the laws of several key commercial and industrial states, and the consequence of a finding of usury in these states. It also provides guidance as to how lenders can protect themselves in light of the inconsistent views of courts that have pronounced on this issue.

One consequence of the unenforceability of a usury savings clause is that the lender may be in violation of either civil or criminal usury statutes or both. Under New Jersey's civil usury law, for example, a lender and a borrower are free to contract for interest at any rate

to which they agree, so long as the loan amount is \$50,000 or more and is not secured by certain types of real property. If the lender ends its inquiry there, thinking it is now safe to charge any rate it likes, it's in for a big surprise because New Jersey's criminal usury statute limits the interest rate on loans to corporate borrowers to 50% per annum. Lenders should be wary of mismatched statutes and must adhere to both civil and criminal limits, with the lower limit (which in the case of New Jersey is the limit found in the criminal statute) effectively serving as the permitted maximum ceiling.

The enforceability of usury savings clauses becomes even more significant in the context of several recent cases that have construed various lender charges, including late charges, commitment fees, origination fees and equity interests, as the functional equivalent of additional interest. Courts have treated such charges as interest where the lender provides no corresponding additional consideration in exchange for the charges. Some state usury statutes, such as those enacted in Massachusetts and Iowa, explicitly define interest to include such fees and payments.

In *In Re Global Outreach*, the court held that because the lender could not prove that it gave additional consideration in exchange for \$38 million in equity participation payments that it was to receive at various phases of a real estate development or for a \$2.05 million origination fee that was due upon the loan closing, the court implicitly lumped these amounts with the more overt interest charges that the borrower was obligated to pay, all of which when aggregated together produced a finding of usury. And in *Mims v. Fidelity Funding Inc.*, a Texas case, the court held that a minimum usage fee charged to the borrower every month under a revolving credit facility constituted a charge of interest. When courts consider the stated interest rate in conjunction with these additional charges, the effective interest rate may exceed permissible rates without the lender's knowledge until it is too late. The enforceability of a savings clause becomes increasingly important in these situations.

In certain states, such as California and Florida, a usury savings clause serves as evidence in the determination of usurious intent (or the lack thereof), but only when the effective rate of interest cannot be determined from the face of the credit agreement. In *Jersey Palm-Gross Inc. v. Paper*, the Florida Supreme Court found that such clauses served legitimate functions in commercial loan transactions.

Other jurisdictions have adopted an absolute view that usury savings clauses are per se invalid, because the intent of the lender is irrelevant based on the language of the state's usury statute. For example, case law in Arkansas, North Carolina and New Jersey indicates that these states do not require intent to charge an illegal interest rate as a necessary element in determining whether a loan is usurious, only that the interest received actually exceeds the maximum permitted amount based on the rate in effect in such state.

A string of New York cases has similarly held that a lender cannot simply rectify an otherwise usurious interest rate by returning interest in excess of the legal limit to the borrower. In *Simsbury Fund Inc. v. New St. Louis Associates*, the Supreme Court of New York, Appellate Division, explained that language within the credit agreement in question, which purported to reduce the interest rate to the legal rate in the event of a finding of usury, did not make the subject agreements non-usurious.

Many jurisdictions only impose usury penalties for loans that are below a stipulated threshold amount, or only upon certain classes of lenders. In New York, for example, parties are permitted to contract at any interest rate so long as the amount of credit extended exceeds \$2.5 million. Under Oregon law, corporations can contract to pay interest at any rate so long as the agreement to do so is in writing. In other states, such as Delaware and Pennsylvania, loans made to corporations and other legal entities are entirely exempt from the usury statutes so that a usury defense is not available to such borrowers. And in Connecticut, providers such as banks, savings and loans, and credit unions are exempt from compliance with state usury laws.

The following outlines the civil and criminal interest rate limits in some key commercial states and provides information regarding a lender's intent and the validity of the savings clause in the usury analysis:

California: The civil contract rate is the greater of 10% or 5% over the amount charged by the Federal Reserve Bank of San Francisco to member banks on the 25th day of the month before origination of the loan. There is no criminal usury statute for commercial loans. Intent is relevant when the interest rate cannot be ascertained from the face of the agreement. Usury savings clauses are enforceable.

Florida: There is no limit for loans over \$500,000. An interest rate between 25% and 45% is a second-degree misdemeanor, and a rate in excess of 45% is a third-degree felony. Usury savings clauses may be determinative on the issue of intent when the actual interest is close to the legal rate or where transaction is not clearly usurious at the outset but only becomes so upon the occurrence of a future contingency.

Illinois: There is no civil or criminal usury limit for commercial loans.

Massachusetts: There is no civil usury limit, but knowingly charging an interest rate in excess of 20% constitutes criminal usury unless the state attorney general is previously notified of the transaction.

New Jersey: There is no limit for loans of \$50,000 or more that are not secured by certain types of real property. An interest rate in excess of 50% constitutes a crime of the second degree. Neither the civil nor the criminal statute includes an intent requirement, and usury savings clauses are not enforceable.

New York: For business loans over \$25,000, the civil limit is the greater of 5% over the primary discount rate or 16%. A rate in excess of 25% is a second-degree felony, and if the lender has been previously convicted of criminal usury, it is a first-degree felony. There is no civil or criminal limit for loans in excess of \$2.5 million. Usury savings clauses cannot salvage a usurious loan transaction.

Pennsylvania: There is no civil usury limit for commercial loans. The criminal usury limit is 25%.

Texas: The civil usury limit is 18% for commercial loans of \$250,000 or more. There is no criminal statute addressing commercial loans. Usury savings clauses are enforceable, but

they will not save a transaction that is usurious on its face.

It is important for lenders and practitioners to be aware of the validity of usury savings clauses in the relevant jurisdiction, given that their potential unenforceability could lead to severe outcomes, ranging from the forfeiture of interest to the loan becoming entirely void to recovery by the borrower of up to three times the excess amount of interest. New York's usury laws provide that all usurious agreements are null and void; the lender loses all principal and interest. In Illinois, when a loan is found to be usurious, the borrower is not obligated to pay any interest and may, at a minimum, recover twice the amount of interest charged under the contract.

In addition, the lender may become liable for the borrower's attorneys' fees. Florida's usury statute provides that a borrower may recover attorneys' fees in successfully litigating a usury claim. The same does not hold true for prevailing lenders in that state. Therefore, it becomes crucial that practitioners are aware of the applicable state law regarding attorneys' fees and accordingly draft provisions in credit agreements enabling the lender to obtain the fees when it is the prevailing party or at least avoid paying the borrower's attorneys' fees.

While usury penalties may have limited application in certain states, the consequence of violating usury laws can be harsh. As a practical matter, lenders must look beyond the stated interest in a financing arrangement and consider that legal rates vary not only among states but at times even within states, where civil and criminal statutes are inconsistent. And when "additional charges" can potentially raise the stated interest rate, lenders cannot simply rely on the usury savings clause to protect themselves against usury claims; lenders must be aware of whether the relevant state law actually recognizes the enforceability of the clause.

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