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Refund on Unlawfully High Interest Rate Loans

Liabilities of Non-Exempt Lenders

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As a result of the downturn in the real estate market, the troubled auto industry, the near collapse of the financial markets, and everything else we can list to have caused or contributed to our current recession, one thing has been made abundantly clear: Banks and financial institutions have reduced the tap of money available for loans to a pathetic drip. This has left many cash-strapped consumers and non-consumers without traditional banking sources from which to borrow money. However, in our capitalistic society, where there is a need, there is someone to fill that need and make a profit by doing so.

The dramatic decrease in traditional bank loans has produced an increase in the number of private lenders. An incentive for private individuals and corporations to get into the business of lending money is the low rate of return from traditional banks and financial institutions for monies invested, as well as the instability in the stock markets. Naturally, due to the sparse availability of loans from traditional banks, the cost of money from private lenders has increased. This is simply the application of the age-old supply and demand theory.

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What does this mean in real life terms? Five years ago, Mr. Joe Borrower may have been able to walk into Acme Bank and borrow $250,000 at a 6% interest rate. Now however, if Acme Bank has not gone out of business or been shut down, it certainly is not going to lend $250,000 to Joe Borrower at any interest rate. However, Mr. Private Lender, who has the cash and nowhere else to invest it, is now willing to lend the $250,000 to Joe Borrower at a healthy interest rate of 14%. At first blush, this may appear to be a win-win situation, in that Joe Borrower is able to obtain the funds and Private Lender is able to invest his money with a greater rate of return than otherwise available through traditional avenues. However, this may very well be an unlawful transaction, giving Joe Borrower significant rights against Private Lender.

The California Constitution provides statutory protections for consumers and non-consumers in California from paying interest rates that are above the legal maximum. The laws in this regard are called Usury Laws. If a non-exempt lender charges a usurious interest rate, the borrower can: (1) cancel all future interest due under the loan, (2) recover the past interest paid for a two year period, (3) recover a penalty against the lender in the amount of three times the total interest paid for a one year period, and (4) if appropriate, recover punitive damages against the lender. Despite these potential recoveries, the borrower will always remain responsible to repay the principal amount of the loan.

Therefore, if you or your company has entered into a loan where the interest rate exceeds the legal maximum, you may have significant rights against the lender. On the other hand, if you are a lender who is not exempt from California Usury Laws and has entered into a loan agreement to recover interest in excess of the legal maximum, there are steps you can take now to prevent the borrower from exercising its rights against you.

Usurious Loans

The foundation for California's Usury Laws is the State's Constitution. Article XV defines a usurious transaction as a "loan or forbearance of money, goods or things" in which a "person, company, association or corporation" receives from a borrower more interest than is authorized by that Article. Cal. Const. Article XV § 1. In order for a transaction to be usurious, there are essentially four elements: (1) The transaction must be a loan or forbearance of the use of money; (2) The loan or forbearance must be made by a non-exempt lender and in a non-exempt transaction; (3) The interest received by the lender must be in excess of the statutory maximum rate that is applicable to the transaction; and (4) The lender must have a willful intent to enter a usurious transaction. Miller & Starr *California Real Estate* (3rd Ed.), Usury § 20:2.

Interest Rates that Exceed the Legal Maximum

For the purpose of determining whether an interest rate is usurious, a distinction must be made between "consumer" and "non-consumer" loans. A "consumer" loan is a loan or forbearance of money used primarily for personal, family or household purposes. The maximum interest rate for "consumer" loans is 10% per annum. Cal. Const. Article XV § 1(1).

"Non-consumer" loans are all other loans that are not consumer loans. The maximum interest rate for "non-consumer" loans is either (1) 10% per annum, or (2) the "Federal Discount Rate" plus 5%, whichever is greater. Cal. Const. Article XV § 1(2). The Federal Discount Rate is the highest rate established by the Federal Reserve Bank of San Francisco on advances to member banks on the 25th day of the calendar month preceding the earlier of (a) the date the loan contract is executed, or (b) the date the loan is made. *Id.*

By example, at the time of the drafting of this article, the Federal Discount Rate was .75%. Therefore, had a non-consumer loan been entered into then, the maximum statutory interest rate for the loan would have been 10%, because the alternative calculation of the Federal Discount Rate plus 5% would only yield an interest rate of 5.75%. It is worthy to note that the 10% legal rate has not always been higher than the alternative calculation. For example, on June 29, 2006, the Federal Discount Rate was 6.25%, which resulted in a maximum statutory rate of 11.25% at that time.

Exemptions to Usury Laws

After determining that the transaction is a loan or forbearance of money and that the interest rate is greater than the statutory maximum, the next step is to determine whether the lender is exempt from Usury Laws. Historically, the large number of exemptions to the Usury Laws swallowed the rule. However, recently there has been a surge of private lenders who do not fall within the many exceptions to the rule. Not all of the many exemptions can be discussed herein, but the more common ones will be mentioned as exemplars.

One of the largest exemptions to the Usury Laws is if a loan was "made or arranged" by a licensed real estate broker. *Civil Code* § 1916.1. With respect to the other narrower exemptions, they can be broken down into two categories: (1) Types of transactions and (2) Types of lenders.

With respect to the types of exempt transactions, there are essentially seven: (1) Debt created by a sale of a property; (2) Shared appreciation loans (which is where the collateral is non-residential property, residential property containing five or more units, or smaller residential property where the borrower does not occupy one of the units); (3) Loans that meet the federally-related home loan test; (4) Loans for business purposes to substantial or sophisticated legal entities; (5) Retail installment contracts and accounts; (6) Indebtedness issued in a corporate reorganization; and (7) High-grade corporate borrowings. Miller & Starr *California Real Estate* (3rd Ed.), Usury § 20:35. Each of these exempt transactions is complicated in and of itself and beyond the space allowed for this article.

The second category of exemptions concerns exempt lenders. There are more than 25 categories of exemptions that pertain to very specific types of lenders; for example, the Franchise Tax Board, medical malpractice insurance cooperatives, credit unions, insurance companies, pension funds, banks, etc. However, many of today's new private lenders do not fall within these traditional categories of lenders that are exempt from Usury Laws.

Willful Intent

The last issue is the intent of the lender. There are transactions in which interest rates are contingent or not structured as a traditional loan. In such cases, there will certainly exist surrounding facts which must be analyzed to determine the intent of the lender. However, when the transaction involves a traditional loan which on its face contains a usurious interest rate, it will be presumed that the lender intended to charge the excessive rate.

It must be noted that while various exemptions provide protection from Usury Laws, if a loan transaction is so egregious to rise to the level of being unconscionable, the exemptions will not protect the lender from liability.

Remedies for Charging Usurious Interest Rates

Those liable under the Usury Laws include a "person, company, association or corporation" that directly or indirectly takes or receives any sum or value greater than that allowed by law. Upon establishing that a loan transaction is usurious, a borrower has several remedies available. Whether couched in the form of an affirmative lawsuit against the lender, a defense asserted in response to a lawsuit brought by the lender, or in a cross-complaint against the lender, the borrower can: (1) cancel the future interest due under the loan; (2) recover past interest paid for the preceding two-year period; (3) recover penalty damages in the amount of three times the interest paid for the preceding one-year period; and (4) obtain punitive damages if the lender's conduct is oppressive, fraudulent or malicious. These remedies are cumulative.

While the borrower will still be obligated to repay the principal of the loan, in seeking these remedies the borrower is not required to tender repayment of the entire principal at the time the borrower seeks these recoveries. However, if the loan is due at the time the borrower obtains a judgment, the amount recovered by way of the judgment can be used to offset repayment of the loan principal.

In the foregoing example where Mr. Private Lender loaned $250,000 to Mr. Joe Borrower at a 14% interest rate, assuming that the exemptions do not apply, the interest rate charged on the loan would be usurious. As such, Joe Borrower could pursue his rights and remedies against Private Lender. Assuming for the purpose of this example that the term of the loan is four years, if Joe Borrower files an action against Private Lender after having paid the usurious interest for two years, he will likely be able to obtain the following remedies: (1) Cancellation of future interest in the amount of $70,000 ($250,000 x 14% = $35,000 x 2 years); (2) Recovery of the $70,000 in past interest paid; (3) $105,000 in penalties ($35,000 x 3 years); and (4) If the facts warrant it, punitive damages. Not considering an award of punitive damages, the total benefit Joe Borrower could obtain in this situation would be $245,000, which is nearly the total amount of the principal of the loan.

Therefore, if you have a loan from a non-exempt lender and are paying more than 10% in interest, you likely have substantial remedies against the lender, which you should pursue immediately. On the other hand, if you are a non-exempt lender who is charging more than 10% interest on any loan, you should take immediate steps to bring yourself within one of the many exemptions to the Usury Laws, or otherwise face substantial liability from the borrower.

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In February 2010, Mr. Miles was recognized as a "Rising Star" by Super Lawyers magazine. This honor is reserved for the top 2.5% of lawyers in Southern California under the age of 40. This is the sixth year in a row he has received this honor.

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