California Usury Laws Part II

By June Lin

I. Introduction

A previous issue of this journal contained an article by your author[1] describing the basic usury laws in California, exemptions from the usury laws, and penalties (and accompanying statute of limitations) for violating the usury laws. This article assumes that readers will review the prior article for a general overview of the California usury laws. This article will instead focus on two specific issues that come up in the usury law context, *i.e.*, choice of law as it relates to usury law, and the effect of usury law on attorneys' fees.

II. Choice of Law

A. General Considerations

When a loan transaction involves parties who reside in different states and the loan agreement has either no governing law or a governing law that is different from the state of residence of one or more parties, difficult choice of law issues may arise as to which state's usury law applies to the transaction. Given the significant differences in the usury laws of different states, a court's choice of law determination could mean the difference between an illegal usurious loan where no interest is payable, or a valid loan that is upheld.

The choice of law cases are fact-specific, with courts examining the relationship of different states to different facets of the transaction. Courts have been influenced by the size of the loan (courts are more likely to apply the law that would validate a large business loan), the location of the property securing the loan in the case of a secured loan (courts are more likely to apply the law of the state where the property is located), and whether the usurious interest rate is

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1. *See* June Lin, *California Usury Laws*, 61 Consumer Fin. L.Q. Rep. 394 (2007).

excessively high (courts are more likely to apply the law of the state holding the loan to be usurious if the interest rate is excessively high), although different courts have not always applied these tests consistently.

The following is a summary of the choice of law analyses made by various federal and California state law courts in deciding whether California or another state's usury laws should apply.

B. Loan Agreements without a Choice of Law Provision

In the situation where a loan agreement does not include a choice of law provision, courts have applied the traditional conflict of laws rule for disputes related to contract performance: A contract should be interpreted according to the place of performance, which, in the case of a loan agreement, is generally the place where the loan is to be repaid. Courts also have applied section 195 of the *Restatement (Second) of Conflict of Laws* (1971) (*Restatement*), which provides that, for loan contracts where the contract does not contain a choice of law provision, the parties' rights under the loan contract are governed by the law of the state where the contract requires that repayment be made, unless some other state has a more significant relationship to the transaction and parties, in which case the law of the other state will be applied.

Shannon-Vail Five Inc. v. Bunch[2] involved loan agreements where the borrowers were California corporations, but the loans were personally guaranteed by a Nevada resident who owned the borrowers, the lenders were Nevada residents, the guarantees provided that Nevada law governed the terms of the guarantees (the promissory notes had no choice of law clauses), and each note specified that the loan was to be repaid in Nevada. The borrowers sued the lenders, asserting violation of the usury laws as the loans had effective interest rates ranging

2. 270 F.3d 1207 (9th Cir. 2001).

from twenty-seven percent to thirty-two percent. The question arose as to whether Nevada usury law (which had no prohibition against usury) or California usury law (which prohibited interest rates in excess of ten percent) applied to the usury question. The United States Court of Appeals for the Ninth Circuit, applying California conflict of law rules, held that Nevada law applied. Because the promissory notes did not provide for a governing law, the court relied on section 195 of the *Restatement* for its choice of law determination. In this case, the court applied Nevada law because the loan was to be repaid in Nevada, and there were sufficient other connections to Nevada (the lenders and guarantor resided in Nevada and loan funds were disbursed from Nevada), so that there was not another state with a more significant relationship to the transaction and parties. The court stressed that the only time the strong presumption that the law of the repayment state governs would be overridden was when the repayment place has a very tangential relationship to the contract or the repayment place is selected solely to circumvent another state's usury laws.[3] The court found that this case was not the situation where the parties and the contract had strong connections to California and the parties structured the contract to evade California's usury law.

Rochester Capital Leasing Corp. v. K& L Litho Corp.[4] involved secured loan agreements (characterized as "sale and lease-back arrangements") with no governing law contract provision;

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3. An Illinois federal district court took a different approach from the *Shannon-Vail Five* court. *In re* First Farmers Financial Litigation, 2016 WL 6647923 (N.D. Ill. 2016), was a usury case involving a secured promissory note without a choice of law clause and with an effective annual interest rate of 75%, where the note specified that the loan was to be repaid in Florida, the lender was a Florida company, the security and guaranty agreements provided for Florida law as the governing law, and the lawyer who drafted the loan documents was a Florida attorney. The court held that Missouri law, rather than Florida law, applied to the usury issue, even though the place of repayment was in Florida, because applying Florida usury law would invalidate the loan, and the court wanted to uphold the parties' expectations that the loan would enforceable given it was a $2,000,000 business loan which the parties expected to be a valid contract. The court also found that Florida was not the state with the most significant relationship to the transaction because the borrower was a Missouri corporation, the loan was personally guaranteed by a Missouri resident who owned the borrower, and the property that secured the note was located in Missouri.

4. 13 Cal.App.3d 697 (1970).

the lender was a New York corporation and repayment was to be made in New York, but the borrower was a California corporation, the loan agreements were executed in California, and the property that secured the loan agreements was in California. The California Second District Court of Appeal applied California law to hold that the loan agreements, which had an interest rate of $11^{1}/_{2}$ percent, were usurious and unenforceable. The court overrode the general principle that the governing law should be the law of the place where the loan is to be repaid (*i.e.*, New York), because of the extensive contacts with California. The court focused on the fact that all acts by the lender to enforce its rights of repossession and disposition of the secured property to recover the balance of sums due were exercised in California, given the property securing the loan agreements was in California.

C. Loan Agreements with a Choice of Law Provision

In the situation where a loan agreement includes a choice of law provision, California follows the approach of section 187 of the *Restatement*, which reflects a strong policy favoring enforcement of contractual choice-of-law provisions. Under this approach, the court enforces the choice of law provision if the chosen state has a substantial relationship to the parties or the transaction, unless the chosen state's law is contrary to a fundamental policy of California. In other words, courts generally respect the parties' choice of law provided there is a reasonable relationship between the loan agreement and the law chosen by the parties, and the chosen state's law is not contrary to a fundamental public policy of another state.

Ury v. Jewelers Acceptance Corp.[5] involved a loan agreement where the borrower was a California corporation, the lender was a New York corporation, and the loan agreement stated that it would be construed pursuant to the laws of New York. The borrower sought rescission of

5. 227 Cal.App.2d 11 (1964).

the loan agreement on the ground that the interest rate of 20.3 percent per annum was usurious under California usury law. The California First District Court of Appeal upheld the parties' choice of New York law (and held that the loan agreement was not usurious under New York law) because of the extensive contacts with New York, which supported the finding that New York law was selected by the parties in good faith and not as a device to evade the usury laws of California. The loan agreement was made in New York because the last act necessary to the contract, the acceptance, was performed in New York. The money was made available to the borrower in New York by deposit to the borrower's bank account in New York, and the money was mainly repaid in New York. The court did not find a strong California public policy against this particular interest rate, which was not so excessive as to be unconscionable, even in California. The court also found that California did not have such significant relationships with the transaction that its governmental interest required application of its own usury laws rather than New York's usury laws.

Another usury case where the court upheld the parties' choice of law is *Gamer v. DuPont Glore Forgan, Inc.*,[6] which involved a secured loan agreement in the form of a securities margin account between a California resident borrower and a New York brokerage firm lender. The lender charged interest at rates which ranged from 9½ percent to 12¼ percent. The loan agreement had a New York choice of law clause. The borrower sued the lender, seeking to recover allegedly usurious interest (under California law) paid to the lender. The California Fourth District Court of Appeal upheld the parties' choice of New York law (and held that the loan agreement was not usurious under New York law) because of the extensive contacts with New York, which supported the finding that the choice of New York law did not offend

6. 65 Cal.App.3d 280 (1976).

California’s public policy against usurious transactions. The lender’s principal place of business was in New York, where it kept its offices and bought and sold stocks. Given that the loan was secured by the underlying securities held as collateral by the lender, and it was in New York that settlement of securities transactions by the lender was made, and it was the making of such a settlement for shares purchased on margin that constituted the extension of credit for which interest was charged, New York was the place of performance of the loan agreement. In upholding the loan and interest rate, the court was influenced by the fact that this particular interest rate was not excessive given that it was a customary rate which fluctuated with changes in the money market, and also given that the prime rate of interest in recent years had been as high as 9%.

The *Gamer* court’s holding relied on section 187 of the *Restatement*. The court also referred to section 203 of the *Restatement*, which provides that a loan agreement will not be held to be usurious if it provides for a rate of interest that is permissible in a state to which the contract has a substantial relationship, and is not greatly in excess of the rate permitted by the usury law of the other state that has ties to the transaction.

The courts in two other usury cases applying California choice of law rules held that the governing law chosen by the parties in a loan agreement would not automatically be upheld, without first examining whether there was a reasonable relationship between the loan agreement and the chosen state and substantial contacts of the parties with the chosen state, and without considering the fundamental policy with respect to usury of the other state with ties to the transaction.

First, the California Fourth District Court of Appeal, in *Mencor Enterprises, Inc., v. HETS Equities Corp.*,[7] found that it could not be determined, as a matter of law, that the forty-four percent interest rate in the parties' promissory note would be enforced under the note's Colorado choice of law provision. This case involved a promissory note where the borrower was a California corporation, the lender was a Colorado corporation, repayments were to be made in Colorado, and the note provided for a forty-four percent interest rate and the application of Colorado law. The borrower sued the lender for treble the amount of interest paid on the promissory note, claiming the forty-four percent rate was usurious under California usury law. The California trial court dismissed the borrower's complaint, relying on the parties' choice of Colorado law which permitted interest rates not exceeding forty-five percent. No factual determination was made by the trial court as to whether there was a substantial relationship between Colorado and the parties and transaction. The court of appeal reversed, holding that the parties' choice of Colorado law would be permitted in a California court only upon the examination of the relationship of the contract to Colorado, the contacts of the parties with Colorado, and consideration of California's fundamental policy with respect to usury; the court sent the case back to the trial court to make this factual determination. Such a factual determination required consideration of the law of: the domicile state of the borrower; the state where the loan was to be repaid (provided that this state bears a normal and natural relationship to the contract); the state where the loan was made or negotiated; and the state of the lender's place of business. Your author does not know the outcome of the trial court's factual determination, but it is likely that the court of appeal was influenced by the relatively high interest rate of forty-four percent.

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7. 190 Cal.App.3d 432 (1987).

Second, the Kansas federal district court, in *Aces Transport, Inc. v. Ryan Transp. Services, Inc.*,[8] applying California choice of law rules, found that a Kansas choice of law provision in a loan agreement (characterized as a factoring agreement) would not automatically be upheld without the court undertaking a fact-intensive analysis to determine whether the connections between Kansas and the transaction were substantial enough to justify the application of Kansas law, and to determine whether the lender chose Kansas as the governing law and place of repayment simply to circumvent California's usury laws. This case involved a loan agreement where the borrower was a California corporation, the lender was a Kansas corporation, and repayments were to be made in Kansas. The loan had a thirty percent effective annual interest rate, which would be usurious under California law but not usurious under Kansas law. The court stated that the fact that the lender was a Kansas corporation and the contractually designated place of repayment was in Kansas could be enough to warrant application of Kansas law, but that further factual analysis was needed to fully resolve the choice of law issue. Again, it is likely that the court was influenced by the relatively high interest rate of thirty percent.

III. Attorneys' Fees

Another issue that comes up in the usury context is the effect of a usurious loan on a party's ability to recover attorneys' fees. The California First District Court of Appeal addressed this question in *Moore v. Russell*,[9] holding that the fact that a loan is usurious does not affect the lender's right to contractual attorneys' fees when suing to collect on principal. This case involved a usurious note, where all payments made on the note were credited as payments to principal. The lender was suing the borrower to enforce collection of the principal, which was

8. 2006 WL 1487008 (2006).

9. 114 Cal.App. 634 (1931).

not affected by the usury laws except for the application of any interest payments to reduce principal. Given the note contained an attorneys' fees clause in favor of the lender, the lender was entitled to collect reasonable attorneys' fees in a lawsuit to enforce payment of the principal on the usurious note. The court pointed out, however, that if the entire case had been on the question of interest payments (with the principal having been paid) and the only issue before the court was that of usury, then recovery of attorneys' fees by the lender would not be allowed. In that case, under California law the borrower should be allowed to recover attorneys' fees (see discussion below).

If a borrower successfully brings a usury claim to recover usurious interest paid to the lender in the last two years, may the borrower recover attorneys' fees? There is nothing in the California usury laws specifically awarding attorneys' fees to borrowers who win in usury cases. However, if the loan agreement is governed by California law (or if the contract was negotiated and signed in California and the parties had sufficient contacts with California) and contains a provision that the lender will recover attorneys' fees if the lender has to enforce the loan, and the borrower then sues the lender purely on a usury claim and wins, the borrower may claim that the loan agreement's one-way attorneys' fees clause should be applied mutually to both parties to the contract because of California Civil Code section 1717, allowing the borrower to recover attorneys' fees.[10] Section 1717 provides that, if a contract specifically provides that attorneys' fees which are incurred to enforce the contract shall be awarded to one of the parties or to the prevailing party, then the party who is determined to be the "prevailing party," whether or not that party is specified in the contract, is entitled to recover reasonable attorneys' fees. Section 1717 grants a reciprocal right to attorney fees when a contract provides the right to one party but

10. *See* June Lin, *Attorney Fees Clause Gives Reciprocal Rights*, Primerus Business Law Institute e-Newsleter (July 2010).

not the other. Section 1717 also clarifies that "the party prevailing on the contract" is the party who recovers a greater relief in the action in a final judgment.

IV. Conclusion

As indicated above, the choice of law determination in usury cases is fact-specific. In choosing which state's usury law applies, courts give significant weight to the governing law chosen by the parties in the loan contract, but may also look at other factors to determine the significance of the contacts between various states and the parties and transaction, and whether a particular state's law was chosen to circumvent the usury laws of another state. Such factors include: the location of the parties; the place of making, performance and repayment of the loan; the location of any property securing the loan; whether the interest rate is excessively greater than the rates permitted by the states with connections to the transaction; and the size and purpose of the loan.

A usurious loan agreement does not affect the lender's right to contractual attorneys' fees when suing to collect on principal. However, a borrower who is the prevailing party in a lawsuit brought against a lender to recover usurious interest paid to the lender may recover reasonable attorneys' fees if there is an attorneys' fees clause in the loan agreement, even if the attorneys' fees clause is only in favor of the lender.