Loyola of Los Angeles Law Review

Volume 13 | Number 1 Article 1

12-1-1979

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RECENT CHANGES IN CALIFORNIA AND FEDERAL USURY LAWS: NEW OPPORTUNITIES FOR REAL ESTATE AND COMMERCIAL LOANS?†

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> If thou lend money to any of my people that is poor by thee, thou shalt not be to him as an usurer, neither shalt thou lay upon him usury.[1]

Recent record high interest rates have focused attention on state usury laws—laws that were originally designed primarily to protect necessitous borrowers from loan sharks and other unscrupulous lenders.[2] However, when the interest rates charged for prime commercial loans and real estate loans exceed the rates permitted by state usury laws, such laws disrupt normal financial markets and no longer serve to protect borrowers but instead operate to deny them access to vitally needed credit. This situation has produced legislation in a number of states to amend state usury laws in order to keep pace with rapidly escalating interest rates. However, the increase has been so rapid that many states have been unable to react in time to pass new legislation. As a result, Congress has preempted all state usury laws with respect to

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 This article, in whole or in part, will be incorporated in a chapter on California Usury Law by Laurence G. Preble, that will be part of a forthcoming California Continuing Education of the Bar book on California Real Estate Financing. The authors acknowledge with appreciation the valuable assistance of Christine M. Olsen, David A. Lamb, and Patricia Frobes, members of the California Bar.

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1. *Exodus* 22:25.

2. "Such laws are intended as a bulwark to protect the needy from the greed of the rapacious. It is the theory of such enactments that those in distress might be plunged into deeper distress if the law did not come to their relief and protect them from the money lender, who would prey upon misfortune and wring from the needy borrower, in his endeavor to tide over present difficulty, the utmost farthing as compensation for what is often an evanescent benefit—merely putting off of an evil day."

Wooten v. Coerber, 213 Cal. App. 2d 142, 148-49, 28 Cal. Rptr. 635, 639 (1963) (quoting *In re* Washer, 78 Cal. App. 759, 771-72, 248 P. 1068, 1073 (1927)).

certain business and agricultural loans and residential real estate loans.[3] This new federal legislation is discussed briefly in Section V.

Amending California's Usury Law has always presented a special problem because, unlike the usury laws of most other states, California's Usury Law is contained in the California Constitution[4] and thus can be amended only by popular vote. Until recently, California's Usury Law was among the most restrictive in the nation. Thus, when market rates exceeded maximum permissible interest rates in California, many lenders, particularly institutional lenders engaged in substantial real estate lending, were unable to lend in California and directed their investments to other states.[5] Previous attempts, once in 1970 and twice in 1976, to amend the Usury Law in response to unprecedented high interest rates proved unsuccessful.[6] The return of high interest rates and double-digit inflation in 1979 again produced severe problems, sharply reducing the amount of money available for mortgage lending and further increasing the rate of interest charged on the money that was available.[7] California borrowers often sought financing from non-California lenders and attempted to avoid the application of the California Usury Law by choosing the law of the lender's state, which often was much more favorable. Although such transactions were generally believed to be valid, until recently there were few California cases expressly upholding this approach. Some lenders were un-

3. *See* the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132.

4. CAL. CONST. art. 15, § 1 (formerly art. 20, § 22). The 1934 constitutional amendment superseded in part a 1918 initiative measure, CAL. CIV. CODE §§ 1916-1 to 1916-3 (West 1954). Together, the two measures are referred to herein as the "Usury Law."

5. *See generally* Curotto, *Conflict of Laws and Usury in California: The Impact on Flow of Mortgage Funds*, 9 U.S.F. L. REV. 441 (1975) [hereinafter cited as Curotto].

6. These Propositions may be summarized as follows:

(a) Proposition 10, submitted to the voters as part of the general election on November 3, 1970, would have included in the list of exemptions a loan or forbearance to a corporation or partnership if the principal amount of the loan was in excess of $100,000. 1970 Cal. Stats. ch. res. 113. The proposition was defeated. *Id.* A-104.

(b) Proposition 12, submitted to the voters as part of the primary election on June 8, 1976, would have kept the maximum rate of interest on loans for personal, family, or household purposes at 10%, but allowed the parties to contract in writing for a rate not exceeding 7% per annum in excess of the federal discount rate. 1975 Cal. Stats. ch. res. 132. The proposition was defeated. *Id.* A-163.

(c) Proposition 5, submitted to the voters as part of the general election on November 2, 1976, was generally the same proposal as Proposition 12, which had been submitted to the voters on June 8, 1976. 1976 Cal. Stats. ch. res. 53. This proposition was also defeated. *Id.* A-164.

7. "Until Proposition 2, California usury law not only blocked off outside money coming into the state . . . but just as effectively drove out home-grown money." L.A. Times, Feb. 3, 1980, Part IX, at 14, col. 1.

willing to assume the risk of a possible usury violation and discontinued making loans to California borrowers. As a result, the California legislature again recommended that a constitutional amendment be placed on the ballot to make the California Usury Law more flexible. This time, however, to the surprise and delight of most lawyers, institutional lenders, and commercial borrowers, the amendment, known as Proposition 2, was enacted on November 6, 1979 and became effective November 7, 1979.[8]

Proposition 2 made some important changes in the California Usury Law, and prior to the recent rapid rise in interest rates caused by federal monetary policy, there were some indications that Proposition 2 was a factor in reducing the rates charged for real estate loans.[9] As with much new legislation, however, some problems and questions remain. This article briefly reviews the California Usury Law and then considers some of the problems and questions created by the enactment of Proposition 2 and the Depository Institutions Act, with emphasis on the application of such laws to real estate and commercial loans.[10] The article also considers the effect the enactment of Proposition 2 may have on the validity of provisions in loan agreements which choose the law of a state other than California to govern the transaction.

I. BACKGROUND OF THE CALIFORNIA USURY LAW

A. *The Usury Law*

Prior to the enactment of Proposition 2, the California Usury Law rested on two principal foundations: a statute adopted as an initiative measure in 1918[11] and an amendment to the California Constitution

8. Proposition 2 was proposed by the California Legislature as Assembly Constitutional Amendment No. 52 (1979 Cal. Stats. ch. res. 49) and became effective November 7, 1979. CAL. CONST. art. 18, § 4. The text of Proposition 2 is set forth in full in the Appendix to this article.

9. "Rates already are lower in California than they would have been without the passage of Proposition 2. . . ." L.A. Times, Jan. 17, 1980, Part III, at 16, col. 2. *See also* L.A. Times, *supra* note 7. Although interest rates remain unusually high in California, the primary cause appears to be national monetary policy, not California usury policy.

10. For another discussion of Proposition 2, see Bosko & Larmore, *Practice Under The New California Usury Law*, 55 CAL. ST. B.J. 58 (1980) [hereinafter cited as Bosko & Larmore]. Proposition 2 did not make any significant changes in many fundamental areas of the California Usury Law. Issues such as what constitutes a "loan or forbearance," what constitutes "interest," and how interest is computed remain essentially unaffected by Proposition 2 and are not discussed in this article. For a general discussion of the California Usury Law prior to the enactment of Proposition 2, see Comment, *California's Model Approach to Usury*, 18 STAN. L. REV. 1381 (1966); Comment, *A Comprehensive View of California Usury Law*, 6 SW. U.L. REV. 166 (1974).

11. CAL. CIV. CODE §§ 1916-1 to 1916-5 (West 1954).

that was adopted in 1934.[12] The 1934 constitutional amendment provided that the maximum permissible rate of interest with respect to any loan or forbearance of money, goods, or things in action was 7% per annum, but that the parties could contract in writing for a rate not in excess of 10% per annum. It also provided that these restrictions did not apply to California savings and loan associations,[13] California industrial loan companies,[14] California credit unions,[15] California pawnbrokers,[16] California personal property brokers,[17] California and national banks,[18] and certain California nonprofit agricultural lenders.[19] The legislature was given the power to regulate these lenders, including the power to set maximum interest rates.[20] The legislature has not set maximum rates for most commercial loans,[21] and many exempt lenders, such as banks and savings and loan associations, are not subject to any interest rate limitation.[22]

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12. CAL. CONST. art. 15, § 1 (formerly art. 20, § 22). The 1934 amendment did not repeal the initiative statute but merely superseded it wherever there was a conflict. *See, e.g.*, Clarke v. Horany, 212 Cal. App. 2d 307, 27 Cal. Rptr. 901 (1963).

13. Associations are defined in the Building and Loan Association Act. CAL. FIN. CODE §§ 5000-5026 (West 1968 & Supp. 1979). Although federal savings and loan associations have generally been assumed to be exempt lenders, there is no specific reference to them in the Usury Law. Presumably, a federal association is an association which is "defined in and which is operated under" the provisions of the California Financial Code. *See, e.g.*, CAL. FIN. CODE §§ 5055, 11000 (West 1968). In order to confirm their exempt status, Senator Russell has introduced a bill in the California legislature which specifically provides that federal savings and loan associations are exempt lenders. SB 1694, Cal. Legis. 1979-80 Reg. Ses. (Mar. 4, 1980). *See also* note 48 *infra*.

14. These are defined in "An act defining industrial loan companies, providing for their incorporation, powers and supervision." CAL. FIN. CODE. §§ 1800-1826 (West 1968 & Supp. 1979).

15. These are defined in "An act defining credit unions, providing for their incorporation, powers, management and supervision." *Id.* §§ 14000-14008.1.

16. Pawnbrokers are persons engaged in the business of receiving goods in pledge as security for a loan. *Id.* §§ 21000-21001, 21200, 21200.5, 21200.7, 21208.

17. These are defined in the Personal Property Brokers Act. *Id.* §§ 22000-22013.

18. These are defined in and operate under the "Bank Act." *Id.* §§ 99-151; CAL. CONST. art. 15, § 1.

19. Nonprofit cooperative associations are organized under CAL. FOOD & AGRIC. CODE §§ 54001-54294 (West 1968 & Supp. 1979); CAL. CONST. art. 15, § 1.

20. "The Legislature may from time to time prescribe the maximum rate per annum of, or provide for the supervision, or the filing of a schedule of, or in any manner fix, regulate or limit, the fees . . . or other compensation which all or any of the said exempted classes of persons may charge or receive from a borrower . . . ." CAL. CONST. art. 15, § 1.

21. *See, e.g.*, CAL. FIN. CODE § 22053 (West Supp. 1979).

22. "[U]ntil the legislature exercises the power granted to it by the amendment to regulate the business of lenders . . . the class not so governed by legislation is subject to no restriction on interest rates or charges." Carter v. Seaboard Fin. Co., 33 Cal. 2d 564, 582, 203 P.2d 758, 770 (1949). *See also* Hiatt v. San Francisco Nat'l Bank, 361 F.2d 504 (9th Cir. 1966) (banks which operate under the laws of California not subject to any restriction on

B. Penalties for Usury

If a transaction is determined to be usurious, the lender may be subject to both civil and criminal sanctions. The statute provides that any usurious contract is void with respect to the obligation to pay interest and that the principal is not due until the expiration of the loan and cannot be accelerated as a result of a default in the payment of interest.[23] The obligation to pay principal, however, remains unaffected and the lender may enforce such obligation in accordance with its terms.[24] The extent of the remedies is affected by the type of action initiated by the lender or the borrower. If the borrower brings an action for money had and received, he may recover all interest paid on a usurious loan, not merely the usurious excess, but the recovery is subject to a two-year statute of limitations.[25] When the lender sues to enforce payment, the borrower may raise usury as a defense, and the statute of limitations does not preclude the borrower from offsetting *all* interest paid, thereby reducing the principal of the loan.[26] Because a claim of usury thus affects the total amount due the lender, a borrower often will be able to enjoin a foreclosure action or other attempted enforcement of liens on collateral until the validity of the usury claim is judicially determined.[27] Finally, the defense of usury may not be waived by the borrower at the time the loan is made, although a usury claim may be subsequently settled or compromised as any other claim.[28]

In addition to the foregoing remedies, a borrower may recover treble the amount of interest paid in the year preceding the action.[29]

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interest rates); Ury v. Jewelers Acceptance Corp., 227 Cal. App. 2d 11, 20, 38 Cal. Rptr. 376, 382 (1964) (legislature has imposed no maximum rate for banks).

23. Any agreement or contract of any nature in conflict with the provisions of this section shall be null and void *as to any agreement or stipulation therein contained to pay interest* and no action at law to recover interest in any sum shall be maintained and the debt can not be declared due until the full period of time it was contracted for has elapsed.

CAL. CIV. CODE § 1916-2 (West 1954) (emphasis added).

24. Harris v. Commercial Mortgage Co., 200 Cal. 609, 255 P. 805 (1927).

25. Stock v. Meek, 35 Cal. 2d 809, 221 P.2d 15 (1950).

26. *In re* Vehm Eng'r Corp., 521 F.2d 186 (9th Cir. 1975); Simmons v. Patrick, 211 Cal. App. 2d 383, 27 Cal. Rptr. 347 (1962); Shirley v. Britt, 152 Cal. App. 2d 666, 313 P.2d 875 (1957).

27. *See, e.g.*, Wheeler v. Superior Mortgage Co., 160 Cal. App. 2d 246, 325 P.2d 156 (1958); Middlekauf v. Vinson, 106 Cal. App. 2d 204, 234 P.2d 742 (1951).

28. Lamb v. Herndon, 97 Cal. App. 193, 275 P. 503 (1929). *See also* Kogan v. Bergman, 244 Cal. App. 2d 613, 53 Cal. Rptr. 371 (1966) (entirely new agreement which purges the old transaction of usury will be enforceable).

29. Every [borrower] who for any loan or forbearance of money, goods or things in action shall have paid or delivered any greater sum or value than is allowed to be received under the preceding sections . . . may . . . recover in an action at law

The recovery of treble interest is a cumulative remedy so that the borrower can recover treble the interest paid within one year of the commencement of the suit, plus actual interest paid prior to the year preceding the action and within two years of the suit.[30] Finally, the awarding of treble interest is always subject to the discretion of the court.[31]

A lender may also be subject to criminal sanctions as a result of making a usurious loan. The 1918 statute made it a misdemeanor to violate the Usury Law.[32] In 1970, however, this section of the Usury Law was amended by an initiative measure which provides that any person who willfully makes a loan with interest in excess of the maximum allowed by law may be guilty of "loan-sharking, a felony . . . punishable by imprisonment in the state prison for not more than five years or in the county jail for not more than one year."[33]

C. Recent Constitutional Challenge

Although the 1934 constitutional amendment was intended to make California's Usury Law more flexible,[34] it did not prove to be responsive to the rapid escalation of interest rates that occurred several times in the 1970's. Many institutional lenders, particularly those who engaged in substantial real estate lending activity, were *not* included in

> against the [lender] who shall have taken or received the same . . . treble the amount of money so paid . . . providing such action shall be brought within one year after such payment or delivery.

CAL. CIV. CODE § 1916-3(a) (West Supp. 1979). The recovery of treble interest is allowed only when the borrower has actually paid interest. Coulter v. Collins, 71 Cal. App. 381, 235 P. 465 (1925).

30. "It is settled that section 3 of the Usury Law providing for treble damages affords the borrower an additional remedy, in the nature of a penalty, which is cumulative to the other remedies for usury." Alston v. Goodwin, 174 Cal. App. 2d 16, 19, 343 P.2d 993, 995 (1959) (citations omitted). *See also* Taylor v. Budd, 217 Cal. 262, 18 P.2d 333 (1933).

31. CAL. CIV. CODE § 1916-3(a) (West Supp. 1979) states that a party *may* receive treble the interest paid. *See also* Burr v. Capital Reserve Corp., 71 Cal. 2d 983, 458 P.2d 185, 80 Cal. Rptr. 345 (1969) (granting of treble damages is discretionary with the trial court); McClung v. Saito, 4 Cal. App. 3d 143, 84 Cal. Rptr. 44 (1970). *But see* McConnell v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 21 Cal. 3d 365, 379, 578 P.2d 1375, 1383, 146 Cal. Rptr. 371, 379 (1978) (trial court does not exercise abstract discretion, but must base its ruling on facts of transaction at issue).

32. CAL. CIV. CODE § 1916-3 (West 1954).

33. *Id.* § 1916-3(b) (West Supp. 1979).

34. "[T]he only cure [to the problems created by the existing Usury Laws] is the enactment of a measure sufficiently flexible to permit the law's adjustment to the needs of various classes." Proposed Amendments to Constitution, Propositions and Proposed Laws to be Submitted to the Electors of the State of California at the General Election to be Held Tuesday, November 6, 1934, Together with Arguments Respecting the Same, at 18. (no opposing argument presented).

the list of exemptions. Life insurance companies, pension funds, non-California state-chartered banks,[35] real estate investment trusts, non-California savings and loan associations, and mortgage bankers were often excluded from the California market when rates exceeded 10% per annum.[36] These circumstances led many of these lenders to challenge the constitutionality of California's Usury Law on the basis that the exemption of some lenders and not others constituted a denial of equal protection and that the California Usury Law operated to create an undue burden on interstate commerce, thereby violating both the equal protection clause[37] and the commerce clause[38] of the United States Constitution. In *Committee Against Unfair Interest Limitations v. State*,[39] the Los Angeles Superior Court upheld the plaintiffs' contentions with respect to commercial loans but concluded that the Usury Law did not violate the United States Constitution with respect to consumer loans. However, the court stayed the effect of its decision pending final result on appeal.[40] All parties appealed[41] and the plaintiffs subsequently filed a petition for hearing with the California Supreme Court. Following the enactment of Proposition 2, and at the request of plaintiffs, the supreme court granted a hearing and dismissed the appeal as moot.[42]

The California Supreme Court's dismissal of the *Committee* case technically leaves standing the original trial court decision, and thus the question arises whether the constitutional arguments raised in that case have any continued validity.[43] The weight of authority in Califor-

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35. *But see* Sondeno v. Union Commerce Bank, 71 Cal. App. 3d 391, 139 Cal. Rptr. 299 (1977) (Ohio state chartered bank held to be a "bank" under "Bank Act" within the meaning of the Usury Law and thus an exempt lender for purposes of certain real estate loans).

36. *See generally* Curotto, *supra* note 5.

37. U.S. CONST. amend. XIV, § 1.

38. *Id.* art. I, § 8.

39. No. C-158433 (Cal. Super. Ct., L.A. County, Feb. 6, 1978).

40. The trial court judgment held that the decision was "prospective only" and "shall have no effect" until an "appeal [is] taken and decided and remittitur filed in this Court." *Id.*

41. On August 2, 1979, the court of appeal reversed the decision of the trial court and upheld the constitutionality of the California Usury Law. 95 Cal. App. 3d 801, 157 Cal. Rptr. 543 (1979).

42. No. 31194 (Cal. Sup. Ct., Nov. 29, 1979) (hearing granted and appeal dismissed as moot). The granting of a petition for hearing automatically vests jurisdiction in the California Supreme Court; thus, the court of appeal opinion is a nullity and will be excised from the official reports. Knouse v. Nimocks, 8 Cal. 2d 482, 66 P.2d 438 (1937).

43. Although the trial court decision is apparently now effective, it should not be binding on borrowers who were not parties to the litigation and it should, therefore, have little practical effect.

nia and elsewhere supports the constitutionality of usury laws[44] and the changes made by Proposition 2 would not seem to add any new constitutional issues. However, the passage of Proposition 2 may not have rendered all of the issues in the *Committee* case moot, although the motivation for a major constitutional challenge may have diminished. Interest rates remain at extraordinarily high levels and nonexempt lenders continue to face questions with respect to the effect of the California Usury Law on their lending activity.[45] Nevertheless, it seems likely that Proposition 2 would survive a constitutional challenge of the type presented in the *Committee* case.

II. CHANGES MADE BY PROPOSITION 2

Proposition 2 amends California's Usury Law in several important respects. First, it distinguishes between loans[46] and forbearances[47] made for "personal, family, or household purposes" and all other loans and forbearances. With respect to loans made by nonexempt lenders

44. *See, e.g.*, Griffith v. Connecticut, 218 U.S. 563 (1910) (state may properly establish classes that are exempt from its usury laws); Carter v. Seaboard Fin. Co., 33 Cal. 2d 564, 203 P.2d 758 (1949) (equal protection clause does not prevent the legislature from classifying loans according to size). Recent changes in usury laws have been upheld in several other states. *See, e.g.*, Cesary v. Second Nat'l Bank, 369 So. 2d 917 (Fla. 1979); State v. Spiegel, Inc., 277 N.W.2d 298 (S.D. Sup. Ct.), *appeal dismissed*, 100 S. Ct. 25 (1979).

45. These problems are not unique to California. Usury laws have caused problems in many states, particularly with respect to the financing of the construction and purchase of residential real property. As a result, Congress has enacted several laws which preempt state usury laws with respect to certain transactions. The most recent enactment (and the most significant) is the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 [hereinafter cited as the Depository Institutions Act]. The Act became effective on April 1, 1980 and is discussed in Section V *infra*. For other recent federal legislation that preempts state usury laws with respect to certain loans, see, *e.g.*, Act of Dec. 28, 1979, Pub. L. No, 96-161, 93 Stat. 1233 (similar in many respects to and partially repealed by Pub. L. No. 96-221, 94 Stat. 161); Act of Dec. 21, 1979, Pub. L. No. 96-153, 93 Stat. 1101 (preempts state usury laws with respect to loans insured under Titles I and II of the National Housing Act); Veterans Disability Compensation and Survivors Benefits Amendments of 1979, Pub. L. No. 96-128, 93 Stat. 982 (preempts state usury laws with respect to certain VA loans); Act of Oct. 29, 1974, Pub. L. No. 93-501, 88 Stat. 1557 (commonly known as the "Brock Bill" (expired July 1, 1977) and similar in many respects to Pub. L. No. 96-161, 93 Stat. 1233); Veterans Housing Amendments Act of 1976, Pub. L. No. 94-324, 90 Stat. 720 (preempts state usury laws with respect to certain FHA and VA loans).

46. A loan is a "contract by which one delivers a sum of money to another, and the latter agrees to return at a future time a sum equivalent to that which he borrowed." CAL. CIV. CODE § 1912 (West 1954).

47. A forbearance is "the act by which a creditor waits for the payment of a debt due him by the debtor after it has become due." Eisenberg v. Greene, 175 Cal. App. 2d 326, 330, 346 P.2d 60, 63 (1959) (citing Murphy v. Agen, 92 Cal. App. 468, 469, 268 P. 480, 481 (1928)).

for personal, family, or household purposes, the maximum permissible rate of interest for written contracts remains at 10% per annum. The maximum permissible rate of interest on all other loans, however, is the higher of 10% per annum or 5% per annum over the rate established by the Federal Reserve Bank of San Francisco on advances to member banks (the "discount rate"). Second, Proposition 2 adds two additional exemptions: (1) loans made or arranged by licensed real estate brokers and secured in whole or in part by liens on real property and (2) successors in interest to exempt loans or forbearances. Third, Proposition 2 expressly grants to the legislature the power to designate additional classes of exempt lenders.[48] Finally, Proposition 2 expressly exempts the "obligations" of exempt lenders from the restrictions of the Usury Law. These changes are discussed in detail below.

A. Personal Loans

As noted above, Proposition 2 provides that the maximum permissible rate of interest on any loan or forbearance of money, goods, or things in action is 10% per annum if the money, goods, or things in action "are for use primarily for personal, family, or household purposes" (referred to herein as "personal loans").[49] Proposition 2 does not define these terms but does state that loans or forbearances, the proceeds of which "are used primarily for the purchase, construction or improvement of real property,"[50] are *not* to be deemed primarily for "personal, family, or household purposes." Although there is no fur-

48. Proposition 2 provides that "any other class of persons authorized by statute" may be exempted from its restrictions. *See* Appendix to this article. This provision will permit additional exemptions to be added by legislative action whereas formerly such action could only be effected through an amendment to the California Constitution. Pursuant to this authority, a bill has been introduced into the legislature to confirm that federal savings and loan associations are exempt lenders for purposes of California Usury Law. See note 13 *supra*. It would not appear, however, that the authority granted by Proposition 2 is broad enough to permit the legislature to make many other changes in the California Usury Law. Thus, many of the problems and ambiguities of Proposition 2 discussed in this article may not be susceptible to legislative resolution or clarification.

49. *See* Appendix to this article. Although the legislative history of Proposition 2 does not contain any definition of "primarily," it would appear that at least 51% of the proceeds must be intended to be used for the designated purposes. *See* Bosko & Larmore, *supra* note 10.

50. *See* Appendix to this article. The maximum permissible interest rate on loans or forbearances made for the purchase, construction, or improvement of real property (which should include most conventional home mortgage loans) will then be the greater of 10% per annum or 5% per annum over the federal discount rate. It should be noted, however, that included in this exclusion are only those loans the proceeds of which are used for the stated purposes; the mere fact that a loan is secured by residential or other real property does not appear to be sufficient to bring it within the terms of the exclusion. Similarly, a loan the

ther clarification in Proposition 2 of what constitutes a personal loan, other California statutes with similar language and purpose have consistently used the phrase "for use primarily for personal, family, or household purposes" to designate consumer transactions and to exclude thereby business or commercial transactions.[51]

As a general matter, most personal loans will be readily identifiable and lenders will need to be concerned about the possibility of making personal loans only when the borrowers are individuals, because it is doubtful that corporations, partnerships, or similar institutional borrowers would use the proceeds for "personal, family, or household purposes."[52] Difficulties in characterization may arise with respect to loans which are made to individuals for investment purposes. Some California authority suggests that the use of loan proceeds by an individual for investment purposes will probably not be considered a personal loan within the meaning of Proposition 2.[53]

The language of Proposition 2 provides that if the loan proceeds "are *for use* primarily" for personal purposes the maximum permissible rate is 10% per annum. Although this language varies somewhat from the language of the exception relating to certain real property loans, which language states that such loans are not personal loans if the proceeds "are *used* primarily for" the purchase, construction, or improvement of real property, it seems unlikely that the legislature intended

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proceeds of which are used to refinance an existing loan secured by real property would apparently not be entitled to the higher rate.

51. *See, e.g.*, CAL. BUS. & PROF. CODE § 302 (West Supp. 1979); CAL. CIV. CODE § 1802.1 (West 1973); CAL. COM. CODE § 9109(1) (West Supp. 1979). *See also* Morgan v. Reasor Corp., 69 Cal. 2d 881, 447 P.2d 638, 73 Cal. Rptr. 3 (1968); James Talcott, Inc. v. Gee, 266 Cal. App. 2d 384, 72 Cal. Rptr. 168 (1968); Fed. Res. Bd. Reg. Z, 12 C.F.R. § 226 (1979). This is consistent with the arguments in favor of Proposition 2 and the analysis prepared by the legislative analyst contained in the Ballot Pamphlet which refer to nonpersonal loans as "nonconsumer" and as being for the purposes of "financing business activity." California Ballot Pamphlet (Nov. 6, 1979).

52. The Consumer Affairs Act, for example, expressly provides that only individuals may be "consumers" within the meaning of that Act. CAL. BUS. & PROF. CODE § 302(c) (West Supp. 1979). *But see* Bosko & Larmore, *supra* note 10 (purpose for which proceeds are to be used controls, rather than nature of borrower).

53. *See* Cessna Fin. Corp. v. Pivo, 58 Cal. App. 3d 281, 129 Cal. Rptr. 888 (1976) (individuals who purchased airplanes for rental to third parties are not consumers within meaning of Unruh Act, CAL. CIV. CODE §§ 1801-1812.10 (West 1973 & Supp. 1979)). Similar conclusions have been reached by federal courts with respect to the Federal Truth in Lending Act, 15 U.S.C.A. § 1601-1667e (West 1974 & Supp. 1979). *See* Puckett v. Georgia Homes, Inc., 369 F. Supp. 614, 618-19 (D.S.C. 1974); Adema v. Great N. Dev. Co., 374 F. Supp. 318, 319-20 (N.D. Ga. 1973). However, loans for investment purposes may not be "business" loans within the meaning of § 511 of the Depository Institutions Act. See note 292 *infra* and accompanying text.

that actual use control with respect to real property loans. Instead, it seems probable that all loans under Proposition 2 should be characterized as personal or nonpersonal in accordance with the intended use of the proceeds at the time such loans are made, rather than by what later proves to be the actual use. If the rule were otherwise, it could create confusion and uncertainty with respect to the validity of the transaction: lenders would be required to monitor the loan for subsequent changes in use, and borrowers could attempt to change the use in order to undermine the validity of the transaction and create a defense to payment. These considerations have led at least one California court to conclude that, for Uniform Commerical Code purposes, the intended use at the time of sale rather than any actual later use controls the designation of goods as consumer or nonconsumer.[54] The conclusion that the intended, rather than the actual, use of the loan proceeds should control for purposes of Proposition 2 is also supported by the principle that if a loan is otherwise valid at its inception, subsequent voluntary actions by the debtor will not render the loan usurious.[55]

Because the intended use of the loan proceeds will determine whether any particular loan is a personal loan, it is probably advisable for a lender to obtain an express representation from the borrower as to the intended use of the proceeds and an agreement not to use the proceeds for any other purpose. Such statements may be easily incorporated into loan application forms or other documents if not already included on forms currently in use. In the absence of facts which may put the lender on notice to the contrary, a lender should be justified in relying on the borrower's statement as to the intended use of the proceeds.[56]

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54. *See* Cessna Fin. Corp. v. Pivo, 58 Cal. App. 3d 281, 129 Cal. Rptr. 888 (1976). The weight of authority in other jurisdictions appears to be in accord with this conclusion. *See* Annot., 77 A.L.R.3d 1225 (1977). However, the Federal Reserve Board appears to have taken the position that, with respect to the Truth in Lending Act, actual use of the proceeds controls. Fed. Res. Bd. Letter by Frederic Solomon (Mar. 14, 1969), CONS. CRED. GUIDE (CCH) ¶ 30,026, at 66,014 (1974). *See also* CAL. COM. CODE § 9401(3) (West Supp. 1979).

55. *See, e.g.*, Sharp v. Mortgage Sec. Corp., 215 Cal. 287, 9 P.2d 819 (1932); First Am. Title Ins. & Trust Co. v. Cook, 12 Cal. App. 3d 592, 90 Cal. Rptr. 645 (1970); Penzer v. Foster, 170 Cal. App. 2d 106, 338 P.2d 533 (1959); Pacific Fin. Corp. v. Crane, 131 Cal. App. 2d 399, 280 P.2d 590 (1959).

56. Estoppel is a defense to a charge of usury when the borrower acts fraudulently or when the lender reasonably relies on the borrower's representations that the transaction is not usurious. *See, e.g.*, Lakeview Meadows Ranch v. Bintliff, 36 Cal. App. 3d 418, 111 Cal. Rptr. 414 (1973); Buck v. Dahlgren, 23 Cal. App. 3d 779, 99 Cal. Rptr. 858 (1972).

B. Nonpersonal Loans

1. Determination of Rate-Setting Date

The maximum permissible interest rate under Proposition 2 for nonpersonal[57] loans is established as the greater of 10% per annum or 5% per annum over the discount rate[58] of the Federal Reserve Bank of San Francisco prevailing on the 25th day of the month preceding the earlier of (1) the date of execution of the contract to make the loan or forbearance or (2) the date of making the loan.[59] The purpose of this language appears to be to enable lenders (particularly real estate lenders) to determine the rate at the time a commitment is issued rather than at the time of funding, which may be months or even years later. Consequently, the parties are permitted to establish the rate at the time the contract is executed even though the discount rate may change prior to the funding of the loan.

This language, however, gives rise to a number of questions: Which document is the "contract" to make the loan? What is the relevant date of execution? If there is no prior agreement, what is the date of the making of the loan?[60] Real estate and commercial loan transac-

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57. As used herein, the term "nonpersonal loan" means any loan that is not for "personal, family, or household purposes," which, as a practical matter, includes most real estate loans and all business and commercial loans.

58. The language of Proposition 2 refers to "the rate . . . established by the Federal Reserve Bank of San Francisco on advances to member banks under Sections 13 and 13a of the Federal Reserve Act." Although historically the rates have been the same, §§ 13 and 13a do permit the establishment of different rates for different transactions. If different rates are established, Proposition 2 provides that the California Superintendent of Banks or such other person or agency as is designated by the legislature shall designate the appropriate rate for purposes of Proposition 2. *See* Appendix. On March 17, 1980, the Federal Reserve Board established a 3% surcharge applicable in certain circumstances to advances and discounts under §§ 13 and 13a to member banks having deposits of $500 million or more. It would not seem, however, that such surcharge should be included in the discount rate for California usury purposes unless the Superintendent of Banks so designates. However, the surcharge is included in determining the effective rate under the recent federal legislation preempting state usury laws. *See* notes 45 *supra* and 286 *infra*.

59. In the event that the 25th day of the preceding month is not a business day, it would appear that the appropriate rate may nonetheless be easily determined by reference to the rate prevailing at the close of business on the next preceding business day, since the discount rate changes only as the result of affirmative action taken by the Federal Reserve Bank. Until changed, therefore, the last rate set is the "prevailing" rate. The discount rate is published by the Federal Reserve Bank in a publication entitled "Circular 6" which is updated from time to time when the rate changes by a publication entitled "Supplement 1 to Circular 6." Copies of such publications may be obtained on a regular or an individual basis from the Federal Reserve Bank.

60. These questions, however, may have little practical significance for loan transactions in which all relevant events took place in the calendar month since the rate-setting date is the 25th day of the preceding month. It may also be expected that often there will be only

tions often involve loan applications, commitment letters, loan agreements, escrow instructions, promissory notes, and security documents, all of which may bear different dates or be signed by the parties on different dates. Which of these documents is the "contract" to make the loan, and how is the relevant date of execution to be determined?

In transactions involving multiple documents, the determination of which document is the "contract" to make the loan would appear to depend on the intent of the parties as to when a binding contract arises.[61] If a loan application is "accepted" by a lender, a contract may arise on the date of such acceptance. On the other hand, many real estate lenders respond to a loan application by issuing a "commitment letter" that incorporates the loan application but often adds additional terms or detail.[62] Sometimes the parties may contemplate the preparation of a loan agreement even though their negotiations have included the preparation of commitment letters or other correspondence. If the parties intend that their negotiations and agreements be incorporated into a formal written loan agreement before either party is bound, a contract should not arise until the definitive loan agreement is executed.[63] Subsequent documents, such as escrow instructions, promissory notes, and security instruments, which do not relate to the creation of the contract but which relate instead to its performance, should not be controlling. Thus, it would appear that the relevant rate-setting date for purposes of Proposition 2 should be determined by the date of execution of the first document which creates a binding agreement.[64] The

one agreement governing the parties' rights, so there will be no need to be concerned about which document is the contract to make the loan.

61. CAL. CIV. CODE § 1912 (West 1954) defines a loan of money as a "contract by which one delivers a sum of money to another, and the latter agrees to return at a future time a sum equivalent to that which he borrowed." This definition indicates that a loan is a "contract" but it also states that such contract is one in which the lender "delivers" money to the borrower. Thus it does not appear to distinguish between an executory contract to make a loan and the actual funding of the loan.

62. In the event the loan commitment letter is incomplete or lacks sufficient detail with respect to material terms, it may not create a binding contract. *See, e.g.*, Laks v. Coast Fed. Sav. & Loan Ass'n, 60 Cal. App. 3d 885, 131 Cal. Rptr. 836 (1976).

63. *See, e.g.*, Grove v. Grove Valve Regulator Co., 4 Cal. App. 3d 299, 84 Cal. Rptr. 300 (1970); Stephan v. Maloof, 274 Cal. App. 2d 843, 79 Cal. Rptr. 461 (1969); Louis Lesser Enterprises, Ltd. v. Roeder, 209 Cal. App. 2d 401, 25 Cal. Rptr. 917 (1962); Woodard v. Schwartz, 181 Cal. App. 2d 360, 5 Cal. Rptr. 231 (1960).

64. A loan commitment may often be analyzed as an option, since it typically lacks an undertaking by the debtor to borrow the money. *See, e.g.*, Lowe v. Massachusetts Mut. Life Ins. Co., 54 Cal. App. 3d 718, 127 Cal. Rptr. 23 (1976); Torlai v. Lee, 270 Cal. App. 2d 854, 76 Cal. Rptr. 239 (1969). However, for purposes of Proposition 2, it would seem that the relevant rate-setting date should be determined by the date upon which the *lender* is bound, even though the borrower may be free to look elsewhere if he chooses.

parties, however, should not leave such matters to chance; instead, they should expressly state which document is intended to be the "contract" to make the loan.

With respect to determining the date of execution of the contract to make the loan, California law states that "execution" means not only "subscribing" it but also delivering it to all persons for whose benefit it is made. It is not effective until it has been delivered.[65] The date of execution, therefore, should be the date on which it becomes "effective," *i.e.*, the date upon which the final delivery takes place.[66] If a commitment is intended to be effective (*i.e.*, binding on the lender) when accepted by the borrower, the relevant rate-setting date should be the date upon which the borrower communicates his acceptance to the lender.[67] On the other hand, if the formation of the contract is subject to some condition precedent, such as the payment of a commitment fee, the relevant date should be the date upon which such condition is satisfied.

A more difficult question is to what extent may the parties control the rate-setting date by agreement? May they agree that their documents are effective "as of" a certain date? May they control the rate-setting date by controlling the date upon which "delivery" is deemed to take place?[68] May they specify the date of funding to be the relevant rate-setting date notwithstanding the prior execution of a written commitment? This may be particularly important with respect to loans that may not be funded for months or years after the date of execution of the commitment. Some institutional lenders, such as life insurance companies and pension funds, who typically make long term, fixed rate

65. CAL. CIV. CODE § 1626 (West 1973); CAL. CIV. PROC. CODE § 1933 (West 1955).

66. This may create some uncertainty for the parties if the maximum permissible rate changes after the issuance of the commitment but prior to the "effective date" of the contract. Consequently, lenders may wish to specify that commitments will be accepted in the same calendar month they were issued, or otherwise control the manner and the time in which commitments are accepted.

67. It seems likely that the word "execution" in Proposition 2 is intended to be equivalent to the concept of "acceptance" under contract law. Normally, acceptance of an offer must be communicated to the offeror by mail or otherwise in order to be effective. *See generally* A. CORBIN, CORBIN ON CONTRACTS § 67 (one vol. ed. 1952) [hereinafter cited as CORBIN]. If a commitment letter is viewed as an offer to make a loan, the relevant rate-setting date should be determined by the date the acceptance is communicated to the lender. On the other hand, the commitment letter may specify the manner in which acceptance is to be made, such as by the payment of a commitment fee and the delivery of an executed copy of the letter to the lender.

68. The concept of delivery normally requires both an act plus an appropriate intent. *See generally* CORBIN, *supra* note 67, at § 244. Thus, the parties may be able to control the effective date of their agreement by depositing documents in an escrow or by stipulating that they intend the agreement to be deemed delivered and effective "as of" a specified date.

loans on improved real property, may desire to use the earlier date as the rate-setting date. On the other hand, other institutional lenders, such as banks and savings and loan associations, who make short term, variable interest rate construction or commercial loans, may desire to use the funding date as the rate-setting date. Are the parties free to select the relevant rate-setting date by mutual agreement?

For lenders, borrowers, and their respective counsel, who have long struggled with an inflexible 10% maximum rate, it is tempting to believe that the floating maximum rate concept inherent in Proposition 2 evidences a general flexibility with respect to the selection of the relevant rate-setting date. A close reading of Proposition 2, however, demonstrates that such flexibility is probably illusory: the language quite clearly refers to the "earlier of" the date of execution or the date of funding. Nevertheless, there are some possible contrary arguments. In *McConnell v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[69] decided prior to the enactment of Proposition 2, the court stated that the parties could "reasonably agree" that the margin account loans there involved would bear interest "at a rate which varies in unison with the call-money rate," *i.e.*, the rate at which Merrill Lynch itself borrows money, and concluded that such agreements may not violate the Usury Law if entered into in good faith.[70] Proposition 2 clearly permits the parties to use the funding date as the rate-setting date in instances when no prior written agreement has been executed and it is hard to see why the rule for written contracts should be more restrictive, especially if the loan commitment requires the contract rate to change in an identical manner with increases or decreases in the maximum permitted rate[71] and if the commitment is also structured as an option so that the borrower is not required to borrow if rates increase.[72] In addition, the parties could perhaps argue that the date of "execution" referred to in Proposition 2 means the date upon which the contract becomes "effective" and that the contract is not "effective" until the occurrence of some predetermined event (such as funding) or until the occurrence of a specified "as of" date. These arguments, however, may create ambiguities with respect to whether the parties are bound prior to the occurrence of such events and they seem to ignore the express language of Proposition 2,

69. 21 Cal. 3d 365, 578 P.2d 1375, 146 Cal. Rptr. 371 (1978).

70. *Id.* at 378, 578 P.2d at 1382, 146 Cal. Rptr. at 378.

71. This is consistent with the policy suggested by CAL. CIV. CODE § 1916.5 (West Supp. 1979) relating to variable interest rate loans to finance the purchase or construction of real property containing four or fewer residential units. *See also* McConnell v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 21 Cal. 3d 365, 578 P.2d 1375, 146 Cal. Rptr. 371 (1978).

72. *See* note 64 *supra*.

which refers to the "earlier of" such dates and which, therefore, probably does not permit such flexibility.[73]

2. Fixed Rate and Variable Rate Loans

Once the relevant rate-setting date is determined, Proposition 2 provides that the maximum permissible rate for nonpersonal loans will be the higher of 10% per annum or 5% per annum over the discount rate "prevailing on the 25th day of the month preceding" such date. This formula suggests that with respect to any particular loan there is a single point in time at which the maximum permissible rate will be established and that, once established, such rate will prevail for the term of the loan, even though a subsequent decrease in the discount rate may produce a maximum rate less than the contract rate. This means that lenders are protected against a subsequent decline in the maximum permissible rate[74] but that they are similarly unable to take advantage of a subsequent increase.

Interpreting the language of Proposition 2 as requiring a single, fixed maximum rate should not cause any conceptual difficulties with respect to fixed rate loans or to variable rate loans which limit the contract rate to such maximum rate. Such an interpretation, however, raises some questions with respect to variable interest rate loans in which the parties desire to provide for a "floating" maximum rate, *i.e.*, a rate that would be limited to the maximum rate permissible from time to time under Proposition 2. The prior discussion considered whether the parties should be permitted to control the rate-setting date by agreement prior to the funding of the loan and pointed out that Proposition 2 probably does not permit such flexibility.[75] Here the question arises again: To what extent does Proposition 2 permit the parties to control such matters in their agreements *after* funding the loan?

Initially, it seems difficult to avoid the conclusion that the express language of Proposition 2 requires the determination of a single, fixed

73. This language should be contrasted with the language of the Depository Institutions Act which refers to loans "made" after March 31, 1980. Because federal law preempts state usury laws only if such laws would require a lower rate, the parties should be able to agree to a loan that bears interest at a rate that does not exceed the greater of the rate permitted on the date of the commitment or the date of making of the loan. *See* notes 294-301 *infra* and accompanying text.

74. This is consistent with existing law. *See, e.g.*, *In re* Zemansky, 39 F. Supp. 628 (S.D. Cal. 1941); First Am. Title & Trust Co. v. Cook, 12 Cal. App. 3d 592, 90 Cal. Rptr. 645 (1970); Cambridge Dev. Co. v. United States Fin., 11 Cal. App. 3d 1025, 90 Cal. Rptr. 333 (1970).

75. *See* notes 68-72 *supra* and accompanying text.

rate and that such rate is effective for the entire term of the loan.[76] This conclusion has the virtue of not only being simple and easy to apply but also being consistent with the express language of Proposition 2, which states that the maximum rate is "the rate prevailing on the 25th day of the month preceding" the rate-setting date. On the other hand, one is again tempted to invent interpretations of Proposition 2 that seem more consistent with its implicit purpose of providing a flexible usury law. Because the maximum rate permitted by Proposition 2 for new loans varies from time to time, there seems to be no compelling policy reason why the parties should not be permitted to agree to a contract rate that varies directly with changes in the maximum permitted rate.[77] In *McConnell v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*,[78] the court considered how to apply the then fixed 10% limit in the Usury Law to open ended, variable rate margin account agreements. It distinguished the rules applicable to fixed rate loans and stated that the question was "whether an agreement which provides for variable interest which under some contingencies may exceed the constitutional limit is usurious."[79] The court noted that the majority of decisions "uphold the legality" of variable interest agreements if the transactions are consummated in good faith without intent to avoid the usury laws and concluded that "[t]he recognition of the right of the parties to contract in good faith for a variable-interest rate, even though such a rate may at times exceed the constitutional maximum, not only finds support in the weight of authority but also in practical good sense."[80]

Variable interest rate loans present at least three distinct conceptual problems: (1) whether a variable rate loan is usurious at its inception merely because the contract by its terms does not limit the amount of interest to be charged and, therefore, the *possibility* of usury exists; (2) whether a variable rate loan is usurious merely because the contract rate may exceed the maximum permitted rate from time to time even though the *average* interest rate never exceeds the maximum rate (a concept often referred to as "spreading"); and (3) whether a variable rate loan is usurious even if the average interest rate ultimately *exceeds* the maximum rate if the parties contracted in good faith and without intent to violate the Usury Law. The contract in *McConnell* did not

76. Under this interpretation, it would appear advisable for parties entering into variable rate loans to acknowledge such upper limit by incorporating a provision in their loan documents that would expressly limit the contract interest to such maximum rate.

77. *See* note 71 *supra*.

78. 21 Cal. 3d 365, 578 P.2d 1375, 146 Cal. Rptr. 371 (1978).

79. *Id.* at 377, 578 P.2d at 1382, 146 Cal. Rptr. at 378.

80. *Id.* at 377-78, 578 P.2d at 1382, 146 Cal. Rptr. at 378.

contain any provision limiting the amount of interest that could be charged—a fact which apparently troubled the court and influenced its decision.[81] The court in *McConnell* implicitly held that a contract is not usurious merely because no maximum interest rate is set forth in the loan agreement. It refused, however, to use the mathematical average of the interest charged over the term of the loan, stating:

> The present case is quite different from those decisions which established the general rule that interest should be averaged over the full term of the loan; indeed, in the present context such a rule would prove unworkable. Plaintiffs' margin account contemplates a credit arrangement of variable interest, of indefinite duration, and fluctuating balance. If interest were to be averaged over the full term of the loan, there would be no way to determine whether an existing credit arrangement were lawful or not; that issue could not be resolved until the account were closed, and either debtor or creditor by choosing the right moment to close the account could cause the interest over the term to exceed lawful rates.
>
> As *Arneill Ranch* explained (see 64 Cal. App. 3d at p. 293), when an agreement provides for a variable-interest rate, no agreed total profit to the lender can be averaged over the entire period of the loan. Under such circumstances, *the interest payable for each portion of the loan term is the compensation to the lender for his forbearance from requiring immediate payment of the principal sum during that specific portion of the term*. Thus the fact that the *average* interest charge on a variable-rate loan does not exceed the maximum rate is not in itself sufficient to establish that the loan complies with the usury laws if the interest charged for a particular period of forbearance exceeds the legal limit.[82]

Thus, the *McConnell* court resolved this apparent difficulty in determining the validity of the interest payable on a variable rate loan by concluding that each period of time for which the interest rate was ad-

81. As the *McConnell* dissent pointed out, it is difficult to conceive how a loan in which the average interest rate *never* exceeded the maximum rate could be usurious. *Id.* at 384, 578 P.2d at 1386, 146 Cal. Rptr. at 382 (Clark, J., dissenting). It was stipulated in *McConnell* that the average interest rate never exceeded the legal maximum and thus the majority opinion's resort to a subjective "good faith" test, rather than a mathematical test, is troubling even though the majority also seems to suggest that the average interest rate could exceed the maximum rate without violating the usury laws, if the parties contracted with the requisite good faith. *Id.* at 377, 578 P.2d at 1382, 146 Cal. Rptr. at 378.

82. *Id.* at 376-77, 578 P.2d at 1381-82, 146 Cal. Rptr. at 377-78 (emphasis added).

justed produced a separate term of forbearance.[83] This rationale, that an adjustment in the interest rate triggers a new period of forbearance, suggests that the parties to a variable rate loan may be able to specify in their agreement that a new maximum rate should be applicable to each such forbearance. Proposition 2 rejects the inflexibility of the fixed maximum rate of 10% per annum, which had prevailed irrespective of the rates existing in money markets from time to time, and establishes a "floating" maximum rate responsive to changes in the cost of funds to commercial banks. These rates primarily reflect national monetary policy and are thus clearly outside the control of both lender and borrower, a factor which the court in *McConnell* found to be significant.[84] Nevertheless, even if each change in the interest rate produces a new period of forbearance, the express language of Proposition 2 suggests that all such "forbearances" may arise under a single "contract" previously executed that incorporates a single, maximum rate.

In summary, *McConnell* indicates that the mere absence of a "cap" limiting the interest charged to the maximum rate permitted by law will not render a loan usurious if excessive interest is not actually charged or collected. In addition, *McConnell* should not be interpreted as disapproving the "spreading" concept, at least when the parties expressly state in their agreement that the interest charged and collected on amounts outstanding during the term of the loan is limited to the maximum amount permitted by law. On the other hand, in the absence of such a limitation, or in instances in which the interest collected over the term of the loan actually exceeds the maximum permitted rate, *McConnell's* reliance on a "good faith" test is not likely to provide a satisfac-

83. *Id.* at 378, 578 P.2d at 1382, 146 Cal. Rptr. at 378. This analysis relies on the decision in Arneill Ranch v. Petit, 64 Cal. App. 3d 277, 134 Cal. Rptr. 456 (1976). Several commentators have expressed some difficulty with the logic of both the *Arneill* and *McConnell* opinions to the extent such opinions rely on the "contingent interest" rule and also conclude that each change in the rate produces a separate period of forbearance. *See* Comment, McConnell v. Merrill Lynch, Pierce, Fenner & Smith, Inc.: *Variable Rate Loans Under California's Usury Law*, 67 CALIF. L. REV. 621 (1979); Comment, McConnell v. Merrill Lynch, Pierce, Fenner & Smith, Inc.: *New Tests for Variable-Interest Rate Loans*, 30 HASTINGS L.J. 1843 (1979). The better rule appears to be that the parties should be able to designate by contract the period of forbearance and the rate to be charged therefore and so long as the cumulative, aggregate interest charged on the outstanding balance for such term never exceeds the maximum permissible rate, the transaction should be free of usury even though the per diem rate may, at times, exceed the maximum rate. In *McConnell* and *Arneill*, the parties failed to specify contractually the period of forbearance or to limit the interest charged and the court's analysis appears to be an effort to resolve that uncertainty. Consequently, if the parties specify such matters in their agreements, *McConnell* and *Arneill* should not be controlling.

84. 21 Cal. 3d at 378, 578 P.2d at 1382, 146 Cal. Rptr. at 378.

tory answer to such questions. Consequently the parties should include in their loan documents a provision that expressly provides for "spreading" and limits the interest to be charged over the term of the loan to the maximum rate permitted, as determined by the applicable rate-setting date under Proposition 2.

3. Additional Advances and Amendments

Similar questions are raised with respect to loans that contemplate multiple advances and loans that may be subsequently amended or modified. With respect to loans contemplating multiple advances, may the parties agree that the rate for each advance will be determined at the time of each funding, even though all advances will be made pursuant to a single contract executed prior to the initial funding? Does it make any difference if the advances are optional rather than obligatory?

Although there do not appear to be any precedents directly on point, some general observations may be made. First, subsequent *obligatory* advances should probably be analyzed in the same manner as variable rate loans. Although there appears to be no compelling policy reason for prohibiting the parties from designating each advance as a separate loan and selecting the funding date for each advance as the relevant rate-setting date, each such advance is likely to be made pursuant to a single contract. Consequently, such agreements may be at variance with the express language of Proposition 2, which requires that one rate be established at the "earlier of" the funding or the execution of the contract to make the loan.

Second, loans involving subsequent *optional* advances may present a much easier problem because, by definition, there is not likely to be any prior "contract" to make such advances. Consequently, the parties should be able to agree that each such advance is a new loan and that the funding date (or the date upon which the lender agrees to make such advances) is the relevant rate-setting date. This rationale should also apply when the parties mutually agree at some later date to amend or modify the terms of the loan. If the parties desire to adjust the rate in connection with a subsequent amendment or modification to the loan, they should be permitted to do so by selecting the effective date of the amendment as the relevant rate-setting date. Conservative lawyers, however, are likely to insist that such transactions be structured as a refinancing of the existing indebtedness to remove all doubt whether there exists a subsequent "contract" to make a loan or forbearance that has been executed after the effective date of Proposition 2.[85] So long as there exists adequate consideration[86] for such an agreement, it should constitute a subsequent "contract" for a "forbearance" within the meaning of Proposition 2 thereby permitting the parties to adjust the interest rate to the then permitted maximum interest rate.[87]

C. Obligations of Exempt Entities

Proposition 2 modifies the language of former section 1 of article 15 of the California Constitution with respect to the exemptions contained therein by providing that "none of the above restrictions shall apply to any *obligations of*, loans made by, or forbearances of, any" of the enumerated exempted entities.[88] Former section 1 simply provided that "none of the above restrictions shall apply to any" of the enumerated exempted entities. The prior formulation was arguably ambiguous as to whether the enumerated entities were exempt solely in their capacity as lenders or whether they were also exempt in their capacity as borrowers. The possible ambiguity caused some concern among financial institutions as to its effect on certificates of deposit or other debt instruments issued when market conditions required rates in excess of 10% per annum.[89] Assuming, *arguendo*, that such certificates of deposit are "loans or forbearances" within the meaning of Proposition 2, the addition of the phrase "obligations of" appears to make it clear that any obligation issued by an exempted financial institution, including a certificate of deposit or other debt security, is not subject to the Usury Law.[90] In addition, the Depository Institutions Act specifically

85. *See, e.g.*, Lakeview Meadows Ranch v. Bintliff, 36 Cal. App. 3d 418, 111 Cal. Rptr. 414 (1973); Brown v. Cardoza, 67 Cal. App. 2d 187, 153 P.2d 767 (1944).

86. Examples of such consideration might include the advancement of additional funds, the extension of the maturity date, a change in the amortization rate, or modification of other material covenants in the agreement.

87. Similar questions arise under the Depository Institutions Act. See notes 282-283 *infra* and accompanying text.

88. *See* Appendix (emphasis added).

89. In 1974, during a period in which interest rates on certificates of deposit were in excess of 10%, Congress made any possible problem moot by enacting preemptive legislation which in essence prohibited banks, savings and loan associations and their affiliates from raising the defense of usury with respect to such obligations. This legislation was commonly known as the "Brock Bill," which expired on July 1, 1977. *See* Act of Oct. 29, 1974, Pub. L. No. 93-501, 88 Stat. 1557. The Depository Institutions Act contains similar provisions. See notes 304-308 *infra* and accompanying text.

90. Although strict grammatical construction of this section may give rise to an argument that the exemption relating to obligations does not apply to each of the enumerated entities, there is no persuasive reason to construe the section in such a fashion. Proposition 2 reads in pertinent part:

preempts state usury laws with respect to obligations issued by specified financial institutions. Thus, there seems to be no need for any further concern with respect to whether such obligations are subject to any state interest rate limitations.

D. Loans by Licensed Real Estate Brokers

Proposition 2 adds to the list of exemptions from the restrictions of the Usury Law "any loans made or arranged by any person licensed as a real estate broker by the State of California and secured in whole or in part by liens on real property." Although this exemption seems very broad, it is likely that it includes only such loans as are made or arranged by persons who are in fact licensed as real estate brokers under California law and that it does not include loans made or arranged by persons who may be otherwise permitted by law to engage in some or all of the activities of a real estate broker without being required to obtain a license.[91] Restricting the exemption to real estate brokers ac-

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> However, none of the above restrictions shall apply to any obligations of, loans made by, or forbearance of, any building and loan association . . ., or to any . . . industrial loan companies, . . . or any . . . credit unions, . . . or any duly licensed pawnbroker or personal property broker, or any loans made or arranged by any person licensed as a real estate broker . . ., or any bank . . . or any [designated agricultural lenders] . . ., or any other class of persons authorized by statute, or to any successor in interest to any loan or forbearance exempted under this article . . . .

It is apparent from a review of the quoted language that the grammatical continuity of the sentence is broken twice: once by the inclusion of "to" prior to "industrial loan companies" and a second time by the inclusion of the phrase "any loans made or arranged" by licensed real estate brokers. A strict grammatical construction would argue in the first instance that the phrase "obligations of, loans made by, or forbearance of" applies only to building and loan associations, and in the second that this phrase applies only to the entities preceding licensed real estate brokers. Such a restrictive construction, however, would appear to thwart, at least in part, the apparent intent of the California legislature in including such language. In addition, it does not further any discernible purpose of the Usury Law. Consequently, a court should construe the exemptive language relating to obligations, loans, and forbearances to apply to each of the enumerated entities.

91. Included in this latter group are finders, *see, e.g.*, Tyrone v. Kelley, 9 Cal. 3d 1, 507 P.2d 65, 106 Cal. Rptr. 761 (1973); Zappas v. King Williams Press, Inc., 10 Cal. App. 3d 768, 89 Cal. Rptr. 307 (1970), persons acting for their own account, attorneys and certain fiduciaries, CAL. BUS. & PROF. CODE § 10133 (West 1964), and certain specified lenders, *id.* § 10133.1 (West Supp. 1979). In general, the list of lenders who are not required under § 10133.1 to obtain real estate brokers' licenses is the same as the list of exempt lenders contained in Proposition 2.

With respect to the exemptions contained in CAL. BUS. & PROF. CODE § 10133.1, it should be noted that although § 10133.1 exempts "[a]ny person or employee thereof doing business under any law of [California], any other state, or of the United States relating to banks, trust companies, savings and loan associations, industrial loan companies, pension trusts, credit unions, or insurance companies" from licensing requirements arising out of their real estate lending activities, it does not exempt non-employee authorized representatually licensed by the California Department of Real Estate is consistent not only with the language of Proposition 2 but also with the rationale underlying the exemptions—that borrowers do not need the protection of usury laws with respect to exempted lenders who are otherwise subject to special regulation under California law.[92]

The exemption for loans "made" by a licensed real estate broker seems self-explanatory: the broker should act as a principal and advance the broker's own funds.[93] Subsequent transfers or assignments of such loans should be governed by the exemption for "successors in interest" discussed below.[94] The exemption for loans "arranged by" licensed real estate brokers may be more difficult to define. On its face, this exemption seems so broad that it may be subject to possible abuse. As a result, minimal involvement in a loan transaction by a licensed real estate broker may not necessarily be sufficient to exempt the loan from the restrictions of Proposition 2. To be consistent with the protec-

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tives, agents, or loan correspondents of such lenders. Authorized representatives, agents, and loan correspondents are required to be licensed, although they are exempted from certain other regulations relating to transactions in trust deeds, real property sales contracts and securities, and real property loans. *See id.* § 10133.15.

92. *See, e.g.*, Carter v. Seaboard Fin. Co., 33 Cal. 2d 564, 203 P.2d 758 (1949); *In re* Fuller, 15 Cal. 2d 425, 102 P.2d 321 (1940). Real estate brokers are not only required to be licensed by the California Real Estate Commissioner but are also subject to regulation by such Commissioner with respect to other aspects of their business activities as well. *See* CAL. BUS. & PROF. CODE §§ 10130-10148, 10230-10236.1 (West 1964 & Supp. 1979); CAL. ADMIN. CODE, Title 10, § 2700 *et seq.* (April 16, 1977). Such regulations may apply, however, only if the broker is performing acts for which a license is required. *See* Buccella v. Mayo, 102 Cal. App. 3d 315, — Cal. Rptr. — (1980).

93. The California Attorney General has apparently concluded that the broker must also be acting as a licensee, *i.e.*, performing an act for which a license is required. *See* Ops. Cal. Att'y Gen. No. 80-122 (April 29, 1980). His concern is apparently based on the premise that if the rule were otherwise, a licensed broker could escape all regulation merely by claiming he is acting as a principal. *See* Buccella v. Mayo, 102 Cal. App. 3d 315, — Cal. Rptr. — (1980). Although his concern is understandable, his reasoning seems somewhat circular and confusing. How can a broker act both as a principal and as a licensee, *i.e.*, as an agent for others? By stating that such a loan by the broker must be made "within the scope and course of such license," does the Attorney General intend that the broker must be involved in some *other* aspect of the transaction, such as the sale of real property? If the purpose of the Attorney General's opinion is merely to make sure that certain regulations, *e.g.*, CAL. BUS. & PROF. CODE §§ 10176, 10177, 10241, 10242 (West 1964 & Supp. 1980) are applicable to such activities, the better view seems to be to request the legislature to exercise the authority granted to it under Proposition 2 to enact appropriate legislation regulating loans made by licensed real estate brokers.

94. *See* notes 116-141 *infra* and accompanying text. Mortgage bankers who are licensed as real estate brokers often fund loans in their own name and with their own money but pursuant to a prearranged commitment to sell concurrently such loans to a non-exempt investor. Under such circumstances there may be a question whether the loan was "made" by the mortgage banker or whether it was arranged by him. In either case, however, the loan should be exempt if it otherwise complies with the requirements of Proposition 2.

tive purposes of Proposition 2 and in keeping with the rationale underlying the exemptions, it appears that in order to qualify as an exempt transaction the real estate broker who arranges a loan should be acting as a licensee, that is, performing a function for which a license is required under the California Business and Professions Code.[95] Section 10131 of that Code defines a real estate broker as

> a person who, for a compensation or in expectation of a compensation, does or negotiates to do one or more of the following acts for another or others:[96]
>
> . . . .
>
> (d) Solicits borrowers or lenders for or negotiates loans or collects payments or performs services for borrowers or lenders or note owners in connection with loans secured directly or collaterally by liens on real property or on a business opportunity.
>
> (e) Sells or offers to sell, buys or offers to buy or exchanges or offers to exchange a real property sales contract, or a promissory note secured directly or collaterally by a lien on real property or on a business opportunity, and performs services for the holders thereof.[97]

Courts have distinguished those functions which come within the scope of section 10131 from those which do not require licensing. They have consistently held that considerations of competency and integrity require that individuals who participate in negotiations and who are otherwise actively involved in helping to consummate real estate transactions (including real estate loan transactions) must be licensed as brokers and be otherwise subject to the regulations of the Department of Real Estate.[98] Only "finders," *i.e.*, those persons who merely introduce

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95. The California Attorney General has reached a similar conclusion. See note 93 *supra*.

96. Persons who are licensed as real estate brokers and who make or arrange loans in the ordinary course of their employment but who are salaried employees and not specifically compensated for such loans on a transactional basis would nonetheless appear to be acting "for a compensation or in expectation of a compensation" within the meaning of § 10131. Such language does not appear to be intended to require that a broker receive compensation on a loan-by-loan basis but, rather, it appears to be intended to exclude transactions in which persons act for their own account rather than as agents of others. *See* Williams v. Kinsey, 74 Cal. App. 2d 583, 169 P.2d 487 (1946); 32 OPS. CAL. ATT'Y GEN. 210 (1958).

97. CAL. BUS. & PROF. CODE § 10131 (West Supp. 1979).

98. *See, e.g.*, Tyrone v. Kelley, 9 Cal. 3d 1, 507 P.2d 65, 106 Cal. Rptr. 761 (1973); Zappas v. King Williams Press, Inc., 10 Cal. App. 3d 768, 89 Cal. Rptr. 307 (1970); Evans v. Riverside Int'l Raceway, 237 Cal. App. 2d 666, 47 Cal. Rptr. 187 (1965); Williams v. Kinsey, 74 Cal. App. 2d 583, 169 P.2d 487 (1946). As a matter of practice, in transactions in which the parties are relying on the licensed real estate brokers' exemption, it would appear advisa-

interested parties and who do not participate in the transaction in any way, are free of regulation.[99] Under such circumstances, it is doubtful that a finder could be said to have "arranged" a loan.

How much involvement by a licensed real estate broker is required? Must the broker be retained by the borrower to negotiate on his behalf? If he acts as an agent for or employee of the lender or as an independent contractor, is the loan still entitled to the usury exemption? The purpose of usury laws is to protect borrowers,[100] and the advice and assistance of a licensed real estate broker may be of substantial benefit to a borrower, especially with respect to a loan that might otherwise be classified as a personal loan. When engaged by borrowers to arrange loans on their behalf, real estate brokers have been held to be agents and, therefore, to be subject to fiduciary obligations.[101] A recent California decision indicates that these obligations include certain affirmative disclosure requirements. In *Wyatt v. Union Mortgage Co.*,[102] the California Supreme Court held that general principles of agency and the statutory duties of licensed real estate brokers imposed on the broker-defendant an obligation to make a full and accurate disclosure of the terms of the loan, which obligation extended beyond mere delivery of the loan documents to the borrower.[103] However, there is nothing in the language of Proposition 2 or in its legislative history that suggests that the broker must be an agent of the borrower or that the usury exemption depends on technical principles of agency law. Other exempt lenders are not subject to any special fiduciary obligations and there seems to be no logical reason to impose such a duty on all loans "arranged" by licensed real estate brokers. In

ble to preserve evidence of the broker's license and the broker's involvement in the transaction.

99. *See* note 91 *supra.*

100. *See, e.g.*, Buck v. Dahlgren, 23 Cal. App. 3d 779, 100 Cal. Rptr. 462 (1972); Wooten v. Coerber, 213 Cal. App. 2d 142, 28 Cal. Rptr. 635 (1963).

101. *See, e.g.*, Tyrone v. Kelley, 9 Cal. 3d 1, 507 P.2d 65, 106 Cal. Rptr. 761 (1973); Rattray v. Scudder, 28 Cal. 2d 214, 169 P.2d 371 (1946); Zappas v. King Williams Press, Inc., 10 Cal. App. 3d 768, 89 Cal. Rptr. 307 (1970).

102. 24 Cal. 3d 773, 598 P.2d 45, 157 Cal. Rptr. 392 (1979).

103. In the *Wyatt* case, the broker had published misleading advertisements and had made oral misrepresentations to the borrowers as to the terms of a possible loan. After the borrowers decided to obtain a loan from the broker, the broker provided the borrowers with all required documents that contained the actual terms of the loan. The borrowers eventually defaulted on the loan and sued the broker and certain affiliates, including a controlling shareholder and certain officers, to recover compensatory and punitive damages based on breach of fiduciary obligations. The court found that the broker's conduct did not satisfy the broker's fiduciary obligations of disclosure and good faith toward the borrowers because they "extend beyond bare written disclosure of the terms of a transaction to duties of oral disclosure and counseling." *Id.* at 738, 598 P.2d at 51, 157 Cal. Rptr. at 398.

mortgage loan transactions, brokers often render services to both borrowers and lenders by preparing loan applications, appraisals, and other documents, by handling the escrow and closing, and by servicing the loan following the funding by the lender.[104]

On the other hand, California's usury policy seems to be based on the premise that borrower protection is best supplied not by regulating interest rates but by regulating the persons or entities engaged in the money lending business. Such lenders are subject to licensing procedures and other state regulations.[105] However, with respect to loans "arranged" by licensed real estate brokers, the lenders may be totally unregulated. Under such circumstances, will the licensing and regulation of the broker provide adequate protection? How much involvement of the broker is necessary to establish the usury exemption? The logical answer should be that the degree of the broker's involvement and the extent of his fiduciary duty to the borrower should vary with the borrower's need for advice and assistance.[106] Viewed in this light, the *Wyatt* case suggests that an agency relationship with the borrower may be important with respect to personal loans when the borrower may not have counsel available or when the borrower may be unsophisticated or inexperienced. However, a formal agency relationship with the borrower should not be required with respect to establishing the exemption for other loans. The requirement that real estate brokers be licensed and remain subject to substantial regulation of their activities seems sufficient to justify the usury exemption for such loans. Brokers who abuse their responsibilities are, like other exempt lenders, subject to possible discipline and further regulation.[107] However, even in commercial loan transactions, some involvement by the broker seems necessary in order to ensure that the loan has been "arranged by" the broker. In such transactions, the broker's involvement should perhaps include at least some of the following activites: (1) "qualifying" the borrower, *i.e.*, determining whether the borrower has counsel available or is otherwise sufficiently experienced and sophisticated to protect himself; (2) preparing the loan application and participating to

104. Guyselman v. Ramsey, 179 Cal. App. 2d 802, 4 Cal. Rptr. 133 (1960). Brokers may have responsibilities to lenders as well as borrowers. *See, e.g.*, CAL. BUS. & PROF. CODE §§ 10230-10236.1 (West 1964).

105. *See* Ops. Cal. Att'y Gen. No. 80-122 (April 29, 1980).

106. An analogy might be made to certain provisions of the securities laws in which certain requirements are not applicable to transactions involving sophisticated investors. *See, e.g.*, the "safe harbor" rules set forth in 17 C.F.R. § 230.146 (1979).

107. CAL. BUS. & PROF. CODE §§ 10176-10177 (West 1964 & Supp. 1979). *See also* note 92 *supra*.

some extent in the negotiations; (3) ensuring that all required disclosures have been made; and (4) delivering or causing to be delivered to the borrower a closing statement and a complete set of loan documents.[108]

Proposition 2 not only requires that exempt loans be made or arranged by licensed real estate brokers but also that the loans be secured "in whole or in part" by real property. The legislative history of Proposition 2 does not furnish any guidance as to the appropriate percentage of the total value of the collateral that the real property security must constitute so that the loan is secured "in part" by real property within the meaning of Proposition 2. An analogy can perhaps be made to the lending activities of licensed personal property brokers.[109] In order for a loan to "qualify" as a personal property broker loan, such loan must be secured "in whole or in part" by personal property and, although there is no direct authority, it has generally been assumed that the value of the personal property security for the loan should be at least 20-25% of the principal amount of the loan.[110] It seems logical to conclude that a similar rule should apply to real property security and that so long as such security is taken in good faith, the loan should qualify for the usury exemption.[111]

One final concern relating to the exemption for licensed real estate brokers is the continued effectiveness of certain statutory provisions that restrict the maximum rate of interest on certain loans negotiated or made by such brokers to 10% per annum. Section 10242(c) of the California Business and Professions Code provides that no loan negotiated by a broker, which is to be secured by a first lien on real property in a principal amount of less than $20,000 or a junior lien in a principal amount of less than $10,000, may provide for the "payment of interest in excess of ten percent (10%) per year as provided by Section 1 of

108. Some of these duties are already imposed on brokers with respect to certain loans. *See, e.g.*, CAL. BUS. & PROF. CODE §§ 10240-10248.9 (West 1964 & Supp. 1979).

109. CAL. FIN. CODE §§ 22000 *et seq.* (West 1968).

110. *Id.* § 22009; Budget Fin. Plan v. Gamson, 34 Cal. 2d 95, 207 P.2d 825 (1949). *See also* Riebe v. Budget Fin. Corp., 264 Cal. App. 2d 576, 70 Cal. Rptr. 654 (1968). A subsequent release of the statutorily required security, if done in good faith and for a bona fide reason, would not appear to render the transaction usurious. *See generally* Sharp v. Mortgage Sec. Corp., 215 Cal. 289, 9 P.2d 819 (1932); Knoll v. Schleussner, 112 Cal. App. 2d 876, 247 P.2d 370 (1952); Goldenzwig v. Shaddock, 31 Cal. App. 2d 719, 88 P.2d 933 (1939); Penziner v. West Am. Fin. Co., 133 Cal. App. 578, 74 P.2d 252 (1933).

111. Lenders and real estate brokers may wish to preserve evidence of the value of the real property security in the form of appraisals, assessed value for tax purposes, or other appropriate materials.

Article XV of the California Constitution."[112] Similarly, the California Real Estate Commissioner has promulgated regulation 2845, which provides that no broker may make a loan that is to be secured by real property at an interest rate in excess of 10% per annum.[113]

This statute and regulation, insofar as they restrict the interest rate on loans made or arranged by licensed real estate brokers to 10% per annum, appear to be in clear conflict with legislative statements of purpose relating to Proposition 2. Both the analysis prepared by the Legislative Analyst and the arguments in favor of Proposition 2 contained in the Ballot Pamphlet make specific references to loans made or arranged by licensed real estate brokers.[114] The interest rate limitations contained in section 10242(c) and in regulation 2845 are inconsistent with the exemption of licensed real estate brokers contained in Proposition 2 and, as such, should be deemed to be implicitly repealed by the enactment of Proposition 2.[115] However, until this conclusion has been confirmed by judicial decision or legislative action, brokers and lenders

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112. CAL. BUS. & PROF. CODE § 10242(c) (West Supp. 1979).

113. CAL. ADMIN. CODE, Title 10, § 2845 (Dec. 15, 1973).

114. In pertinent part, the analysis by the Legislative Analyst states:

> Under existing law, loans made or arranged by any person licensed as a real estate broker by the State of California and secured in whole or in part by liens on real property are subject to a 10 percent interest rate ceiling. Such loans commonly are made by mortgage brokers and mortgage bankers. Under this measure such loans would be exempt from the constitutional limitations on interest rates that may be charged.

California Ballot Pamphlet (Nov. 6, 1979) at 10. Similarly, the proponents of Proposition 2 argued that:

> Because 10 percent is not enough today, many lenders no longer lend money in California (although others who are *now* exempt from the Usury Law still do). For example, mortgage bankers, who last year provided $13 billion for housing loans in California, are limited to a 10 percent rate and in 1979 have practically abandoned providing conventional mortgage loans.
>
> . . . .
>
> Because sometimes we all need money, we need to remove outdated limitations on the availability of that money. Vote "YES" on Proposition 2.

California Ballot Pamphlet (Nov. 6, 1979) at 12.

115. *See, e.g.*, Nuckolls v. Bank of Cal., 10 Cal. 2d 266, 74 P.2d 264 (1937); Penziner v. West Am. Fin. Co., 10 Cal. 2d 160, 74 P.2d 252 (1937); Gardiner v. Bank of Napa, 160 Cal. 577, 177 P. 667 (1911); Ops. Cal. Att'y Gen. No. 80-122 (April 29, 1980). Although the legislature has the express authority to regulate exempted lenders under Proposition 2, including the rate of interest that may be charged, it is difficult to argue that § 10242(c) and regulation 2845 evidence such an intention and are therefore not inconsistent with Proposition 2 for three reasons: first, these provisions were enacted prior to the passage of Proposition 2; second, such an argument appears to be in direct conflict with the stated intention of the legislature with respect to Proposition 2; and third, the reference to § 1 of article 15 of the California Constitution in § 10241(c) indicates that the statutory provision was intended merely to reflect the limitations on brokers contained in the constitution rather than to regulate such brokers independently of the constitution.

should be aware of the potential conflict between these provisions and Proposition 2.

E. Sales By or Participations With Exempt Lenders: The Exempt Status of Successors In Interest

Proposition 2 also provides that the usury restrictions shall not apply to "any successor in interest to any loan or forbearance exempted under this article." Prior to the enactment of Proposition 2, there was some uncertainty with respect to the extent to which nonexempt investors could participate with or purchase loans from exempt lenders. The uncertainty was created because it could be contended that only exempt lenders could *receive* interest in excess of the maximum rate or that the involvement of the nonexempt investor created a loan directly from such investor to the borrower. The question is important because the secondary mortgage market is of enormous significance in that it involves billions of dollars annually, enables California exempt lenders to maintain liquidity and stability, and encourages additional investment in California.[116] Although it was generally assumed that such secondary market transactions were valid, until recently there was little direct authority upholding their validity.[117]

1. Sales of Promissory Notes

With respect to the sale of promissory notes by exempt lenders to nonexempt lenders, most lawyers and institutional lenders breathed a little more easily after the decision in *Strike v. Trans-West Discount Corp.*[118] In that case, the sale of a note by an exempt lender to a nonexempt lender was expressly upheld against a claim of usury. The plaintiff in *Strike* borrowed $105,000 from Barclays Bank, a California state-chartered bank. The note evidencing the loan carried an interest

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116. [T]he passage of Proposition 2 can not be underestimated as a factor in shoring up the secondary money market . . . [a] financing mechanism used to funnel dollars from capital surplus to capital short areas around the country. The [existence of the secondary market] . . . permits a conventional lender, such as a savings association, to lend money to home buyers even though its own net savings are weak, by virtue of selling off a portion of those mortgage loans to an institution . . . .

L.A. Times, Feb. 3, 1980, Part IX, at 14, col. 1.

117. Secondary market transactions may also take the form of loans by investors to exempt lenders secured by a portion of the exempt lender's portfolio of loans. In such instances, the interest rate on the underlying loans should be irrelevant and it is the yield on the funds advanced to the exempt lender that may raise a usury question. This problem, however, has apparently been resolved by the addition of the language in Proposition 2 relating to "obligations" of exempt lenders. *See* notes 89-90 *supra* and accompanying text.

118. 92 Cal. App. 3d 735, 155 Cal. Rptr. 132, *appeal dismissed*, 100 S. Ct. 417 (1979).

rate of 11% per annum and was secured by a deed of trust on a residence owned by Strike. The note was eventually purchased by Trans-West, a nonexempt lender.

Strike defaulted under certain obligations owing to Trans-West, and Trans-West instituted foreclosure proceedings on the real property securing the Barclays note. Strike brought suit to enjoin the foreclosure, contending, among other things, that the receipt by Trans-West of 11% interest under the Barclays note constituted usury. Although Trans-West held a personal property brokers license, the court apparently concluded that the license was not sufficient to shelter the real estate loan that Trans-West acquired from Barclays. Nevertheless, judgment was given for Trans-West in the trial court and Strike appealed.

The court of appeal rejected Strike's contention that the receipt of 11% interest on the Barclays note by Trans-West was usurious. The court first noted that Strike offered no authority "for the proposition that the assignee of an exempt lender becomes thereby a usurer unable to collect any interest."[119] The court then noted that Strike's contention, if upheld, would effectively prohibit the sale of notes by exempt lenders and was contrary to the public policy expressed in the constitutional exemption afforded exempt lenders in California.[120] The court concluded by referring to the general rule that usury is to be determined on the basis of facts in existence at the inception of the loan or forbearance; a subsequent event, such as a sale of the loan, is irrelevant.[121]

The finding that a nonexempt purchaser of a loan carrying an interest rate in excess of 10% per annum originated by an exempt lender is logically sound and is supported by prior decisional law even though the court in *Strike* did not discuss such law in detail.[122] The language

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119. *Id.* at 745, 155 Cal. Rptr. at 139.

120. *Id.*

121. *Id. See also* Boerner v. Colwell Co., 21 Cal. 3d 37, 577 P.2d 200, 145 Cal. Rptr. 380 (1978); Sharp v. Mortgage Sec. Corp. of America, 215 Cal. 287, 9 P.2d 819 (1932); Cambridge Dev. Co. v. United States Fin., 11 Cal. App. 3d 1025, 90 Cal. Rptr. 333 (1970); Knoll v. Schleussner, 112 Cal. App. 2d 876, 247 P.2d 370 (1952); Goldenzwig v. Shaddock, 31 Cal. App. 2d 719, 88 P.2d 933 (1939); Grall v. San Diego Bldg. & Loan Ass'n, 127 Cal. App. 250, 15 P.2d 797 (1932).

122. *See, e.g.*, O.A. Graybeal Co. v. Cook, 111 Cal. App. 518, 535, 295 P. 1088, 1094 (1931) (payment of bonus and commission by maker of existing note to induce certain persons to purchase it from the holder thereof was not interest for usury purposes because the transaction between such purchasers and the maker was not a loan); Smith v. Cavaglieri Mortgage Co., 111 Cal. App. 136, 141, 295 P. 366, 368 (1931) (after negotiable instrument has once been validly negotiated by transfer upon valuable consideration, it becomes article of commerce and can be bought and sold as freely as any other property).

of Proposition 2 concerning "successors in interest" confirms the decision in *Strike* and should put to rest any concern about the validity of such transactions.

Strike, however, involved the purchase of a loan several years after its original funding by the exempt lender, Barclays. To what extent may a purchase be prearranged? May it occur concurrently, or nearly so, with the original funding by the exempt lender? Although there is no direct authority involving exempt lenders, the recent California Supreme Court decision in *Boerner v. Colwell Co.*[123] suggests that even prearranged transactions may be valid if they are entered into with good faith and without intent to violate the usury laws. In *Boerner*, the Colwell Company, a mortgage banking firm, entered into a series of financing agreements with a number of contractors who were in the business of constructing vacation homes and making home improvements. When a customer of the contractors desired financing, the customer and the contractor completed a "purchase contract" and credit application on Colwell forms. Colwell ordered the preliminary title report and approved the customer's credit. The customer then executed a note and deed of trust on Colwell forms and the contractor assigned both to Colwell, again, on a Colwell form. The Colwell notes typically exacted interest rates in excess of 10% per annum, and several customers instituted a class action seeking a determination that Colwell's notes exacted usurious rates of interest.

Colwell defended primarily on the ground that the so-called "time-price doctrine" removed its dealings with plaintiffs from the purview of the Usury Law. The time-price doctrine holds essentially that a seller of property may elect to sell for cash at one price or to sell on credit for a higher price. The difference between the cash sale price and the credit sale price is often referred to as the "time-price differential" or as a "finance charge" and, from an economic standpoint, probably represents interest on the unpaid balance of the purchase price. Nonetheless, it has long been the rule in California and in most other states that such credit sales are beyond the ambit of usury laws.[124]

Plaintiffs conceded that, absent the involvement of Colwell, no charge of usury could have been asserted against the contractor be-

123. 21 Cal. 3d 37, 577 P.2d 200, 145 Cal. Rptr. 380 (1978).

124. *Id.* at 45-47, 577 P.2d at 204-06, 145 Cal. Rptr. at 385-86. *See* Milana v. Credit Discount Co., 27 Cal. 2d 335, 163 P.2d 869 (1945); Wilson v. J.E. French Co., 214 Cal. 188, 4 P.2d 537 (1931); Verbeck v. Clymer, 202 Cal. 557, 261 P. 1017 (1927). Indeed, as the holding in *Boerner* clearly demonstrates, the unpaid purchase price may be incorporated into a promissory note and the time-price differential may be expressed as an interest rate without creating any usury problems so long as the obligation arises out of a bona fide sale.

cause of the time-price doctrine. Accordingly, plaintiffs contended that Colwell's intimate involvement in the transaction transformed what would otherwise have been a bona fide credit sale by the contractors into a loan by Colwell. The California Supreme Court disagreed and found that the close connection between Colwell and the contractors was "without significance" in determining whether Colwell's purchase of the installment contracts amounted to a loan.[125]

The principal factor to which the supreme court ascribed significance was that the trial court found that bona fide credit sales had occurred and that Colwell had acted in good faith.[126] The California Supreme Court took note of the fact that the contractor assigned to Colwell the lien contract and the deed of trust with various warranties, including the warranty that there were no defenses to the validity of the contract. The contractor further agreed to repurchase the note in the event of misrepresentation or breach of warranty.[127] At the time of trial, the Boerner lien contract and deed of trust had been reassigned to the builder under the assignment warranty provisions.[128] The supreme court refused to disturb the trial court's findings with respect to the bona fides of the credit sales and Colwell's good faith and did not otherwise explain what it meant by "good faith."

Certainly, had plaintiffs independently sought credit directly from Colwell, the finance charges would have been held usurious. Equally certain, had the contractors financed the purchases themselves, and later, in a completely independent transaction, sold the time-price paper to Colwell, no usury would have resulted. It is difficult to perceive how Colwell's "good faith" could vary from one situation to the other. Nonetheless, the trial court (and the supreme court) evidently viewed Colwell's supplying of forms to the contractors and purchase of the time-price paper concurrently with the execution thereof as being moti-

125. 21 Cal. 3d at 53, 577 P.2d at 210, 145 Cal. Rptr. at 390. It should be noted that the decision in *Boerner* was 4-3; thus some caution may be appropriate with respect to fact situations that differ from those in *Boerner*.

126. The "good faith" test was one of the primary factors which enabled the court to distinguish its prior decision in Glaire v. La Lanne-Paris Health Spa, Inc., 12 Cal. 3d 915, 528 P.2d 357, 117 Cal. Rptr. 541 (1974). The court contrasted the facts in *Glaire*, in which the time-price differential was "buried" in the form of an undisclosed discount on the sale of the installment contract to a financial institution, with the facts in *Boerner*, in which proper disclosures were apparently made and the trial court expressly found that the parties' dealings were in good faith. 21 Cal. 3d at 52, 577 P.2d at 209, 145 Cal. Rptr. at 389.

127. 21 Cal. 3d at 42 n.3, 577 P.2d at 202 n.3, 145 Cal. Rptr. at 383 n.3.

128. *Id.* at 43 n.5, 577 P.2d at 203 n.5, 145 Cal. Rptr. at 383 n.5.

vated by legitimate business needs and, therefore, in good faith.[129]

If Colwell's prearrangement with the contractor with respect to the purchase of installment contracts is irrelevant to the determination of "good faith," what is relevant? The only logical conclusion is that "good faith" is not tested solely by Colwell's intent, but instead by reference to the intent of the other parties to the transaction.[130] Certainly, plaintiffs intended to buy and the contractors intended to sell, on an installment basis, the home improvements and vacation homes. The interjection of Colwell into the transaction simply facilitated its consummation. Thus, Colwell's "good faith" may in large part have derived from the bona fides of the underlying transaction.

The essence of the holding in *Boerner* is that the original transaction between the contractor and the customer was not a loan and its characterization was not affected by a subsequent assignment to a third party, such as Colwell. The sale of a promissory note held by an exempt lender, however, clearly involves an original loan transaction between the exempt lender and the borrower. Is this a material difference? May the parties, based on the rationale of *Boerner*, rely on the bona fides of the underlying transaction with the exempt lender? If the notes assigned or sold are negotiable instruments, could it be contended that the transaction is exempt because the transferee of such a note is a "holder in due course?"[131] It is well established in California that usury is a personal defense that is not available against a holder in due course.[132] Whether the purchaser of a note is a holder in due course turns upon whether the purchaser holds such a note in good

129. The role of the financing institution in transactions of this kind is basically a beneficial one, for the essence of their function is that of providing needed financial assistance to sellers unable to handle their own consumer financing, thus permitting those sellers to compete on a more equal footing with their more established competitors.

Id. at 53, 577 P.2d at 211, 145 Cal. Rptr. at 391.

130. In Glaire v. La Lanne-Paris Health Spa, Inc., 12 Cal. 3d 915, 528 P.2d 357, 117 Cal. Rptr. 541, it was alleged that the seller of the health club membership and the assignee of the membership contract were "interlocking corporations with common ownership and control," a fact which apparently influenced the court's decision. *Id.* at 918, 528 P.2d at 359, 117 Cal. Rptr. at 543. On the other hand, in Boerner v. Colwell Co., 21 Cal. 3d 37, 577 P.2d 200, 145 Cal. Rptr. 380 (1978), the developers and Colwell were clearly independent companies. Thus, Colwell was able to benefit from the bona fide nature of the underlying transactions.

131. CAL. COM. CODE § 3104 (West 1964).

132. *See, e.g.*, Nuckolls v. Bank of Cal., 10 Cal. 2d 278, 74 P.2d 271 (1937); Brown v. Guaranty Mortgage Co., 220 Cal. 532, 31 P.2d 788 (1934); Liebelt v. Carney, 213 Cal. 250, 2 P.2d 144 (1931); Szczotka v. Idelson, 228 Cal. App. 2d 399, 39 Cal. Rptr. 466 (1964); Anderson v. Lee, 103 Cal. App. 2d 24, 228 P.2d 613 (1951); Baker v. Butcher, 106 Cal. App. 358, 289 P. 236 (1930).

faith and without notice of any defense against it.[133] On the one hand, because the loans, when made by the exempt lender, are clearly not subject to a claim of usury, it is arguable that a purchaser takes the notes in good faith and without notice of any defense against the notes. This is consistent with the principle that usury is determined at the time the loan is made.[134] On the other hand, a purchaser will certainly be charged with knowledge of its status as a nonexempt lender, the exempt status of the original lender, and the interest rate on the notes. Upon this ground, one could argue that when a purchaser holds a note having an interest rate in excess of the legal rate, the purchaser does not take such a note in good faith and without notice that it may be subject to the defense of usury.[135] Thus, the note could become usurious in the hands of a nonexempt transferee. This argument is based on the premise that the exemptions create a special privilege in that only an exempt lender is entitled to "receive" interest in excess of the maximum rate; however, this argument was rejected by the court in *Strike*.[136]

These principles must now be examined in light of the language of Proposition 2 which exempts from the interest rate restrictions "any successor in interest to any loan or forbearance exempted under this article." The purpose of this provision, as stated in the legislative analysis, was to establish that a loan, which was exempt when made, would continue to be exempt after sale or transfer to a nonexempt third party.[137] Is the concept of a "successor in interest" identical to or different from the concepts upheld in *Strike* and *Boerner*? Must a transferee act in good faith to be a "successor"? Although it could be argued that the blanket exemption of all "successor[s] in interest" relaxes the "good faith" test articulated in *Boerner*, it is unlikely that a court will deem itself precluded from inquiring into whether there was a bona

133. "(1) A holder in due course is a holder who takes the instrument (a) For value; and (b) In good faith; and (c) Without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person . . . ." CAL. COM. CODE § 3302 (West 1964). *See also id.* § 3305, comment 1.

134. *See generally* Abbot v. Stevens, 133 Cal. App. 2d 242, 284 P.2d 159 (1955); Knoll v. Scheussner, 112 Cal. App. 876, 247 P.2d 370 (1952); Goldenzwig v. Shaddock, 31 Cal. App. 2d 719, 88 P.2d 933 (1939); O.A. Graybeal Co. v. Cook, 111 Cal. App. 518, 295 P. 1088 (1931).

135. If this rule were followed, it could create confusion with respect to how the maximum rate under Proposition 2 should be determined. Would the relevant rate-setting date be the date of the original contract or the date of the assignment to the nonexempt transferee?

136. 92 Cal. App. 3d at 745, 155 Cal. Rptr. at 139.

137. "Under the measure, a loan which is exempt from the provision of the usury law at the time it is made would continue to be exempt from these provisions even if it is sold or transferred to another party." California Ballot Pamphlet (Nov. 6, 1979), at 10.

fide transaction in the first instance or whether, viewing the transaction as a whole, the exempt lender was merely a "conduit," and the transaction was actually a loan made by the nonexempt transferee at an interest rate in excess of the maximum permissible rate.[138] The obvious risk associated with "conduit" financing, however, does not necessarily mean that all prearranged or concurrent transactions may be invalid. *Boerner* expressly upheld prearranged, concurrent transactions. What *Boerner* does suggest is that such transactions must be consummated in good faith and that such good faith is likely to be measured by the relationship between the exempt lender and the borrower.

How is such "good faith" to be determined in the context of a loan by an exempt lender and a sale of that loan to a nonexempt lender? Relevant questions might be: Whose customer is the borrower? Who made the credit decision? Were proper disclosures made to the borrower?[139] Whose funds were advanced? Is the loan of a type that the exempt lender regularly makes in the ordinary course of business for its own account? Is the sale of the loan an isolated transaction or part of a "package" purchase of a portion of the exempt lender's portfolio? If the loan is originated by the exempt lender, funded by the exempt lender and sold to an investor in a bona fide, separate transaction, it is likely to be upheld even though the sale may have been prearranged. These concepts are supported by provisions of the California Corporations Code[140] which specifically exempt certain activities of foreign lending institutions from many California regulations, including qualification, licensing, and taxation, if such activities are carried on outside California. Included in the permitted activities are "the acquisition by purchase, by contract to purchase, by making advance commitments to purchase or by assignment of loans, secured or unsecured, or any interest therein."[141] Therefore, except for sham transactions, exempt lenders should be able to sell loans to nonexempt lenders and, under proper circumstances, to enter into advance commitments to sell such loans,

138. *See, e.g.*, Boerner v. Colwell Co., 21 Cal. 3d 37, 577 P.2d 200, 145 Cal. Rptr. 380 (1978); Milana v. Credit Discount Co., 27 Cal. 2d 335, 163 P.2d 869 (1945); Sondeno v. Union Commerce Bank, 71 Cal. App. 3d 391, 139 Cal. Rptr. 229 (1977); O.A. Graybeal v. Cook, 111 Cal. App. 518, 295 P. 1088 (1931); Smith v. Cavaglieri Mortgage Co., 111 Cal. App. 136, 295 P. 366 (1931); 50 OPS. CAL. ATT'Y GEN. 110 (1967). *See also* Coral Gables First Nat'l Bank v. Constructors of Fla., Inc., 119 So. 2d 741 (Fla. Dist. Ct. App. 1960). *But cf.* California Ballot Pamphlet (Nov. 6, 1979), at 10 (Proposition 2 may restrict the court from inquiring into the circumstances surrounding a sale or transfer).

139. This fact assisted the *Boerner* court in distinguishing *Glaire*. *See* note 126 *supra*.

140. CAL. CORP. CODE §§ 191, 2104 (West 1977).

141. *Id.* § 191(d)(1).

provided such commitments are entered into in good faith in the ordinary course of business.

The language of Proposition 2 does not resolve an open question under current law as to whether a transferee is protected only with respect to the initial loan or forbearance or whether any subsequent advances or forbearances should be considered to be new loans or forbearances and, as such, subject to the interest rate restrictions of Proposition 2 if made by a nonexempt lender. It seems likely that a transferee would not be a "successor" with respect to subsequent advances or forbearances and in view of the lack of any explicit authority indicating that the exemption was intended to encompass such matters, a nonexempt transferee should not make subsequent advances or forbearances at a rate not otherwise permissible under Proposition 2. As a practical matter, this may mean that some subsequent advances and forbearances may have to bear an interest rate *lower* than the rate on the original loan.[142]

2. Loan Participations Between Exempt and Nonexempt Lenders

A related problem is whether the "successors in interest" language of Proposition 2 will be effective to shelter participations by nonexempt lenders with loans made by exempt lenders. In a typical transaction, the loan is originated by an exempt lender who is named as payee in the promissory note executed by the borrower and who is named as the secured party in the relevant collateral documents. The exempt lender then "sells" a participation, *i.e.*, a percentage of the principal amount of the loan, to an investor for an equivalent cash price.[143] The transac-

142. Two recent cases, McConnell v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 21 Cal. 3d 365, 578 P.2d 1375, 146 Cal. Rptr. 371 (1978), and Arneill Ranch v. Petit, 64 Cal. App. 3d 277, 134 Cal. Rptr. 456 (1976), have raised, at least in theory, an additional area of concern for the nonexempt lender who is a transferee of a variable rate loan. The cases suggest that each change in the interest rate may constitute a separate term of forbearance. This premise could lead to the conclusion that adjustments to the interest rate after assignment to the transferee might produce a subsequent "forbearance" within the meaning of Proposition 2. Nevertheless, the general rule that usury is determined at the time the loan is made and the "earlier of" language in Proposition 2 should resolve such concerns and permit the transferee to receive interest in accordance with the terms of the note without being subject to the Usury Law.

143. If the participation is sold "with recourse" against the exempt lender or if the exempt lender guarantees payment or agrees to repurchase the participation upon default, the transaction may be viewed as a loan from the participant to the exempt lender. *See, e.g.*, West Pico Furniture Co. v. Pacific Fin. Loans, 2 Cal. 3d 594, 469 P.2d 665, 86 Cal. Rptr. 793 (1970). However, even if such transactions are deemed to be loans to the exempt lenders, the language in Proposition 2 relating to the "obligations" of exempt lenders should resolve the usury issue. *See* notes 89-90 *supra* and accompanying text.

tion entitles the investor to a pro rata portion of the interest paid on the loan and, of course, to the repayment of his portion of the prinçipal at maturity. The exempt lender usually retains the servicing[144] of the loan and the borrower often may not know that a participant is involved. Thus, in form, the loan has been made by and continues to be held by an exempt lender. The sale of a participation, however, is often prearranged and occurs concurrently with the original funding. Thus, in fact, a portion of the loan proceeds may come directly from the nonexempt participant and the exempt lender may never bear the entire credit risk. Under such circumstances, the nonexempt participant could be held to be a "lender" for purposes of the Usury Law.

In the case of *Sondeno v. Union Commerce Bank*,[145] the defendant bank, Union, was an Ohio state-chartered bank and thus apparently was not entitled to one of the exemptions enumerated in the California Constitution. Union extended a commitment to a California borrower for a $1,912,000 construction loan on condition that the borrower find a California bank to participate in the loan. Barclays, a California state-chartered bank, agreed to participate and, in accordance with the commitment, the loan was closed by Barclays, the note and deed of trust were executed in favor of Barclays, and Union obtained a 75% participation in the loan. The borrower experienced difficulty in obtaining its permanent financing and requested a six-month extension. Union informed Barclays that it would approve the extension conditioned, *inter alia*, upon payment of interest at 11.5% plus an additional fee of $9,562.50.[146] After the loan was repaid, the borrower alleged that the extension was usurious and sought treble damages for the interest paid during the extension term, together with punitive damages of $750,000. The trial court sustained Union's demurrer and dismissed the complaint.

On appeal, Union urged that the loan documents established that the loan was made solely by Barclays because Barclays was the sole payee of the note and the sole beneficiary under the deed of trust. The court of appeal rejected this argument because the complaint alleged that the form of the transaction was a device to avoid the Usury Law and held that the dispositive issue was whether Union was an exempt lender for purposes of the Usury Law. After examining relevant sec-

144. "Servicing" a loan normally includes receiving payments, keeping certain books and records, monitoring and inspecting collateral, and assisting in enforcement and collection matters. Typically, the exempt lender receives a servicing fee which is based on the outstanding principal balance of the loan and which is usually deducted from the interest paid by the borrower.

145. 71 Cal. App. 3d 391, 139 Cal. Rptr. 229 (1977).

146. *Id.* at 393, 139 Cal. Rptr. at 230.

tions of the California Financial Code, the court affirmed the judgment of the trial court, concluding that, with respect to the loans at issue, Union was a "bank as defined in and operating under . . . [the] Bank Act" and was thus entitled to the usury exemption.[147]

It is important to observe, however, that the *Sondeno* court considered the exemption provisions of the California Constitution only because the court refused to rule that Union had not made a loan to the California borrower. Without much discussion, the court concluded that Union was a direct lender (rather than an assignee) for purposes of the Usury Law. This result seems justified, since Union made the initial credit decision, issued a loan commitment directly to the borrower, funded 75% of the loan, and participated in the decision to raise the interest rate for the extension term. *Sondeno* was decided before *Boerner* and the court in *Sondeno* did not discuss the possible application of any "good faith" test. Nevertheless, it is likely that the transaction in *Sondeno* would not pass the "good faith" test in *Boerner* because the borrower was Union's customer, Union issued the original commitment and made the credit decisions, and Barclays was apparently involved merely to facilitate the consummation of the transaction and had no significant independent role. These facts perhaps distinguish *Sondeno* from *Boerner* and suggest that participations which meet the test in *Boerner* may be valid and that such participants may be held to be "successor[s] in interest" within the meaning of Proposition 2. If the exempt lender retains the servicing, as is customary, both the loan and the exempt lender remain subject to regulation and it is difficult to see why the borrower should object since he will not be paying more than he contracted to pay. Nevertheless, the law appears to be unsettled, at least with respect to investors other than non-California state-chartered banks, and concurrent participations should, therefore, be viewed with considerable caution even though such transactions might otherwise be negotiated and consummated in good faith.

147. *Id.* at 396, 139 Cal. Rptr. at 232-33. The court based its conclusion on three principles: first, the reference to the "Bank Act" in the constitution was construed to be a reference to the California Financial Code; second, the definition of "bank" in § 102 of the Financial Code was broad enough to include a non-California state-chartered bank; and third, § 1757 of the Financial Code permitted the activities undertaken by Union without subjecting it to licensing requirements, thus Union was "operating under" the provision of the Financial Code. *Id.* at 394-96, 139 Cal. Rptr. at 231-32. Although the first two principles seem defensible, the conclusion that Union was "operating under" the provision of the Financial Code may require somewhat more faith than most institutional lenders and their counsel find acceptable.

III. Effect of Proposition 2 on Existing Transactions

Although the effective date of Proposition 2 is November 7, 1979,[148] the effect that Proposition 2 will have on loans made or contracts to make loans executed prior to that date is uncertain under present California law. On the one hand, there is no indication that the legislature intended Proposition 2 to have a retroactive effect and the general rule is that in the absence of an express intention to the contrary, constitutional or other statutory provisions operate only prospectively.[149] This conclusion is supported by the general proposition that the validity of a contract is determined by the law in existence at the time the contract is made and that subsequent changes in the law do not affect its validity or become a part of the contract unless the parties clearly intended otherwise.[150] Therefore, if this reasoning is followed, existing usurious loans should continue to be so after the effective date of Proposition 2.[151]

There is some California authority, however, which suggests that contracts that would have been usurious under a prior law, but which would not be usurious if made after the enactment of a change in the law, become valid and enforceable.[152] In *Wolf v. Pacific Southwest Dis-*

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148. *See* note 8 *supra.*

149. Hopkins v. Anderson, 218 Cal. 62, 21 P.2d 560 (1933); Vallejo Ferry Co. v. Lang & McPherson, 161 Cal. 672, 120 P. 421 (1911); Gurnee v. Superior Court, 58 Cal. 88 (1881). Prior statutory or constitutional enactments in California relating to usury have been held to operate only prospectively after being amended to operate more restrictively. *See In re* Zemansky, 39 F. Supp. 628 (S.D. Cal. 1941) (1934 constitutional amendments); Wilbur v. Griffins, 56 Cal. App. 668, 206 P. 112 (1922) (1918 usury initiative). Because the new enactments addressed in both of these cases were more restrictive than prior law, to construe such enactments as operating retroactively, therefore, may have raised constitutional questions as to the impairment of the obligations of existing contracts. U.S. CONST. art. I, § 10, cl.1; CAL. CONST. art. 1, § 16. Proposition 2, however, does not operate more restrictively than prior law and therefore would not raise these problems.

150. *See, e.g.,* Swenson v. File, 3 Cal. 3d 389, 475 P.2d 852, 90 Cal. Rptr. 580 (1970); Interinsurance Exch. v. Ohio Cas. Ins. Co., 58 Cal. 2d 142, 373 P.2d 640, 23 Cal. Rptr. 592 (1962); Equitable Bldg. & Loan Ass'n v. Wolfangle, 111 Cal. App. 119, 295 P. 388 (1931). To the same effect are decisions specifically holding that the validity of the interest payable on a loan or forbearance is determined at the time of the execution of the contract. *See, e.g.,* Islais Co. v. Matheson, 3 Cal. 2d 657, 45 P.2d 326 (1935); Kraemer v. Coward, 2 Cal. App. 2d 506, 38 P.2d 458 (1934).

151. *See, e.g.,* Westman v. Dye, 214 Cal. 28, 4 P.2d 134 (1931); Abbot v. Stevens, 133 Cal. App. 2d 242, 284 P.2d 159 (1955); Grall v. San Diego Bldg. & Loan Ass'n, 127 Cal. App. 250, 15 P.2d 797 (1932); CAL. CIV. CODE § 1916-2 (West 1970). The penalty provisions contained in §§ 1916-2 and 1916-3 of the California Civil Code do not appear to be inconsistent with the provisions of Proposition 2 and, therefore, would not be affected by Proposition 2. *See* Nuckolls v. Bank of Cal., 10 Cal. 2d 266, 74 P.2d 264 (1937); Penziner v. West Am. Fin. Co., 10 Cal. 2d 160, 74 P.2d 252 (1937).

152. Wolf v. Pacific Sw. Discount Corp., 10 Cal. 2d 183, 74 P.2d 263 (1937). There is

count Corp.,[153] the California Supreme Court held that an action to recover treble the amount of usurious interest paid to a licensed personal property broker could not be maintained after the adoption of the 1934 constitutional amendment, which exempted personal property brokers even though the loan had been made and the interest paid prior to the effective date of the constitutional amendment. The court found that

> [t]he constitutional amendment repealing provisions of the usury law as to those exempted classes contains no saving clause as to causes of action accruing prior to the adoption of said amendment. A repeal of the statute, or an amendment thereof, resulting in a repeal of the statutory provision under which the cause of action arose, wipes out the cause of action unless the same has been merged into a final judgment.[154]

Construed narrowly, *Wolf* only furnishes a precedent that may validate prior usurious loans made by newly exempted lenders, such as licensed real estate brokers. Proposition 2 does not contain any savings clause preserving prior claims or causes of action arising out of prior usurious loans and, therefore, if *Wolf* is followed, such loans should now be valid and enforceable. The rationale in the *Wolf* case, however, is based on the much broader principle that a statutory right, as opposed to a common law right, is destroyed by the repeal of the statute under which it arose unless such right was reduced to a final judgment prior to such repeal or unless the repealing statute contains a savings clause.[155] *Wolf*, therefore, supports the premise that Proposition 2, by repealing the 10% limitation on interest rates for nonexempt lenders, effectively validates any existing loans or contracts to make loans at rates in excess of 10% but less than the rates permitted by Prop-

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substantial authority in other jurisdictions holding that usury law amendments may operate retroactively so as to validate contracts that were usurious when made. The rationale of the courts is generally similar to that of *Wolf*, or it is based on the premise that usury laws are in the nature of penal statutes so that repeal of such statutes without a savings clause destroys any rights of action or defenses that may have arisen thereunder. *See, e.g.*, United Realty Trust v. Property Dev. & Research Co., 269 N.W.2d 737 (Minn. 1978); American Sav. Life Ins. Co. v. Financial Affairs Mgmt. Co., 20 Ariz. App. 479, 513 P.2d 1362 (1973). There is dictum to the effect of the latter rationale in Willcox v. Edwards, 162 Cal. 455, 123 P. 276 (1912), and Fenton v. Markwell & Co., 11 Cal. App. 2d Supp. 755, 52 P.2d 297 (1935). There is, however, scant authority which has not given retroactive effect to amendments to usury laws in similar circumstances. *See, e.g.*, Tremper v. Northwestern Mut. Life Ins. Co., 11 Wash. 2d 461, 119 P.2d 707 (1941).

153. 10 Cal. 2d 183, 74 P.2d 263 (1937).

154. *Id.* at 185, 74 P.2d at 264.

155. *See, e.g.*, Southern Serv. Co. v. County of Los Angeles, 15 Cal. 2d 1, 97 P.2d 963 (1940); Krause v. Rarity, 210 Cal. 644, 293 P. 62 (1930).

osition 2.[156] It should be noted, however, that section 1916-2 of the California Civil Code does not provide merely that usury is a defense to the payment of interest; rather, it provides that the obligation to pay interest on a usurious loan is "null and void."[157] If "void" means "void" rather than "voidable," an existing usurious loan may continue to be usurious, notwithstanding the enactment of Proposition 2.[158]

Although the rationale of *Wolf* seems persuasive, lenders and borrowers may wish to consider how their existing transactions can be brought within the coverage of Proposition 2. In this respect, a distinction may be made between funded and unfunded loans. With respect to funded loans, it is clear that although the protection of the Usury Law may not be waived by the borrower at the inception of the loan,[159] a potential usury claim may be settled like any other claim.[160] If a lender wishes to validate a transaction that arguably would have been usurious under prior law, the lender should obtain a release of the usury claim for a valid consideration (such as the advancement of additional funds, the extension of the term of the loan, the waiver of a default, etc.), or purge the transaction of usury for the period prior to the effective date of Proposition 2 and apply the higher rate only for subsequent periods. If commitment letters are issued, or contracts are executed prior to the effective date of Proposition 2 but the loan has not yet been funded, the parties should be able to obtain the benefits of Proposition 2 by executing a new contract or commitment at a date subsequent to the effective date of Proposition 2. Such new contract or commitment should include an acknowledgment that its purpose is to rescind the previous agreement and to substitute a new, valid agreement that complies with the provisions of Proposition 2.[161]

A related question is the effect of provisions in existing loans that

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156. *See, e.g.*, Swenson v. File, 3 Cal. 3d 389, 475 P.2d 852, 90 Cal. Rptr. 580 (1970). Of course in cases in which the parties wish to amend their contract or commitment in some substantive respect, or to rescind their obligations thereunder, such amendments will require mutual consideration to be binding. *See, e.g.*, Fairlane Estates, Inc. v. Carrico Constr. Co., 228 Cal. App. 2d 65, 39 Cal. Rptr. 35 (1964); Selby v. Battley, 149 Cal. App. 2d 659, 309 P.2d 120 (1957).

157. *See* note 23 *supra*.

158. If this argument was made in *Wolf*, it was not reflected in the court's opinion. However, a void contract cannot generally be revived by a subsequent change in law, although usury may be an exception to such a rule. *See generally* Willcox v. Edwards, 162 Cal. 455, 123 P. 276 (1912).

159. *In re* Vehm Eng'r Corp., 521 F.2d 186 (9th Cir. 1975); Stock v. Meek, 35 Cal. 2d 809, 221 P.2d 15 (1950).

160. Taylor v. Budd, 217 Cal. 262, 18 P.2d 333 (1933); Westman v. Dye, 214 Cal. 28, 4 P.2d 134 (1931); Kogan v. Bergman, 244 Cal. App. 2d 613, 53 Cal. Rptr. 371 (1966).

161. *See* notes 85-86 *supra* and accompanying text.

limit the interest charged thereunder to the "maximum rate permitted by law." Even if Proposition 2 is not applied retroactively, there remains the question whether such provisions permit the lender to adjust the interest charged for the balance of the term of the loan, commencing upon the effective date of Proposition 2.[162] The answer turns on whether the parties properly expressed their intent to incorporate a change in the law if such an event should occur and whether the enactment of Proposition 2 is such a change in the law that permits the parties to accomplish their expressed intent. Although each transaction must necessarily be examined separately to determine the intent of the parties and the particular language used, the enactment of Proposition 2 should permit lenders to adjust the interest rate in accordance with the provisions of the note for the balance of the term of the loan so long as the adjusted rate does not exceed the maximum rate now permitted under Proposition 2. Such a result should not be construed as applying Proposition 2 "retroactively" but merely as giving full effect to the existing agreement of the parties. The enactment of Proposition 2 is, therefore, analogous to the occurrence of any other future condition or event that the parties may contemplate and provide for in their agreements so long as the provision is lawful at the time performance is required.[163]

Assuming that existing loan contracts are entitled to the benefits of Proposition 2, because Proposition 2 operates retroactively to eliminate a borrower's usury claim, or because the parties contracted for a variable rate not to exceed the "maximum permitted by law," or because the parties expressly bring their agreements within the coverage of Proposition 2, it is unclear how the maximum interest rate should be determined. Is the relevant rate-setting date the date of execution of the original contract to make the loan, the effective date of Proposition 2, or some other date? As indicated above, the language of Proposition 2 seems to require that the appropriate rate be determined by reference to the "earlier of" the date of the original funding or the date of execution of the original loan contract. This could mean a rate-setting date determined months or years prior to the enactment of Proposition 2 when the parties could not have contemplated its adoption or anticipated its provisions. Although this result seems unnecessary and could create confusion, it is probably the conclusion most consistent with the

162. A similar question arises under the Depository Institutions Act. *See* notes 299-303 *infra* and accompanying text.

163. *See, e.g.*, United Bank & Trust Co. v. Brown, 203 Cal. 359, 264 P. 482 (1928); CAL. CIV. CODE §§ 1451, 1599, 1641, 1643 (West 1954).

express language of Proposition 2.[164] An argument may be made, however, that the effective date of Proposition 2, November 7, 1979, is a more appropriate date because it provides a common reference point for all existing loans affected by Proposition 2 and appears to be more consistent with the general rule that changes in the law are incorporated into existing contracts upon the effective date of such changes, assuming the parties intended subsequent changes in the law to become a part of their contract.[165] Ordinarily, such changes are incorporated at the time the new law takes effect and do not operate retroactively or readjust prior rights between the parties, unless the parties clearly intended such a result.[166]

In conclusion, although there seem to be persuasive arguments and respectable authority for the retroactive application of Proposition 2, if the parties desire to confirm the validity of their agreements and to receive the benefits of Proposition 2, the parties should consider executing an amendment or modification to their loan agreements, expressly acknowledging the enactment of Proposition 2 and confirming their mutual intent with respect to the determination of the maximum interest rate. As indicated above,[167] such amendments should constitute subsequent "contracts" for a "forbearance" within the meaning of Proposition 2, thus enabling the parties to utilize the date of execution of such amendments as the relevant rate-setting date.

IV. Choice-of-Law Policies and Usury in California

Prior to the enactment of Proposition 2, when market rates exceeded 10% per annum, California borrowers and non-California lenders often attempted to shelter their transactions from a claim of usury by choosing the law of another state (usually the lender's state) with a more favorable usury law. Since many institutional lenders have opportunities to invest money in other states without usury risks, the motivation for such transactions often originated with the borrower, not the lender. Although this approach may be less necessary in light of the enactment of Proposition 2 and the Depository Institutions Act, it still is likely to remain a viable alternative for many loans, especially until some of the uncertainties created by Proposition 2 are resolved. In addition, the enactment of Proposition 2 may be viewed as facilitat-

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164. *See* note 76 *supra* and accompanying text.

165. *See* note 150 *supra* and accompanying text.

166. *See, e.g.*, Swenson v. File, 3 Cal. 3d 389, 475 P.2d 852, 90 Cal. Rptr. 580 (1970); Equitable Bldg. & Loan Ass'n v. Wolfangle, 111 Cal. App. 119, 295 P. 388 (1931).

167. *See* notes 85-86 *supra* and accompanying text.

ing such non-California transactions because it further demonstrates that California does not have a strong public policy against rates that exceed 10% per annum and that commercial loans and real estate loans may be treated in a more favorable, flexible manner than was the case prior to the enactment of Proposition 2. With these factors in mind, this article examines the impact of Proposition 2 on usury and choice-of-law policies in California.

A. Introduction

"Conflict of laws is one of the most hazardous of subjects, and it is with hesitation that I approach it."[168] In the twenty years since Chief Justice Traynor made the above comment, the law governing choice-of-law questions has continued to receive a great deal of attention. The traditional view relies on fixed rules of conflict of laws, such as those set forth in the Restatement of Conflict of Laws.[169] For example, the Restatement provides that the law of the place of contracting controls the validity of the contract,[170] but that if the place of performance is elsewhere, the law of the latter jurisdiction controls with respect to questions relating to the performance of the contract.[171] With respect to debt obligations, the place of payment is normally considered to be the place of performance for purposes of determining the applicable law.[172] These rules were used in order to obtain certainty of application and often worked to the exclusion of state interests.

A second theory, manifest in the Restatement (Second) of Conflict of Laws[173] prefers, in the absence of a stipulation by the parties, the law of the jurisdiction that has the "most significant relationship" to the transaction.[174] When the parties expressly choose a governing law, however, a more liberal rule is applied. Section 203 of the Restatement (Second) provides that the validity of a contract will be sustained against a charge of usury if it provides for a rate of interest that is permissible in a state to which the contract has a "substantial relationship" provided the rate of interest is not greatly in excess of the rate permitted by the usury law otherwise applicable under the rule set forth

168. Traynor, *Is This Conflict Really Necessary?*, 37 TEX. L. REV. 657 (1959) [hereinafter cited as Traynor].
169. RESTATEMENT OF CONFLICT OF LAWS (1934) [hereinafter cited as RESTATEMENT].
170. *Id.* § 311.
171. *Id.* § 358.
172. *Id.* § 365.
173. RESTATEMENT (SECOND) OF CONFLICT OF LAWS (1969) [hereinafter cited as RESTATEMENT (SECOND)].
174. *Id.* § 188.

in section 188. Under this rule, it may be possible for a transaction to have a "substantial relationship" with more than one state, thereby permitting the parties to choose the governing law from several such states for their transactions.[175] On the other hand, in the absence of such a choice, section 188 appears to provide that there is only one state with the "most significant relationship."[176]

A third approach, suggested by a number of writers in the field of usury, is the "rule of validation." This well established rule, which "enjoys an undisputed existence,"[177] provides that a contract for the payment of interest will be validated, whenever possible, by applying the more lenient usury statute of any state sufficiently connected with the contract. Section 203 of the Restatement (Second) appears to adopt a similar rule.[178]

Another theory, considered by many to be the trend in California, is the governmental interest approach, which is based on the determination of whether the forum state has a legitimate interest in the application of its own law.[179] Using this approach, the forum state considers all of the foreign and domestic contacts with a transaction and determines the interests of each state in the application of its law to the transaction. If the forum state has substantial contacts with the transaction and a legitimate interest in applying its law, then the forum state will apply its law to the transaction, even though other states have contacts with the transaction and a legitimate interest in the application of their law.[180] Recent decisions suggest that California courts have adopted the governmental interest approach, perhaps with modifications, in noncommercial transactions.[181] Although the language in such opinions is quite broad, it is not yet certain whether the govern-

175. *See, e.g.*, Gamer v. duPont Glore Forgan, Inc., 65 Cal. App. 3d 280, 135 Cal. Rptr. 230 (1976). *See* notes 184-191 *infra* and accompanying text.

176. *See* note 200 *infra*.

177. Comment, *Usury in the Conflict of Laws: The Doctrine of the Lex Debitoris*, 55 CALIF. L. REV. 123, 125 (1967) (quoting Nussbaum, *Conflict Theories of Contracts*, 51 YALE L.J. 893, 912 (1942)).

178. RESTATEMENT (SECOND) § 203, *supra* note 173, provides as follows:

> The validity of a contract will be sustained against the charge of usury 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 general usury law of the state of the otherwise applicable law under the rule of § 188.

Comment b states: "Usury is a field where this policy of validation is particularly apparent." *Id.* comment b. *See also id.* comment b, Illustrations 1 & 2.

179. *See generally* Traynor, *supra* note 168.

180. *See* B. CURRIE, *The Constitution and the Choice of Law: Governmental Interests and the Judicial Function*, in SELECTED ESSAYS ON THE CONFLICT OF LAWS 188, 188-89 (1963).

181. *See, e.g.*, Bernhard v. Harrah's Club, 16 Cal. 3d 313, 546 P.2d 719, 128 Cal. Rptr. 215 (1976).

mental interest approach would be applied to disputes concerning commercial transactions.

B. The California Cases

Although there are numerous California cases involving conflicts of laws in other fact situations, California courts have not often considered these problems with respect to potentially usurious interstate or international commercial transactions. Early California cases involving choice-of-law questions, decided at a time when the Restatement approach predominated, upheld the commercial transactions involved therein on the basis of, *inter alia*, the rule of validation.[182] Three recent California appellate decisions and one Ninth Circuit decision, however, have considered choice-of-law issues in cases dealing with potentially usurious commercial transactions.[183] In three of these cases, the contract had a choice-of-law provision and the courts relied primarily on the special usury rules of section 203 of the Restatement (Second) in determining whether the chosen state had a substantial relationship with the transaction and whether there was a violation of a fundamental forum policy. In the fourth case, there apparently was no choice-of-law provision in the contract and the court seems to have relied on concepts similar to the general contract rules of section 188 of the Restatement (Second) in determining which state had the "most significant relationship" to the transaction.

1. The *Gamer* Case

The most recent California appellate decision involving choice-of-law and usury is *Gamer v. duPont Glore Forgan, Inc.*[184] In that case, the court upheld a contract against a charge of usury by applying New York law. The dispute arose under a contract for a securities margin account on which, for the periods in dispute, the effective rate of interest charged the plaintiff ranged between 9.5% per annum and 12.25% per annum. The plaintiff sought to recover the allegedly usurious interest on behalf of himself and a class of other parties to such agreements. The contract contained a provision which stated that the laws of the State of New York were to govern the rights of the parties. The trial

182. *See, e.g.*, Robbins v. Pacific E. Corp., 8 Cal. 2d 241, 272-74, 65 P.2d 42, 58-59 (1937); Kraemer v. Coward, 2 Cal. App. 2d 506, 38 P.2d 458 (1934).

183. Gamer v. duPont Glore Forgan, Inc., 65 Cal. App. 3d 280, 135 Cal. Rptr. 230 (1976); Rochester Capital Leasing Corp. v. K & L Litho Corp., 13 Cal. App. 3d 697, 91 Cal. Rptr. 827 (1970); Ury v. Jewelers Acceptance Corp., 227 Cal. App. 2d 11, 38 Cal. Rptr. 376 (1964); Sarlot-Kantarjian v. First Pa. Mortgage Trust, 599 F.2d 915 (9th Cir. 1979).

184. 65 Cal. App. 3d 280, 135 Cal. Rptr. 230 (1976).

court, relying on this provision and on the validity of the interest charged under New York law, granted summary judgment for the defendant and the plaintiff appealed.

On appeal, the court considered three grounds for rejecting the choice-of-law provision in the contract. First, plaintiff argued that because the contract was a printed form prepared by the defendant, it was a contract of adhesion that violated California's public policy. Second, plaintiff argued that the contract's choice of New York law had no substantial relationship to the transaction because the agreement was signed, all buy and sell orders were placed, many orders were executed, and all payments were made in California. Third, plaintiff argued that the choice of New York law, if upheld, would result in a violation of California's fundamental public policy against usury. The court rejected all three arguments.

First, the court noted that contracts of adhesion are frequently enforced, and that the plaintiff had read and understood the provisions of the contract. It cited *Windsor Mills, Inc. v. Collins & Aikman Corp.*[185] to the effect that even choice-of-law provisions in contracts of adhesion are usually respected unless they violate a fundamental forum policy.

Second, the *Gamer* court concluded that the transaction had a substantial relationship with the chosen state, New York, citing the Restatement (Second) section 187.[186] Even though the court accepted plaintiff's contentions that the transaction had a substantial relationship with the forum state, California, because the agreement was signed in California, all payments were made in California, all orders were placed in California, and most orders were executed on the Pacific Stock Exchange in California, the court ruled that the transaction also

185. 25 Cal. App. 3d 987, 101 Cal. Rptr. 347 (1972).

186. RESTATEMENT (SECOND) § 187, *supra* note 173, provides as follows:

(1) The law of the state chosen by the parties to govern their contractual rights and duties will be applied if the particular issue is one which the parties could have resolved by an explicit provision in their agreement directed to that issue.

(2) The law of the state chosen by the parties to govern their contractual rights and duties will be applied, even if the particular issue is one which the parties could not have resolved by an explicit provision in their agreement directed to that issue, unless either

(a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice, or

(b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties.

(3) In the absence of a contrary indication of intention, the reference is to the local law of the state of the chosen law.

bore a substantial relationship to the State of New York because the defendant's principal place of business was in New York and the defendant's making of a settlement for shares purchased for the plaintiff's margin account was accomplished in New York. In the court's view, this settlement, not the accepting of an order to buy securities for plaintiff, was the extension of credit, and thus the loan was made in New York.[187] The important aspect of *Gamer* is that it recognizes that a transaction may have a "substantial relationship" with more than one state. So long as it has a substantial relationship with the *chosen* state, the transaction is likely to be upheld.[188] This test is different from the test set forth in section 188 of the Restatement (Second) in which, in the absence of a choice by the parties, the court is required to apply the law of the state with the "most significant relationship" to the transaction.

With respect to the third argument, the court held that the choice of New York law would not violate a fundamental California policy against usury. The court distinguished between a policy against usury (the charging of excessive interest) and a policy against interest that exceeded a particular rate.[189] After noting that any enforcement of a choice-of-law provision assumes some difference in policy, the court considered various factors, including the regulation of securities markets by the federal government and the legitimate connections of the transaction with New York. The court also took judicial notice that the "prime rate" had been as high as 9% per annum in the period at issue and referred to the exemptions granted certain lenders from the California usury laws. In addition, the court cited section 1105 of the California Commerical Code,[190] which permits choice-of-law provisions, as supporting "by analogy" the validity of the choice-of-law made in the contract at issue. Summing all the factors it had discussed, the court held that the contract at issue in *Gamer* "did not offend against a policy of California law," although the precise reasoning by which it reached this conclusion was not disclosed.[191]

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187. The Washington Supreme Court reached the opposite conclusion in a case involving similar facts. O'Brien v. Shearson Hayden Stone, Inc., 90 Wash. 2d 680, 586 P.2d 830 (1978).

188. The court in *Gamer* held that "substantial relationship" and "reasonable relationship" are equivalent to each other. 65 Cal. App. 3d at 290, 135 Cal. Rptr. at 235.

189. *Id.* at 287, 135 Cal. Rptr. at 234.

190. CAL. COM. CODE § 1105 (West Supp. 1979) provides that "[w]hen a transaction bears a reasonable relation to this state and also to another state or nation the parties may agree that the law either of this state or of such other state or nation shall govern their rights and duties."

191. 65 Cal. App. 3d at 290, 135 Cal. Rptr. at 235.

2. The *Ury* Case

An earlier appellate decision involving choice of law and usury is *Ury v. Jewelers Acceptance Corp.*[192] The lender in that case, a New York corporation, had only six or seven clients located in California. The plaintiff-borrower was first contacted by a representative of the lender in California, but his initial application for credit was rejected. The borrower made persistent efforts to obtain a loan, including a trip to New York, and the application was eventually approved. At the insistence of the lender, the borrower incorporated, thereby losing the protection of the New York usury law,[193] and the financing was consummated. The lender prepared a financing contract in the form of a proposal by the borrower that was accepted by the lender in New York and that expressly stipulated that the contract was to be construed according to New York law. The loan provided for interest payments at a rate slightly more than 20% per annum and was secured by the borrower's accounts receivable which presumably had a situs in California. The borrower subsequently sued for declaratory relief, rescission or reformation of the contract and penalties, all on the basis that the contract was usurious. The trial court upheld the contract on the ground that New York and not California usury law controlled and the plaintiff appealed.

The judgment was affirmed by the court of appeal, which emphasized four elements in the case. First, there was evidence that the contract was made in New York because the last act necessary to the creation of the contract, the acceptance, was performed in that state.[194] Second, New York was the place of principal performance of the contract; the money was made available to the borrower there by deposit to its bank account and was partially repaid.[195] Third, the parties had stipulated that the contract was to be "construed" according to the laws of New York.[196] Although the stipulation was not as broad as those in which the parties stipulated that the law of a certain state should prevail in all matters concerning the contract, the court concluded that the stipulation did effectively contradict any idea that the parties intended California usury law to apply. Fourth, the agreement was not a "con-

192. 227 Cal. App. 2d 11, 38 Cal. Rptr. 376 (1964).

193. N.Y. GEN. OBLIG. LAW § 5-521(1) (McKinney 1978) provides: "No corporation shall hereafter interpose the defense of usury in any action." A corporation may, however, impose a defense based on criminal usury, *i.e.*, interest in excess of 25% per annum. *Id.* § 5-521(3).

194. 227 Cal. App. 2d at 16, 38 Cal. Rptr. at 379.

195. *Id.* at 16-17, 38 Cal. Rptr. at 380.

196. *Id.* at 17, 38 Cal. Rptr. at 380.

tract of adhesion" because the borrower engaged in extensive negotiation and was acting with the advice of counsel available. More importantly, the court appeared to single out commercial loan transactions for special treatment:

> In general, the courts have treated commercial loan transactions in a special manner and have enforced contracts which are valid in the state of making and performance although they are usurious in the state of the forum, where all or even some of the factors given above are present.[197]

The *Ury* court rejected the borrower's contention that California has a strong public policy against usury, at least in a choice-of-law context, stating that such a policy would be incompatible with the exemptions from the Usury Law contained in the California Constitution:

> A strong public policy, based on a settled concept of justice or morality would not be meshed with such alterable rates as the Legislature might choose to impose. In fact, the Legislature has imposed no maximum rate for banks. The loan in this case, if it had been made by a bank in California and was payable here, could be enforced.[198]

3. The *Rochester* Case

Another appellate decision suggests, however, that the California courts will not invariably validate otherwise usurious transactions by applying choice-of-law doctrines. In *Rochester Capital Leasing Corp. v. K & L Litho Corp.*,[199] the court held a personal property sale-leaseback transaction to be a disguised loan with an imputed interest rate of 11.5% per annum. Rochester argued on appeal that since the documents required all payments to be made at its New York office, New York was the place of performance of the contract and its law should govern,[200] citing *Ury*. The court rejected that argument, reciting the substantial contacts of the transaction with California.

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197. *Id.* at 19, 38 Cal. Rptr. at 382.
198. *Id.* at 20, 38 Cal. Rptr. at 382.
199. 13 Cal. App. 3d 697, 91 Cal. Rptr. 827 (1970).
200. RESTATEMENT (SECOND) § 188, *supra* note 173, provides as follows:

The Law Governing in Absence of Effective Choice by the Parties

(1) The rights and duties of the parties with respect to an issue in contract are determined by the local law of the state which, with respect to that issue, has the most significant relationship to the transaction and the parties under the principles stated in § 6.

(2) In the absence of an effective choice of law by the parties (see § 187), the contacts to be taken into account in applying the principles of § 6 to determine the law applicable to an issue include:

The *Rochester* transaction was apparently negotiated and carried out, to a substantial extent, in California. Moreover, it does not appear that the documents contained a New York choice-of-law provision, and the court's decision appears to be based on a conclusion that California had the "most significant relationship" to the transaction, although the court did not cite section 188 of the Restatement (Second) or discuss choice-of-law theories in any detail. The *Rochester* decision is troubling to the extent that it lacks any discussion of "policy" issues and is based in part on post-closing contacts in California created by Rochester's efforts to enforce its rights under the agreement. Nevertheless, in light of *Gamer* and recent California cases adopting the governmental interest approach, the *Rochester* opinion is not likely to be influential in resolving future choice-of-law problems.

4. The *Sarlot-Kantarjian* Case

In the recent Ninth Circuit case of *Sarlot-Kantarjian v. First Pennsylvania Mortgage Trust*,[201] the court upheld a choice-of-law provision selecting Massachusetts law. Sarlot-Kantarjian (S-K) was a California general partnership formed to develop a sixty-six unit condominium project in Los Angeles. Sarlot, a contractor, and Kantarjian, a lawyer, were both knowledgeable and experienced in construction and real estate ventures.[202] S-K sought construction financing from First Pennsylvania Mortgage Trust (the Trust), a Massachusetts business trust with its principal place of business in Boston, Massachusetts. The Trust issued a commitment to provide a two-year $3.2 million loan at a rate of 5% over the prime rate. After the commitment letter was executed by S-K and received by the Trust, the Trust engaged California legal counsel to prepare the loan documents. The documents specified that the documents should be construed in accordance with Massachusetts law. Sarlot and Kantarjian travelled to Boston to close the loan and obtain the initial disbursement of funds. The loan documents were

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(a) the place of contracting,
(b) the place of negotiation of the contract,
(c) the place of performance,
(d) the location of the subject matter of the contract, and
(e) the domicile, residence, nationality, place of incorporation and place of business of the parties.

These contacts are to be evaluated according to their relative importance with respect to the particular issue.

(3) If the place of negotiating the contract and the place of performance are in the same state, the local law of this state will usually be applied, except as otherwise provided in §§ 189-199 and 203.

201. 599 F.2d 915 (9th Cir. 1979).

202. *Id.* at 916.

executed in Boston, the closing occurred in Boston, and all loan proceeds were paid into S-K's transfer account in Boston. All repayments of the loan were made to the Trust's account in Boston. When the loan was fully repaid, S-K initiated an action against the Trust for usury. The Trust acknowledged that the interest paid was in excess of 10% and thus would be usurious under California law, but contended that Massachusetts law should govern in accordance with the agreement of the parties.

The court agreed, citing section 187 of the Restatement (Second), which states that the law of the chosen state will be applied unless the chosen state has no substantial relationship to the parties or transaction or if the application of the law of the chosen state would be contrary to a fundamental policy of the forum state.[203] The court rejected S-K's contention that the chosen state must have the *most* substantial relationship and found that "Massachusetts had very significant contacts with the transaction"[204] even though the borrower was a California general partnership and the loan was secured by real estate in California. The court then cited *Ury* to support its finding that "California's public policy against usury is not offended by the adoption of Massachusetts law in this case."[205]

Sarlot-Kantarjian is thus consistent with *Ury* and *Gamer* in its conclusion that the location of the lender and the situs of certain other elements, such as closing, funding, and repayment, are sufficient to create a "substantial relationship with the chosen state." These cases also conclude that California does not have a strong policy against usury, at least with respect to commercial loan transactions when the rate does not greatly exceed the rate permitted in California.

C. *The Governmental Interest Approach*

Although *Ury, Gamer, Rochester*, and *Sarlot-Kantarjian* are important and have been discussed in some detail because they are the only recent authority involving California Usury Law and choice-of-law policies, it is not certain whether they would be strictly followed if the issue were to be considered by the California Supreme Court. Several recent California Supreme Court decisions hold, at least in tort cases, that mechanical application of the principles set forth in the Restatement (Second) is no longer the accepted response to a problem

203. *Id.* at 917 n.1. Under Erie R.R. Co. v. Tompkins, 304 U.S. 64 (1938), the court was required to apply California law in order to resolve the conflict-of-laws issue.
204. 599 F.2d at 917.
205. *Id.* at 918.

involving conflict of laws.[206] The California Supreme Court now requires the courts to " 'determine the law that most appropriately applies to the issue involved' "[207] based on a careful analysis of the respective interests of the litigants and the states involved.[208] The governmental interest approach has not yet been specifically applied to commercial loan transactions when choice-of-law issues are involved, but it has been applied consistently in other areas[209] and its concepts appear to have broad application.

In these recent cases, the California Supreme Court has given special attention to the actual interests of the concerned states and of the parties in the resolution of the particular issues involved in such cases. Although not framed in terms of forum interest, the discussion of public policy in *Gamer* is consistent with this standard. In *Reich v. Purcell,*[210] the California Supreme Court stated the proper approach to a conflicts problem in a multistate tort situation as follows:

> In a complex situation involving multi-state contacts, however, no single state alone can be deemed to create exclusively governing rights. The forum must search to find the proper law to apply based upon the interests of the litigants and the involved states.[211]

The court began with the premise that the law of the forum will be displaced only if there is a compelling reason for doing so. However, the court need not disregard relevant contacts with other states and the parties' contractual choice of a certain state's law. Rather, the transaction's contacts and the choice-of-law clause are directly relevant to the "interests of the litigants" to be examined together with the respective interests of the states involved in the transaction. Recent decisions indicate that in applying the governmental interest approach, California courts will attempt to avoid frustrating the policies of other states when possible.

The California Supreme Court decisions also indicate a willing-

206. *See, e.g.*, Offshore Rental Co. v. Continental Oil Co., 22 Cal. 3d 157, 148 Cal. Rptr. 867, 583 P.2d 721 (1978); Bernhard v. Harrah's Club, 16 Cal. 3d 313, 546 P.2d 719, 128 Cal. Rptr. 215, *cert. denied*, 429 U.S. 859 (1976).

207. Bernhard v. Harrah's Club, 16 Cal. 3d 313, 316, 546 P.2d 719, 720-21, 128 Cal. Rptr. 215, 216-17, *cert. denied*, 429 U.S. 859 (1976) (quoting Reich v. Purcell, 67 Cal. 2d 551, 555, 432 P.2d 727, 730, 63 Cal. Rptr. 31, 34 (1967)).

208. *Id.* at 316, 546 P.2d at 720, 128 Cal. Rptr. at 216.

209. *See* Hurtado v. Superior Court, 11 Cal. 3d 574, 522 P.2d 666, 114 Cal. Rptr. 106 (1974); Reich v. Purcell, 67 Cal. 2d 551, 432 P.2d 727, 63 Cal. Rptr. 31 (1967); Traynor, *supra* note 168, at 668-70.

210. 67 Cal. 2d 551, 432 P.2d 727, 63 Cal. Rptr. 31 (1967).

211. *Id.* at 553, 432 P.2d at 729, 63 Cal. Rptr. at 33 (citations omitted).

ness to define narrowly the interests embodied in a given California law in the face of broader policy considerations and the need to do justice in the individual case.[212] Although not expressly decided on the basis of the governmental interest approach, both *Gamer* and *Ury* evidence this same willingness. With respect to usury, California courts have traditionally considered forum policy in the context of a broad policy of validation of contracts based on the justified expectations of the parties and have upheld such transactions when the selected state had a reasonable relationship to the transaction. Although the theories articulated by the courts have varied, prior decisions indicate that California's interest in opposing usury is not the only state policy to be considered in a choice-of-law decision. As *Gamer* indicates, a policy against usury is not necessarily a policy against the particular rate of interest under all circumstances and the parties' choice-of-law is a major factor to be considered in determining whether to apply California law. Moreover, as evidenced by *Ury*, California's interest in the application of its usury laws to a particular loan transaction should vary inversely with the ability of the borrower to protect himself and the degree of legitimate contacts with another forum.

The enactment of Proposition 2 provides an opportunity to examine the application of the governmental interest approach in light of the significant changes in the California Usury Law. Although it is unlikely that the enactment of Proposition 2 will change the result in most choice-of-law cases, it does add substantial support to the concepts set forth in *Ury, Gamer*, and *Sarlot-Kantarjian*. It should also provide a reliable basis for applying the governmental interest approach to future loan transactions.

The most recent California Supreme Court decisions applying the governmental interest approach are *Bernhard v. Harrah's Club*[213] and *Offshore Rental Co. v. Continental Oil Co.*[214] The plaintiff in *Bernhard* was injured in California when his motorcycle collided with a car driven by an individual who had previously been served alcohol at the defendant Harrah's Club in Nevada and who was allegedly driving negligently while under the influence of alcohol. Plaintiff alleged that the defendant's negligence was the proximate cause of his injuries and sought to recover under the California rule which imposes civil liability

212. *See* Bernhard v. Harrah's Club, 16 Cal. 3d 313, 319-22, 546 P.2d 719, 722-24, 128 Cal. Rptr. 215, 218-20, *cert. denied*, 429 U.S. 859 (1976); Bernkrant v. Fowler, 55 Cal. 2d 588, 594-96, 360 P.2d 906, 909-10, 12 Cal. Rptr. 266, 269-70 (1961); People v. One 1953 Ford Victoria, 48 Cal. 2d 595, 598-99, 311 P.2d 480, 482-83 (1957).

213. 16 Cal. 3d 313, 546 P.2d 719, 128 Cal. Rptr. 215, *cert. denied*, 429 U.S. 859 (1976).

214. 22 Cal. 3d 157, 583 P.2d 721, 148 Cal. Rptr. 867 (1978).

on one who knowingly serves an intoxicated person. Nevada does not impose such liability, and the defendant argued that the tort, if any, was committed in Nevada and that the law of its domicile should control its liability. After observing that the laws of California and Nevada were not identical with respect to the issue involved, the court examined the interests of the respective states to determine if the apparent difference was a "false conflict." Concluding that each state had an interest in applying its law to the resolution of the issue, the California Supreme Court for the first time found itself faced with a "true" conflict between two policies.[215] Nevada's policy of protecting tavern keepers from liability could not be carried out if California's interest in protecting the public against excessive use of alcohol was enforced. Both states had legitimate and significant contacts with the dispute: Nevada as the place where the liquor was served and the defendant resided; California as the place where the injury occurred and the plaintiff resided.

The supreme court did not merely recite that the governmental interest theory would call for the application of forum law in a "true" conflict situation. Instead, the court considered the degree to which the interests and policies of the respective states would be infringed upon by a refusal to apply their law. Under this "comparative impairment" test, the court decided that California could not achieve its policy unless its statute were applied to out-of-state tavern owners who actively sought California business. The court deliberately limited its decision to those tavern keepers "who regularly and purposely sell intoxicating beverages to California residents in places and under conditions in which it is reasonably certain these residents will return to California."[216] Thus, the court limited the impact of its decision so that it would not necessarily apply to *all* Nevada tavern keepers. The court also recognized that Nevada had criminal statutes making it unlawful to sell intoxicating liquors to any person who is drunk, and thus the application of the California law imposing civil liability would not impose an entirely new duty on the tavern keepers.[217] Since the impairment of Nevada policy was slight in the court's view, it applied the California rule.

The analytical procedure employed by the California Supreme Court in *Bernhard* appears to involve at least three steps: (1) an analysis of the applicable law of every state reasonably connected with the

215. Bernhard v. Harrah's Club, 16 Cal. 3d at 319, 546 P.2d at 722, 128 Cal. Rptr. at 218.
216. *Id.* at 322-23, 546 P.2d at 725, 128 Cal. Rptr. at 221.
217. *Id.* at 323, 546 P.2d at 725, 128 Cal. Rptr. at 221.

transaction to determine whether an apparent conflict exists; (2) a critical examination of the interests of the litigants and the policies of the involved states to determine if a "false" conflict exists; and (3) a further analysis of the comparative impairment of the respective state interests and policies to resolve "true" conflicts. It is significant that the court in *Bernhard* declined to follow the orthodox view of the governmental interest approach and apply forum law in a "true" conflicts situation. Instead, it indicated that

> the "comparative impairment" approach to the resolution of such conflict seeks to determine which state's interest would be more impaired if its policy were subordinated to the policy of the other state. This analysis proceeds on the principle that true conflicts should be resolved by applying the law of the state whose interest would be the more impaired if its law were not applied. Exponents of this process of analysis emphasize that it is very different from a weighing process. The court does not " 'weigh' the conflicting governmental interests in the sense of determining which conflicting law manifested the 'better' or the 'worthier' social policy on the specific issue. An attempted balancing of conflicting state policies in that sense . . . is difficult to justify in the context of a federal system in which, within constitutional limits, states are empowered to mold their policies as they wish. . . . [The process] can accurately be described as . . . accommodation of conflicting state policies, as a problem of allocating domains of law-making power in multi-state contexts—limitations on the reach of state policies—as distinguished from evaluating the wisdom of those policies . . . . [E]mphasis is placed on the appropriate scope of conflicting state policies rather than on the 'quality' of those policies . . . ."[218]

It is clear that both step 2 and step 3 in the court's analysis require a critical examination of the scope of the policy of the forum state; to state that the transaction would have been invalid in the forum state is simply not sufficient. Instead, the forum should "reexamine its policy to determine if a more restricted interpretation of it is more appropriate."[219] This reexamination process includes not only an analysis of

218. *Id.* at 320-21, 546 P.2d at 723-24, 128 Cal. Rptr. at 219-20 (quoting Horowitz, *The Law of Choice of Law in California—A Restatement*, 21 U.C.L.A. L. REV. 719, 753 (1974) [hereinafter cited as Horowitz]).

219. *Id.* at 320, 546 P.2d at 723, 128 Cal. Rptr. at 219.

the particular forum policy that creates the apparent conflict but also an analysis of other competing *forum* policies.

In a usury context, this means that the court must undertake not only a detailed examination of California *usury* policy, but also a review of a number of other California policies relating to the validity of contracts generally. Such other policies include interpreting a contract so that it is lawful and capable of being carried into effect, providing certainty, uniformity and upholding the reasonable expectations of parties to commercial agreements, regulating the activities of certain lending institutions and encouraging the flow of capital into California thereby lowering interest rates and creating employment. The object of this analysis is to determine the aggregate California interest which, in "true" conflicts situations, would then be compared with the aggregate policy of the other state pursuant to the "comparative impairment" test set forth in *Bernhard*. Although the process may appear to be unduly complex and subjective, it responds surprisingly easily to analysis if taken one step at a time.

In applying the governmental interest approach to commercial loan transactions, it appears that the three-step process employed in *Bernhard*[220] may, perhaps, be more easily analyzed if it is expanded into a five-step procedure: (1) a determination of whether California as a forum has *any* interest in the matter, *i.e.*, the "false" conflict issue; (2) if California is determined to have an interest, an examination of the quality and the quantity of the forum contacts which create that interest; (3) an analysis of the scope and extent of the basic forum policy at issue, *i.e.*, the strength of the California policy against usury; (4) an analysis of competing forum policies that may contradict or ameliorate the California policy against usury; and (5) an analysis of the comparative impairment of the aggregate forum policy with the impairment of the policy of the chosen state or the state with the most significant competing interest.

As indicated above, the first step is to determine whether there are sufficient contacts with California to give it, as the forum state, an interest in applying its law to the transaction. However strong California's usury policy might be in the abstract, it has no application unless the parties or the transaction have some minimal contact with California. Since the purpose of usury laws is to protect certain borrowers,[221] normally it will be sufficient to create a forum interest if the transaction involves a California borrower. If the transaction involves a California

220. *See* notes 213-219 *supra* and accompanying text.
221. *See* note 100 *supra* and accompanying text.

lender or other California contacts (such as the location of collateral) but does not involve a California borrower, a "false" conflict is created and California should have no interest in applying forum law to the transaction, unless of course, the parties voluntarily choose California law in their contract. Conversely, the transaction must have sufficient contacts with some other state in order to give such state a legitimate interest in the application of its law. Normally the domicile of the lender will be sufficient to create such an interest, but this factor may not be essential, especially in transactions involving multiple lenders. In such transactions, the parties may wish to choose the law of a state where an agent or trustee for the lenders is located, or perhaps they will find it necessary or convenient to choose the law of some respected "neutral" state that has a well developed body of commercial law.[222] In such instances, the parties' express choice of a governing law, together with some other relevant contacts (such as closing, funding, or repayment) should be sufficient to create the appropriate "nexus" and resulting governmental interest of such state in applying its law to the transaction.

Assuming California is found to have an interest in the transaction, the second step requires an analysis of the quality and quantity of the contacts which create that interest. In a narrow sense, a state should only be concerned with activities that occur within its borders. In the broadest sense, a state may have an interest in protecting its citizens and residents wherever they may elect to engage in business. Both extremes seem unworkable in the context of a modern, mobile society.[223] Thus, the forum must "search to find the proper law to apply based on the interests of the litigants and the involved states."[224] For example, although the fact that a California borrower is involved in the transaction may be sufficient to create an interest in the application of California law, the strength of that interest may depend on the type of borrower involved and the degree to which that borrower needs the protection of the California usury laws. Is a large multinational corporation headquartered in California to be treated the same as an individual resident? Does it make a difference whether the proceeds of the loan will be used for personal, family, or household purposes or for commercial purposes? How much weight should be given to the express choice of law by the parties? Did the borrower have the advice of counsel available? What about other "contacts," such as the place of

222. The Bremen v. Zapata Off-Shore Co., 407 U.S. 1 (1972).
223. *See* Horowitz, *supra* note 218, at 753.
224. Reich v. Purcell, 67 Cal. 2d 551, 553, 432 P.2d 727, 729, 63 Cal. Rptr. 31, 33 (1967).

negotiations, the site of the closing, the location of the collateral, and the place of repayment? Under the traditional approaches to choice-of-law problems, these factors often determined which state's *law* was to be applied to the transaction.[225] Under the governmental interest approach, these factors remain an integral part of the analysis, but instead they help to define the extent of the forum *interest* and to determine the scope of the forum *policy* which should then be reviewed in light of the policies of the other involved states and the express choice of the parties.[226]

Proposition 2 provides a basis for evaluating the relative importance of these contacts. For example, Proposition 2 makes a clear distinction between loans for personal, family, and household purposes and all other loans. Thus, California's interest in protecting individual borrowers should be stronger than its interest in protecting corporate or commercial borrowers. Likewise, the entire thrust of the governmental interest approach is to examine relevant forum interests and policies, not mechanical contacts. Consequently, methodically comparing the number of telephone calls or meetings that occurred in California with those that occurred elsewhere or requiring corporate directors to fly to another state for board meetings seems both transparent and legally irrelevant. If a California borrower is involved, it should be assumed that some negotiations and most internal administrative procedures will occur in California. The situs of these activites should not be viewed as significant because they should be deemed to be included inherently in the context of a transaction involving a California borrower. On the other hand, the location of legally significant actions, such as the execution of documents, the disbursement of funds, and the repayment of amounts borrowed should be considered in determining the strength of the forum interest. While such factors may not be as important as the residence of the parties and their deliberate selection of a particular law to govern their respective rights and obligations, such factors do have a substantial tradition of being included in choice-of-law analyses and are thus likely to continue to be reflected in the governmental interest approach. Thus, California's interest should diminish if a substantial portion of such events occurs outside California.

The third step is to analyze the scope and extent of the forum interest. With respect to usury, it seems clear that California's policy is one of providing flexible protection for certain borrowers in need of

225. *See* RESTATEMENT (SECOND) § 188, *supra* note 173.

226. Dixon Mobile Homes, Inc. v. Walters, 48 Cal. App. 3d 964, 122 Cal. Rptr. 202 (1975).

such protection and that California does not have a strict policy of opposition to interest rates in excess of a certain per annum amount.[227] California banks and savings and loan associations are essentially unregulated in setting interest rates, even for consumer transactions.[228] Licensed personal property brokers are also essentially unregulated with respect to commercial loans in excess of $5,000 and *all* loans in excess of $10,000.[229] Even consumer loans of less than $10,000 may bear interest as high as 2.5% per month, depending on the amount of the loan.[230] Other statutes, such as the Unruh Act, permit finance charges as high as 1.5% per month.[231] The enactment of Proposition 2 with its higher rate for nonpersonal loans continues and expands this tradition. The common thread throughout California's Usury Law appears to be that the desired protection is best supplied not by regulating interest *rates* but instead by regulating the persons or entities who engage in the money-lending business. This objective is accomplished by exempting certain lenders from the Usury Law, establishing a licensing procedure, and granting to the legislature the power to regulate such lenders if it deems regulation necessary.[232] Even such regulation as does exist seems primarily accented toward licensing procedures and disclosure requirements instead of *rate* regulation. Although in some cases California courts have sought to establish the state's power to regulate out-of-state lenders,[233] for the most part the legislature has established a policy of encouraging such lenders to participate in California lending activity without being subject to licensing requirements or other undue regulation.[234] These concepts are further strengthened by the enactment of Proposition 2 and lead to the conclusion that California does not have a strong public policy against rates that are not greatly in excess of the rates permitted by the Usury Law, especially if a similar loan could have been made by a California exempt lender. As indicated above, *Ury, Gamer*, and section 203 of the Restatement (Sec-

227. Gamer v. duPont Glore Forgan, Inc., 65 Cal. App. 3d 280, 287, 135 Cal. Rptr. 230, 234 (1976); Ury v. Jewelers Acceptance Corp., 227 Cal. App. 2d 11, 20-21, 38 Cal. Rptr. 376, 382-83 (1964).

228. *See* note 22 *supra*.

229. CAL. FIN. CODE § 22053 (West 1968).

230. *Id.* §§ 22451, 22451.5 (West Supp. 1979).

231. CAL. CIV. CODE § 1810.2 (West 1973).

232. *See* Carter v. Seaboard Fin. Co., 33 Cal. 2d 564, 203 P.2d 758 (1949); Ops. Cal. Att'y Gen. No. 80-122 (April 29, 1980).

233. *See, e.g.*, People v. Fairfax Family Fund, Inc., 235 Cal. App. 2d 881, 47 Cal. Rptr. 812 (1964), *appeal dismissed*, 382 U.S. 1 (1965).

234. *See, e.g.*, CAL. CORP. CODE §§ 191(d), 2104 (West 1977); CAL. FIN. CODE §§ 1757, 1758 (West 1968).

ond) reach a similar conclusion.[235] Thus, California's interest in applying its Usury Law should diminish as the need for protection of the borrower diminishes.

The fourth step involves an analysis of other competing forum policies that must be weighed with California usury policy to determine the aggregate forum policy. The policy of upholding contracts whenever possible and protecting the reasonable expectation of the parties finds support in several California statutes[236] and in numerous California cases.[237] An example of such a case is *Bernkrant v. Fowler*,[238] cited with approval by the court in *Bernhard*.[239] The plaintiffs in *Bernkrant* owned an apartment house in Las Vegas, Nevada, encumbered by a deed of trust in favor of Mr. Granrud. In 1954, at Granrud's request, plaintiffs refinanced the property and prepaid a portion of the obligation to Granrud. Granrud orally agreed that upon his death the balance of the obligation would be cancelled. Granrud died two years later, a resident of California, and his will made no provision for cancelling the obligation. Plaintiffs continued payments to Granrud's estate under protest while they brought an action to enforce the oral promise to have the note cancelled and discharged and the second deed of trust released and reconveyed.

The California Supreme Court concluded that the oral promise was enforceable under the Nevada statute of frauds although it would have been unenforceable in California. Chief Justice Traynor said the following regarding the choice-of-law problem:

> The contract was made in Nevada and performed by plaintiffs there, and it involved the refinancing of obligations arising from the sale of Nevada land and secured by interests therein. Nevada has a substantial interest in the contract and in protecting the rights of its residents who are parties thereto, and its policy is that the contract is valid and enforceable. California's policy is also to enforce lawful contracts. . . . Since there is thus no conflict between the law of California and the law of Nevada, we can give effect to the common policy of both states to enforce lawful contracts and sustain Nevada's interest in protecting its residents and their reasonable

235. *See, e.g.*, text accompanying note 198 *supra*.
236. *See, e.g.*, CAL. CIV. CODE §§ 1643, 3541 (West 1973); CAL. COM. CODE §§ 1102(2)(b), 1102(3), 1105(1) (West 1964).
237. *See, e.g.*, Barham v. Barham, 33 Cal. 2d 416, 429, 202 P.2d 289, 297 (1949); Moss Dev. Co. v. Geary, 41 Cal. App. 3d 1, 9-10, 115 Cal. Rptr. 736, 742 (1974).
238. 55 Cal. 2d 588, 360 P.2d 906, 12 Cal. Rptr. 266 (1961).
239. 16 Cal. 3d at 320, 546 P.2d at 723, 128 Cal. Rptr. at 219.

> expectations growing out of a transaction substantially related to that state without subordinating any legitimate interest of this state.[240]

Bernkrant suggests that, under the governmental interest approach, California should be regarded as having an interest in protecting the "reasonable expectations" of the parties arising out of a commercial transaction that is "substantially related" to the chosen state. This suggestion, as *Gamer* noted, is supported by section 1105(1) of the California Commercial Code, which expressly provides that "when a transaction bears a reasonable relation to this state and also to another state or nation the parties may agree that the law either of this state or of such other state or nation shall govern their rights and duties."[241]

Although, as *Gamer* acknowledged, it is likely that this provision is directly applicable only to California Commercial Code transactions, the provision does indicate the general policy of California to recognize a stipulated choice of law in the commercial area. One commentator has stated that

> the enactment by the legislature of this provision should be viewed in broader perspective as well: The adoption of a multistate policy by which to resolve a conflict of the laws of states each of which has a "reasonable relation[ship]" (i.e., an interest in having its policy applied) to the transaction. That principle—giving effect to a "private" declaration as to which law should govern—can soundly be applied, as a legislatively-declared "precedent," to other planned bilateral transactions. . . .[242]

Several recent cases also suggest that the need for certainty and uniformity in commercial transactions is a factor that deserves consideration in determining forum policy.[243] The enactment of the California Commercial Code and other Uniform Acts evidences this same policy.[244] In fact, in financial transactions that have contacts with several states, the need for certainty with respect to the governing law is

240. 55 Cal. 2d at 595-96, 360 P.2d at 910, 12 Cal. Rptr. at 270.

241. CAL. COM. CODE § 1105(1) (West Supp. 1979).

242. Horowitz, *supra* note 218, at 768.

243. Bernkrant v. Fowler, 55 Cal. 2d 588, 360 P.2d 906, 12 Cal. Rptr. 266 (1961); The Bremen v. Zapata Off-Shore Co., 407 U.S. 1 (1972).

244. *See* LARMAC, INDEX TO CALIFORNIA LAWS 972-73 (1979). California has also established a Commission on Uniform State Laws whose purpose is "to promote uniformity in State laws upon all subjects where uniformity is deemed desirable and practicable." CAL. GOV. CODE §§ 10400-10433 (West 1966 & Supp. 1979).

likely to be one of the most important factors in determining which law should apply. In such instances the parties should be able to choose the law of a state which has a substantial relationship to the transaction in order to achieve certainty about the extent of their obligations and to ensure that their efforts have created a valid and binding contract.

A recent United States Supreme Court decision upheld such a choice when the express contractual provision was the only contact with the stipulated forum. This case, *The Bremen v. Zapata Off-Shore Co.*,[245] dealt with a choice-of-forum clause rather than a choice-of-law provision, but its reasoning and its treatment of the underlying policy considerations strongly support the conclusion that parties should be able to enter into commercial and financial transactions with certainty as to the nature and extent of their obligations.

The case involved a contract to tow an ocean-going, self-elevating drilling rig from Louisiana to Italy. The contract stipulated that the London Court of Justice was to have jurisdiction over any dispute under the contract. The drilling rig was damaged in a storm in the Gulf of Mexico, and the rig's owner commenced an action for damages in the United States District Court despite the provision in the contract. Additional litigation occurred between the parties, both in the district court and in the London Court of Justice, and the district court subsequently enjoined the tug owner from proceeding further in the London Court of Justice. On appeal by the tug owner, the court of appeals affirmed and certiorari was granted by the United States Surpeme Court.

The Court held that when an American company with special expertise contracted with a foreign company, which was also experienced and sophisticated in business, for towing a complex machine thousands of miles across the ocean, and a clause providing that such disputes be heard only before the London Court of Justice was a part of such contract, the choice-of-forum clause was prima facie valid. The clause was to be honored by the parties and enforced by the courts in the absence of some compelling countervailing reasons making enforcement unreasonable. Significantly, the fact that the London Court would enforce exculpatory clauses invalid under American law was not a compelling reason for denying enforcement. The *Zapata* decision's emphasis on the fact that the clause was agreed to by sophisticated parties who had substantial negotiating experience and who were able to look out for themselves suggests that other courts, including those in California,

245. 407 U.S. 1 (1972).

would likewise enforce similar choices of commercial parties.[246]

A recent decision of the California Supreme Court further supports this argument. In *Smith, Valentino & Smith, Inc. v. Superior Court*,[247] the court considered a contract appointing a local agent for a Philadelphia insurer. The contract contained a reciprocal choice-of-forum clause, whereby the agent agreed to bring actions on the agreement only in Philadelphia and the insurer agreed to bring all such actions in Los Angeles. After a dispute arose, the agent initiated an action in California despite the clause. After the trial court dismissed the action because of the choice-of-forum clause, the plaintiff agent argued that such clauses violated California public policy and were unenforceable.

The California Supreme Court, although noting the "policy favoring access to California courts by resident plaintiffs,"[248] concluded "that the policy is satisfied in those cases where . . . a plaintiff has freely and voluntarily negotiated away his right to a California forum."[249] The court, citing *Zapata*, noted the "modern trend" favoring enforcement of forum selection clauses in contracts "entered into freely and voluntarily by parties who have negotiated at arm's length" and ruled that enforcement of such clauses was within the trial court's discretion.[250]

Perhaps more relevant to the issues involved in this discussion is the court's initial statement that, because the agreement contained a choice of Pennsylvania law and "[s]uch choice of law provisions are usually respected by California courts,"[251] the Pennsylvania policy of enforcing reasonable forum selection clauses should apply. The court's analysis of California law revealed no different standard, and the choice-of-law issue was not discussed further. The court did, however, cite, with apparent approval, the statement from *Windsor Mills, Inc. v. Collins & Aikman Corp.*,[252] that choice-of-law provisions, even those in printed forms used by commercial parties, are usually respected.[253] The *Gamer* court cited this apparent approval as reaffirmation of the

246. *Cf.* Berard Constr. Co. v. Municipal Court, 49 Cal. App. 3d 710, 721-22, 122 Cal. Rptr. 825, 832-33 (1975) (parties may contract in advance to submit to the jurisdiction of a given court).

247. 17 Cal. 3d 491, 551 P.2d 1206, 131 Cal. Rptr. 374 (1976).

248. *Id.* at 495, 551 P.2d at 1209, 131 Cal. Rptr. at 377.

249. *Id.*

250. *Id.* at 495-96, 551 P.2d at 1209, 131 Cal. Rptr. at 377.

251. *Id.* at 494, 551 P.2d at 1208, 131 Cal. Rptr. at 376.

252. 25 Cal. App. 3d 987, 995 n.6, 101 Cal. Rptr. 347, 352 n.6 (1972).

253. Smith, Valentino & Smith, Inc. v. Superior Court, 17 Cal. 3d 491, 494, 551 P.2d 1206, 1208, 131 Cal. Rptr. 374, 376 (1976).

policy to respect parties' choice-of-law provisions.[254]

In addition to these general policies respecting the validity of contracts, there is also substantial evidence of specific California policies favoring commercial loans and real estate loans and encouraging certain activities by foreign lenders.[255] For example, California Corporations Code sections 191 and 2104 exempt certain foreign lending institutions from many California regulations including licensing, qualification to do business in California, and taxation.[256] Section 1757 of the California Financial Code, cited by the court in *Sondeno*,[257] exempts foreign banking institutions from licensing requirements that might otherwise be applicable with respect to real estate loans. Finally, the provisions of Proposition 2 which entitle certain real estate loans to the higher rate of interest and which totally exempt loans made or arranged by licensed real estate brokers suggest a special concern for real estate loans. The ballot arguments confirm that Proposition 2 was intended to encourage increased investment in California, thereby lowering interest rates.[258] As indicated at the beginning of this article, there were some preliminary indications that, but for the intervention of federal monetary policy, such expectations were being realized.[259]

All of these general policies relating to upholding the validity of contracts and the specific policies relating to encouraging the activities of certain foreign lenders must be weighed with California usury policy to determine the aggregate California interest. Depending on the facts of the case, a court might well conclude that the aggregate California policy is to uphold the transaction. Because this conclusion is consistent with the express choice of the parties and the interest of the other state, there would be no need to engage in a comparative impairment analysis. On the other hand, if it is concluded that California has an interest in applying its Usury Law to the transaction, *Bernhard* requires that such interest be compared with the interest of the other state to determine which interest will be more impaired by the application of the other state's law.[260] The final step, therefore, involves a compara-

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254. Garner v. duPont Glore Forgan, Inc., 65 Cal. App. 3d 280, 286-87, 135 Cal. Rptr. 230, 233 (1976).

255. These policies are also reflected at the federal level by the enactment of the Depository Institutions Act.

256. CAL. CORP. CODE §§ 191(d), 2104 (West 1977).

257. 71 Cal. App. 3d at 394, 139 Cal. Rptr. at 231.

258. California Ballot Pamphlet (Nov. 6, 1979), at 12.

259. *See* note 9 *supra* and accompanying text.

260. Bernhard v. Harrah's Club, 16 Cal. 3d 313, 546 P.2d 719, 128 Cal. Rptr. 215, *cert. denied*, 429 U.S. 859 (1976).

tive impairment analysis of the California Usury Law and the law of the state chosen by the parties. Most states have usury laws that specifically exempt corporate borrowers, transactions in excess of certain amounts, and certain real estate loans[261] and this discussion has assumed that the transaction at issue would be valid under the laws of the chosen state. It seems reasonable to assume that most states likewise have policies in favor of upholding the validity of contracts and providing certainty and uniformity for the interpretation of commercial agreements. A restrictive California usury policy could deprive the lenders in such states from access to the California market and deprive California borrowers from access to capital and funds needed for business and development, thereby impairing the interest of such states without advancing any significant California policy. The governmental interest approach, therefore, permits the anticipated flexibility in California Usury Law intended by Proposition 2 to be likewise reflected in choice-of-law analysis, validating the great majority of legitimate transactions while protecting the interests of the borrower in need of such protection. So long as the transaction is valid in the chosen state, has a reasonable relationship with the chosen state, and does not involve a loan for personal, family, or household purposes, there should be no overriding forum interest that requires the application of California law.

V. RECENT FEDERAL USURY LEGISLATION

On March 31, 1980, President Carter signed the Depository Institutions Deregulation and Monetary Control Act of 1980.[262] The Depository Institutions Act is the latest and most comprehensive in a series of recent federal laws attempting to respond to the problems created by rapidly escalating interest rates.[263] It became effective April 1, 1980 and preempted state usury laws[264] in four significant areas.

261. For a summary of state usury laws, see 1 CONS. CRED. GUIDE (CCH) ¶ 510, at 1309-17 (April 29, 1980).

262. Pub. L. No. 96-221, 94 Stat. 132 [hereinafter cited as the Depository Institutions Act or the Act].

263. *See* note 45 *supra*. In addition, in order to implement federal monetary policy designed to control inflation, the Federal Reserve Board has issued a series of regulations affecting consumer credit. *See, e.g.*, 45 Fed. Reg. 17,927 (1980) (to be codified in 12 C.F.R. Part 229). However, on April 17, 1980 the Board indicated that such regulations were not intended to preempt state usury laws. Federal Reserve Board Press Release (April 17, 1980).

264. Most state usury laws provide for both civil and criminal penalties. *See, e.g.*, CAL. CIV. CODE § 1916-3 (West 1980). A question might be raised whether the preemption was intended to extend to such criminal laws. The language of the Depository Institutions Act

A. Residential Loans

Section 501(a)(1) of the Depository Institutions Act preempts state usury ceilings on first mortgage loans on residential real property made by specified institutional lenders.[265] The states, however, are granted the power to override the preemption if they act within three years.[266] Any such law enacted to override the federal usury preemption, however, must do so expressly and will not be effective with respect to commitments issued prior to such enactment even though the loans are

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clearly seems broad enough to include criminal usury laws, and any other result would seem illogical.

265. Section 501(a)(1) provides as follows:

> The provisions of the constitution or the laws of any State expressly limiting the rate or amount of interest, discount points, finance charges, or other charges which may be charged, taken, received, or reserved shall not apply to any loan, mortgage, credit sale, or advance which is—
>
> (A) secured by a first lien on residential real property, by a first lien on stock in a residential cooperative housing corporation where the loan, mortgage, or advance is used to finance the acquisition of such stock, or by a first lien on a residential manufactured home;
>
> (B) made after March 31, 1980; and
>
> (C) described in section 527(b) of the National Housing Act (12 U.S.C. 1735f-5(b)), except that for the purpose of this section—
>
> (i) the limitation described in section 527(b)(1) of such Act that the property must be designed principally for the occupancy of from one to four families shall not apply;
>
> (ii) the requirement contained in section 527(b)(1) of such Act that the loan be secured by residential real property shall not apply to a loan secured by stock in a residential cooperative housing corporation or to a loan or credit sale secured by a first lien on a residential manufactured home;
>
> (iii) the term "federally related mortgage loan" in section 527(b) of such Act shall include a credit sale which is secured by a first lien on a residential manufactured home and which otherwise meets the definitional requirements of section 527(b) of such Act, as those requirements are modified by this section;
>
> (iv) the term "residential loans" in section 527(b)(2)(D) of such Act shall also include loans or credit sales secured by a first lien on a residential manufactured home;
>
> (v) the requirement contained in section 527(b)(2)(D) of such Act that a creditor make or invest in loans aggregating more than $1,000,000 per year shall not apply to a creditor selling residential manufactured homes financed by loans or credit sales secured by first liens on residential manufactured homes if the creditor has an arrangement to sell such loans or credit sales in whole or in part, or if such loans or credit sales are sold in whole or in part to a lender, institution, or creditor described in section 527(b) of such Act or in this section or a creditor, as defined in section 103(f) of the Truth in Lending Act, as such section was in effect on the day preceding the date of enactment of this title, if such creditor makes or invests in residential real estate loans or loans or credit sales secured by first liens on residential manufactured homes aggregating more than $1,000,000 per year; and
>
> (vi) the term "lender" in section 527(b)(2)(A) of such Act shall also be deemed to include any lender approved by the Secretary of Housing and Urban Development for participation in any mortgage insurance program under the National Housing Act.

Pub. L. No. 96-221, § 501(a)(1), 94 Stat. at 161.

266. *Id.* § 501(b)(2), 94 Stat. at 162.

funded after the effective date of such enactment.[267] If the states do not act within three years, the preemption becomes permanent.

The preemption applies to any state law limiting the rate or amount of interest, discount points, finance charges, or other charges which may be charged, taken, received or reserved with respect to such loans, and the Act does not specify any interest rate limitation for such loans. In order to be entitled to the preemption, such loans must be secured by first liens on residential real property, stock in a residential cooperative housing corporation, or a residential manufactured home.[268] The loan must be made after March 31, 1980 and be a "federally related mortgage loan" as that term is defined in section 527(b) of the National Housing Act.[269] However, section 501(a)(1)(C) removes several restrictions and substantially broadens the definition of "federally related mortgage loans" with the result that most "conventional" first mortgage loans made by institutional lenders on residential real property will be entitled to the usury preemption.[270]

The Depository Institutions Act authorizes the Federal Home Loan Bank Board to issue rules and regulations and to publish interpretations governing the implementation of section 501 of the Act.[271] On April 3, 1980, the Board adopted a series of regulations implementing section 501 of the Act.[272] It defined residential real property as property "improved or to be improved by a structure or structures designed primarily for dwelling, as opposed to commercial use"[273] and concluded that there is no limitation on the number of dwelling units

267. *Id.* § 501(b)(3), 94 Stat. at 162.

268. *Id.* § 501(a)(1), 94 Stat. at 161.

269. *See* 12 U.S.C. § 1735f-5(b) (1976).

270. It should be noted, however, that sellers of residential real property who finance such sale by "taking back" a note for the balance of the purchase price may not be covered by § 501 even if such note is secured by a first mortgage. However, in California, such sellers would not be subject to the Usury Law as a result of the application of the time-price doctrine. *See* note 124 *supra* and accompanying text. In addition, many real estate brokers may not be qualified lenders for purposes of § 501(a)(1). However, loans by brokers should be covered by Proposition 2. *See* notes 91-94 *supra* and accompanying text. Congress was apparently aware that sellers of real property and loans by real estate brokers were not covered by § 501(a)(1). *See* 126 CONG. REC. H2280 (daily ed. March 27, 1980) (remarks of Rep. St Germain).

271. Pub. L. No. 96-221, § 501(f), 94 Stat. at 163.

272. 45 Fed. Reg. 24,112 (1980) (to be codified in 12 C.F.R. Part 590). These regulations replace the regulations issued under Act of Dec. 28, 1979, Pub. L. No. 96-161, 93 Stat. 1233, but the Board has indicated that it will continue to adhere to the positions taken in such regulations. See 45 Fed. Reg. 2,840 (1980); 45 Fed. Reg. 6,165 (1980); 45 Fed. Reg. 8,000 (1980); 45 Fed. Reg. 15,921 (1980).

273. 45 Fed. Reg. 24,112, 24,114 (1980) (to be codified in 12 C.F.R. § 590.2(e)).

contained in the structure.[274] Accordingly, a question has arisen whether construction loans for multi-unit apartment buildings are exempted from state usury ceilings. Although there is legislative history, which suggests that some members of Congress may have considered such loans to be business loans governed by section 511 instead of residential loans covered by section 501,[275] the regulations seem to reach a contrary conclusion. The Board's interpretation is consistent with the basic policy of the federal usury law in promoting the construction and financing of residential housing,[276] and it is also consistent with previous federal usury legislation.[277] Thus, the better view seems to be that construction loans for residential apartment projects are included in the usury preemption.

There are a number of other questions raised by the Act. To what extent will existing state law determine what types of transactions constitute "loans" and what types of charges constitute "interest?" For example, section 501(a)(1) refers to any "loan, mortgage, credit sale or advance" but does not use the word "forbearance." Are forbearances included? Most state usury laws apply to both loans and forbearances

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274. *Id.* at 24,113.

275. On March 27, 1980, Congressmen St Germain and Mattox engaged in the following colloquy:

> Mr. MATTOX.
>
> . . .
>
> Does a loan issued to a builder for the construction of commercial property like a shopping center, for instance, constitute a business loan within the definition of the statute?
>
> Mr. ST GERMAIN. Mr. Speaker, will the gentleman yield?
>
> Mr. MATTOX. I yield to the gentleman from Rhode Island.
>
> Mr. ST GERMAIN. Mr. Speaker, as the gentleman from Ohio (Mr. WYLIE) pointed out, the answer is: Absolutely.
>
> Mr. MATTOX. Mr. Speaker, the next question is this: Does a loan issued to a builder, a homebuilder, for the purpose of constructing residential dwellings for the purpose of resale to homebuyers constitute a business loan, or is it a residential loan?
>
> Mr. ST GERMAIN. Mr. Speaker, this would be business financing. It is a business loan in that there is indeed interim financing: Therefore, it would be a business loan.

126 CONG. REC. H2291 (daily ed. March 27, 1980).

276. *See* 125 CONG. REC. S18959 (daily ed. Dec. 18, 1979); 125 CONG. REC. S19163 (daily ed. Dec. 19, 1979). It is difficult to believe that Congress intended to stimulate jobs in residential construction by making permanent mortgage funds available while not making construction funds available on the same terms. Section 528 of the Depository Institutions Act also provides that if one or more provisions of the Act or other federal statutes apply with respect to the same loan, the loan may be made at the highest applicable rate. Thus, the fact that a construction loan may be a "business" loan under § 511 does not mean that it could not also be a residential loan under § 501.

277. *See, e.g.*, 12 U.S.C. § 1709-la (1976) (temporary construction loans or other interim financing for projects to be permanently financed by FHA and VA loans are included in the federal usury preemption).

and it would seem illogical to exempt loans but not forbearances.[278] Section 501(a)(1) also refers to "interest, discount points, finance charges or other charges," but it does not specify what "other charges" are included. What about commissions, late charges, prepayment penalties, attorneys' fees, closing costs, etc.? California has enacted a number of statutes regulating or limiting the amount of such charges.[279] Are such statutes preempted by the Depository Institutions Act? The answer should be that such questions should be determined by state law[280] and that if such charges are not interest under state law, they should not be preempted by section 501. Accordingly, consumer protection statutes regulating closing costs, late charges, prepayment penalties, and similar charges probably remain valid, notwithstanding the federal preemption of state usury laws.[281]

To what extent may lenders with existing commitments take advantage of the new federal usury provisions? May they now fund loans at rates that would have been usurious prior to April 1, 1980? Although section 501(a)(1) refers to loans "made" after March 31, 1980, the Federal Home Loan Bank Board has apparently concluded that the usury preemption does not apply to loans for which commitments were made prior to the effective date of the Act but which are to be funded after April 1, 1980.[282] It noted that commitments made between December 28, 1979 and March 31, 1980 were exempted from state interest ceilings by Public Law 96-161 and concluded that commitments not covered by Public Law 96-161 or commitments made prior to December 28, 1979 continue to be governed by state law even if funded after April 1, 1980. This result seems contrary to the express language of

278. Under California law, "interest" is defined as "the compensation allowed by law or fixed by the parties for the use, or *forbearance*, or detention of money." CAL. CIV. CODE § 1915 (West 1980) (emphasis added). Thus, if federal law preempts state usury laws with respect to "interest," such preemption should apply to both loans and forbearances.

279. *See, e.g.*, CAL. CIV. CODE §§ 2954.4 (late charges), 2954.9 (prepayment penalties) (West 1980); CAL. BUS. & PROF. CODE §§ 10242 (expenses and charges), 10242.5 (late charges), 10242.6 (prepayment penalties) (West 1967 and Supp. 1980).

280. Such charges are usually determined not to be "interest" for usury purposes. *See, e.g.*, Garrett v. Coast & S. Fed. Sav. & Loan Ass'n, 9 Cal. 3d 731, 511 P.2d 1197, 108 Cal. Rptr. 845 (1973) (late charges); Lazzareschi Inv. Co. v. San Francisco Fed. Sav. & Loan Ass'n, 22 Cal. App. 3d 303, 99 Cal. Rptr. 417 (1971) (prepayment penalties); Haines v. Commercial Mortgage Co., 200 Cal. 609, 254 P. 956, 255 P. 805 (1927) (expenses and closing costs).

281. The Federal Home Loan Bank Board has reached a similar conclusion. Regulation § 590.3(c) provides that federal law does not preempt "limitation[s] in state laws on prepayment charges, attorneys fees, late charges or other provision designed to protect borrowers." 45 Fed. Reg. 24,112, 24,114 (1980) (to be codified in 12 C.F.R. § 590.3(c)).

282. *Id.* at 24,113.

section 501(a)(1) and the intent of some members of Congress.[283] Until the law is clarified, however, lenders should carefully consider the risks involved in attempting to fund prior commitments at rates in excess of those permitted by state usury laws. The parties should, however, be able to amend existing commitments and to refinance existing loans in order to take advantage of the new law.[284]

B. Business and Agricultural Loans

Section 511 of the Depository Institutions Act preempts state usury laws with respect to business and agricultural loans in the amount of $25,000 or more.[285] In contrast to loans made under section 501, loans may be made by any "person," not just certain specified lenders. Such loans are subject, however, to a maximum interest rate of "5 per centum in excess of the discount rate, including any surcharge thereon,[286] on ninety-day commercial paper in effect at the Federal Reserve bank

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283. On March 27, 1980, Congressman St Germain responded to a question by Congressman Mattox as follows:

> Mr. MATTOX. Mr. Speaker, on floating rate loans, on which the interest is contractually tied to the prime interest rate, plus additional points, and where the total effective rate . . . stipulated in the contract could not be put into effect because of the existence of State or Federal usury ceilings, could the full effect of the contract interest rate be utilized on the total loan amount, assuming the enactment of this legislation and, then, would this rate as stated in the contract be legal?
>
> Mr. ST GERMAIN. Yes, it would.
>
> Mr. MATTOX. Mr. Speaker, let me ask my final question in the form of an example:
>
> Let us assume that a commitment for a floating rate construction loan, as I have just described, was made in January 1980, but such loan is not closed until after the effective date of this act (April 1, 1980). Is the maximum interest rate "allowed by law" the rate which is in existence at the time of the commitment (January 1980), or is it the rate in existence at the time of closing (after April 1980)?
>
> Mr. ST GERMAIN. It would be the rate at the time of the closing.

126 CONG. REC. H2291 (daily ed. March 27, 1980).

284. The Federal Home Loan Bank Board concluded that an agreement to refinance an existing loan would be considered to be a new loan for the purposes of the Act of Dec. 28, 1979, Pub. L. No. 96-161, 93 Stat. 1233. *See* 45 Fed. Reg. 6,165, 6,166 (1980). A similar question arises under Proposition 2. *See* notes 85-86 *supra* and accompanying text.

285. Section 511(a) provides as follows:

> If the applicable rate prescribed in this section exceeds the rate a person would be permitted to charge in the absence of this section, such person may in the case of a business or agricultural loan in the amount of $25,000 or more, notwithstanding any State constitution or statute which is hereby preempted for the purposes of this section, take, receive, reserve, and charge on any such loan, interest at a rate of not more than 5 per centum in excess of the discount rate, including any surcharge thereon, on ninety-day commercial paper in effect at the Federal Reserve bank in the Federal Reserve district where the person is located.

Pub. L. No. 96-221, § 511(a), 94 Stat. at 164.

286. On May 7, 1980, the Federal Reserve Board deleted the 3% surcharge imposed on March 17, 1980. Wall St. J., May 7, 1980, at 2, col. 2. Thus, the maximum rate currently permitted under the federal law is the same as permitted under Proposition 2.

in the Federal Reserve district where the person is located."[287] Unlike section 501, this preemption is temporary and will expire on the earlier of April 1, 1983 or the date upon which a state enacts a measure expressly stating that such state does not want [such provisions] to apply with respect to loans made in such state."[288] The Act does provide, however, that commitments for loans made prior to such enactment will be valid even though the loan is funded after the date of such enactment.[289] Unlike the authority given to the Federal Home Loan Bank Board under section 501, no federal agency is given express authority to interpret or implement sections 511 and 512. However, the language in section 511 had its origins in the Brock Bill,[290] and rulings and interpretations issued by the Comptroller of the Currency for the Administrator of National Banks may be useful in interpreting section 511.[291]

Although many of the basic concepts underlying section 511 seem similar to the concepts underlying Proposition 2, the language of section 511 is different from the language in Proposition 2 in several significant respects. For example, section 511 preempts state usury laws with respect to "business" loans. On the other hand, Proposition 2 permits the parties to agree to a higher rate for loans for uses other than "personal, family or household" purposes. Are these concepts the same? It seems probable that the term "business" loans may be construed more narrowly than the definition of nonpersonal loans under Proposition 2 with the result that real estate loans and loans for investment purposes, which are nonpersonal loans under Proposition 2, may not be "business" loans under section 511.[292] Also, Proposition 2 refers to a "loan or forbearance" but there is no reference to a "forbearance" in the federal law. Are forbearances included? As with section 501, the resolution of this issue may be left to state law.[293] Finally, the determination of the rate-setting date may not be the same under Proposition 2

287. Pub. L. No. 96-221, § 511(a), 94 Stat. at 164.

288. *Id.* § 512, 94 Stat. at 164.

289. *Id.*

290. Act of Oct. 29, 1974, Pub. L. No. 93-501, 88 Stat. 1557 (expired July 1, 1977).

291. *See, e.g.*, Letters from Thomas G. DeShazo, Deputy Comptroller of the Currency (March 12, 1975; March 27, 1975).

292. The Administrator of National Banks, in an unpublished letter, which interpreted similar language under the "Brock Bill," Act of Oct. 29, 1979, Pub. L. No. 93-501, 88 Stat. 1557 (expired July 1, 1977), concluded that loans for personal investment purposes were not "business" loans. Letter from Thomas G. DeShazo, Deputy Comptroller of the Currency (March 27, 1975). *See also* note 53 *supra* and accompanying text. *But see* 126 CONG. REC. H2286 (daily ed. March 27, 1980).

293. *See* note 228 *supra*.

as it is under section 511. Section 511 refers to loans "made" on or after April 1, 1980. There is no language similar to the "earlier of" language in Proposition 2. However, since federal law preempts state usury laws only if such laws would require a lower rate, for purposes of determining the applicable maximum rate the parties should be able to specify the higher of either the maximum rate permitted on the commitment date or the maximum rate permitted on the funding date in their agreement.[294]

As with Proposition 2, section 511 permits the parties to enter into long term, fixed-rate loans at the maximum allowable rate permitted at the time the loan is made and appears to provide that such loans will be valid notwithstanding a subsequent decline in the discount rate.[295] May the parties agree to a floating rate loan limited by subsequent changes in the discount rate? Although section 512 refers to loans "made" on or after April 1, 1980 and would thus appear to refer to a single rate-setting date, loans with a floating maximum rate have been allowed under the National Bank Act, which contains language similar to section 511.[296] Moreover, portions of the congressional debate on the Act indicate that Congress assumed that maximum floating rate loans are permitted by section 511.[297] However, the rate on such loans should float down as well as up with changes in the discount rate.[298]

A question also arises under section 511 with respect to its application to existing floating rate loans. May the interest rate on such loans now be raised to the maximum rate permitted by either state or federal law? A similar issue was discussed in Section II above[299] with respect to Proposition 2 and it was concluded there that lenders should be permitted to adjust the interest rate in accordance with the provisions of the note for the balance of the term of the loan so long as the adjusted rate does not exceed the maximum rate permitted by Proposition 2. A similar result apparently was intended by Congress[300] but there is some

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294. *See* note 73 *supra*.

295. *See* Comptroller Staff Interpretive Letter, [1978-1979 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 85,190 (Aug. 10, 1979).

296. *Id.* A similar question arises under Proposition 2. *See* notes 74-84 *supra* and accompanying text.

297. *See* note 283 *supra* and note 300 *infra*.

298. Comptroller Staff Interpretive Letter, [1978-1979 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 85,190 (Aug. 10, 1979).

299. *See* notes 162-163 *supra* and accompanying text.

300. On April 21, 1980, Senator Tower referred to such intent and inserted into the Congressional Record the following colloquy between himself and Senator Proxmire that occurred during the Senate passage of the Conference Report for the Depository Institutions Act:

question whether the express language of section 511 permits such adjustment. Since section 512 states that the preemption applies only to loans *made* during the period beginning on April 1, 1980 and ending on April 1, 1983 or the date of state override, presumably the preemption does not apply to loans made prior to the effective date of the Act. In an attempt to clarify congressional intent on the matter, Senator John Tower introduced an amendment to section 512,[301] which was

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Mr. TOWER. Mr. President, if the distinguished Senator from Wisconsin will indulge me, I have a question about a provision of the bill I would like to get clarified. It relates to preemption of State usury laws for agricultural and business loans over $25,000.

It is my understanding that, on floating rate loans where the interest is contractually tied to the prime interest rate plus additional points, and where the total effective rate that is stipulated in the contract could not be put into effect because of the existence of State or Federal usury ceilings, the full effect of the contract interest rate could be charged on the total loan amount, assuming the increase does not exceed the limitations of this bill.

As an example, let us assume that a loan was made in January 1980, which called for an interest rate of prime plus 5 percent. Let us assume that a State usury law limiting such loans was 18 percent, and the effective contract rate could not be charged, because the prime rate was 18 percent and, if the 5 percent was added, the total would exceed the State usury law. With enactment of this bill, however, the State usury law would be preempted and, while the lender could not charge the maximum amount allowable in this example, 23 percent, it could charge up to 21 percent, the maximum amount allowed today under this bill.

Mr. PROXMIRE. May I say to my friend from Texas that I agree that a loan which called for an interest rate of prime plus 5 percent, and in this example the assumption is that prime is 18 percent, this bill would allow floating rate loans to be adjusted upward to the maximum amount allowed under this bill.

The precise language of the particular contract would be governing, in any particular case. But, if a contract stated that the interest rate to be charged would be prime plus 5 percent, or the maximum amount allowed under law, not to exceed prime plus 5 percent, or other similar language which would provide flexibility in determining what the rate would be, I see no reason why the rate allowed under this bill could not be charged on existing floating rate loans.

Of course, any person governed by these provisions should consult with their own lawyer about particular factual situations because of possible penalties under State usury laws, which, of course, differ.

126 CONG. REC. S3986 (daily ed. April 21, 1980). *See also* note 283 *supra*.

301. The text of the amendment is as follows:

Sec. —. Section 512 of the Depository Institutions Deregulation and Monetary Control Act of 1980 is amended by adding at the end thereof the following: "A loan shall be deemed to be made during the period described in the preceding sentence if such loan—

"(A)(i) is funded or made in whole or in part during such period, regardless of whether pursuant to a commitment or other agreement therefor made prior to April 1, 1980;

"(ii) was made prior to or on April 1, 1980, and which bears or provides for interest during such period on the outstanding amount thereof at a variable or fluctuating rate; or

"(iii) is a renewal, extension, or other modification during such period of any loan, if such renewal, extension, or other modification is added to Senate Bill 2177[302] and was passed by the Senate on April 22, 1980.[303] The amendment provides that section 511 applies to all floating rate loans made prior to April 11, 1980. On the other hand, the fact that an amendment is necessary in order for the preemption to apply to existing loans suggests that the Act, as currently written, does not preempt state usury laws on loans made prior to April 1. As a result, until the Tower amendment is passed by the House, lenders should consider carefully whether sections 511 and 512 permit them to raise the interest rate unilaterally on existing floating rate loans to a rate in excess of that permitted by state law.

C. Obligations Issued by Depository Institutions

Section 501(a)(2) of the Depository Institutions Act provides that state usury laws shall not apply to interest "charged, taken, received or reserved" with respect to "any deposit or account held by or other obligations of a depository institution."[304] The term "depository institution" is defined to include banks, savings banks, credit unions, savings and loan associations, and other insured institutions except certain insured banks located in Puerto Rico.[305] The preemption is permanent and there is no provision granting the states the power to override the federal preemption. This provision contains language similar in content to the language of Public Law 96-161[306] and similar in purpose to the provisions of the Brock Bill[307] enacted in 1974. The basic premise is that depository institutions do not need the protection of the usury laws and should be permitted to pay to the public any interest rate the institution wants for the use of their funds.[308] Although the language in the Act is not identical to the language in Proposition 2, most depository institutions are also exempt lenders under Proposition 2 and, as a practical matter, there seems no justification for continued concern

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made with the written consent of any person obligated to repay such loan; and

"(B)(i) is in an original principal amount of $25,000 or more; or

"(ii) is part of a series of advances if the aggregate of all sums advanced or agreed or contemplated to be advanced pursuant to a commitment or other agreement therefor is $25,000 or more."

126 CONG. REC. S4046 (daily ed. April 22, 1980).

302. S. 2177, 96th Cong., 2d Sess. (1980).

303. 126 CONG. REC. S4046 (daily ed. April 22, 1980).

304. Pub. L. No. 96-221, § 501(a)(2), 94 Stat. at 162.

305. *Id.*

306. *See* Act of Dec. 28, 1979, Pub. L. No. 96-161, §§ 208-210, 93 Stat. 1233, 1238-39.

307. Act of Oct. 29, 1974, Pub. L. No. 93-501, 88 Stat. 1557 (expired July 1, 1977). *See* note 45 *supra*.

308. 125 CONG. REC. S15673 (daily ed. Nov. 1, 1979) (remarks of Sen. Cranston).

about the possible application of the usury laws to the obligations issued by such entities.

D. *Other Loans*

The Depository Institutions Act contains special provisions for loans by "small business investment companies"[309] and it also provides for an alternate rate for specified depository institutions of 1% per annum over the discount rate.[310] This latter provision, unlike seciton 511, applies to all loans, not just business and agricultural loans, and permanently preempts state usury laws. However, the states are given the power to override the federal law and there is no time limit specified within which the states must enact such legislation.[311] Sections 521-523 are similar to portions of the National Bank Act, which for nearly fifty years has permitted national banks to charge the greater of rates permitted by applicable state law or 1% in excess of the discount rate on ninety-day commercial paper in effect at the Federal Reserve Bank in the district where the national bank is located.[312] In recent months, as a result of rapid increases in the discount rate, this provision resulted in a distinct advantage for national banks in many states, particularly with respect to residential mortgage loans.[313] The provision has not

309. Pub. L. No. 96-221, § 524, 94 Stat. at 166.

310. *Id.*, §§ 521-523, 94 Stat. at 164-66. Section 521(a) provides as follows:

> In order to prevent discrimination against State-chartered insured banks, including insured savings banks and insured mutual savings banks, or insured branches of foreign banks with respect to interest rates, if the applicable rate prescribed in this subsection exceeds the rate such State bank or insured branch of a foreign bank would be permitted to charge in the absence of this subsection, such State bank or such insured branch of a foreign bank may, notwithstanding any State constitution or statute which is hereby preempted for the purposes of this section, take, receive, reserve, and charge on any loan or discount made, or upon any note, bill of exchange, or other evidence of debt, interest at a rate of not more than 1 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal Reserve bank in the Federal Reserve district where such State bank or such insured branch of a foreign bank is located or at the rate allowed by the laws of the State, territory, or district where the bank is located, whichever may be greater.

Similar language is contained in §§ 522 and 523 with respect to insured savings and loan associations and insured credit unions. In addition, §§ 521(b), 522(b) and 523(b) each provides a special penalty, similar to the penalties set forth in the National Bank Act, for violations of the federal usury law. *See* 12 U.S.C. § 86 (1976).

311. Pub. L. No. 96-221, § 525, 94 Stat. at 167.

312. *See* 12 U.S.C. 85 (1976 & Supp. 1978). National banks have been described as "national favorites" and may charge the highest rates available to any competing state lender even though state banks may not charge such rates. *See, e.g.*, Tiffany v. National Bank of Mo., 85 U.S. 409 (1873); Marquette Nat'l Bank v. First of Omaha Serv. Corp., 439 U.S. 299 (1978).

313. This provision has been described as a "federal loophole" that was not available to state-chartered lenders. *See, e.g.*, Wall St. J., Aug. 28, 1978, at 2, col. 1.

heretofore been significant in California because national banks are exempt from the Usury Law and because their primary California competitors with respect to residential mortgage loans, *e.g.*, state banks and state savings and loan associations, are likewise exempt. However, this provision operated to discriminate against such lenders in other states.

Sections 521-523 of the Depository Institutions Act extend the power to charge 1% per annum over the discount rate to state banks, state savings and loan associations, and other specified institutions. On the surface, because most of these lenders are already exempt from the Usury Law in California, and in light of the rates permitted by section 511, it appears that this change in the law should have little impact in this state. But when the language of sections 521-523 is coupled with the recent United States Supreme Court decision in *Marquette National Bank v. First of Omaha Service Corp.*,[314] it is apparent that this part of the Act may have far-reaching implications in California and in other states.

In *Marquette*, The First National Bank of Omaha (Omaha Bank), a national bank located in Nebraska, sought to enroll in its bank credit card program residents, merchants, and banks in Minnesota. Under Nebraska law and pursuant to the provisions of the National Bank Act,[315] the Omaha Bank was able to charge 18% interest on the outstanding balances in the accounts of its BankAmericard customers.[316] In contrast, national banks located in Minnesota were limited by state law to only 12% interest.[317] Although Minnesota law allowed Minnesota banks to charge cardholders an annual fee for the privilege of using the bank credit cards, the Minnesota banks apparently were still at a disadvantage when the Minnesota rates were compared to the rates charged by Nebraska banks. Thus, when the Omaha Bank began soliciting Minnesota customers, Marquette National Bank, a national bank located in Minnesota, brought suit claiming that the Omaha Bank was violating Minnesota usury law.[318]

The Supreme Court held that the Omaha Bank was governed by the National Bank Act, not by Minnesota law, and that the Omaha

314. 439 U.S. 299 (1978).

315. 12 U.S.C. § 85 (1976 & Supp. 1978). This section of the Code provides, in pertinent part:

> Any association may take, receive, reserve, and charge on any loan or discount made . . . interest at the rate allowed by the laws of the State, Territory or District where the bank is located, or at a rate of 1 per centum in excess of the discount rate on ninety-day commercial paper . . . whichever may be the greater . . . .

316. 439 U.S. at 302.

317. *Id.*

318. *Id.* at 304.

Bank was allowed to charge interest at the rate permitted by the state in which it was located.[319] The Court concluded that the Omaha Bank was located in Nebraska, notwithstanding its activities in Minnesota. The bank could, therefore, charge Nebraska rates on all of its loan transactions regardless of where the borrower was located or where the transaction was consummated.[320]

Because *Marquette* involved only national banks, the decision did not change the status of loans made by state banks to customers in other states, and the validity of such loan transactions continued to be governed by the choice-of-law principles discussed in Section IV above.[321] However, sections 521-523 of the Depository Institutions Act may have the effect of extending the *Marquette* holding to all state banks, state savings and loan associations, and credit unions.

Section 521 provides that "*[i]n order to prevent discrimination against State-chartered insured banks*" such banks may charge interest on any loan at the rate of 1% over the discount rate "or at *the rate allowed by the laws of the State . . . where the bank is located, whichever may be greater*."[322] Similar provisions are contained in sections 522 and 523 with respect to insured savings and loan associations and insured credit unions. The remarks of the original sponsors of section 521 indicate that its purpose is to allow state-chartered, federally insured banks, and other insured institutions to charge the same rate of interest as national banks.[323] May insured state-chartered banks, savings and loan associations, and credit unions also take advantage of the

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319. *Id.* at 308.

320. *Id.*

321. The Supreme Court in *Marquette* declined to interpret the term "located" as being subject to the "elastic" principles of conflicts of law. Instead it held that the term "located" means the state in which the national bank was issued its certificate of organization. *Id.* at 313.

322. Pub. L. No. 96-221, § 521, 94 Stat. at 164-65 (emphasis added).

323. In referring to the bill which he and Senator Bumpers were to introduce, Senator Pryor commented as follows:

> Mr. President, all Senators may not be aware of a statute that exists today which gives national banks an unfair advantage over many State banks and other financial institutions.
>
> Section 85 of title 12 of the United States Code provides that a national bank may charge 1 percent above the Federal discount rate, notwithstanding any State laws setting an interest-rate ceiling. Such an advantage obviously discriminates in the strongest possible way against State banks or savings and loans in those States where the usury-rate ceiling is below the discount rate.
>
> The bill my colleague (Mr. BUMPERS) and I shall introduce would merely allow State chartered, federally insured banks, federally insured savings and loans, small business investment companies, and Federal credit unions to charge the same interest rate as national banks.

125 CONG. REC. S15684 (daily ed. Nov. 1, 1979).

Marquette decision and charge interest at the rate allowed by the state in which such institutions are located, regardless of the location of the borrower or the transaction? For example, a state-chartered bank located in a state other than California may be allowed by the laws of such state to charge interest on commercial loans at rates of up to 25% per annum. May such bank now make a loan to a California borrower even though the rate may exceed the rate permitted under Proposition 2? Under *Marquette*, a national bank located in such state clearly could make such a loan.

The express purpose of section 521 is to prevent discrimination against state-chartered banks, and the testimony on the floor of the Senate when the bill was introduced makes it clear that the bill was intended to eliminate the advantage given to national banks under the National Bank Act.[324] Although sections 522 and 523 do not contain the preamble "in order to prevent discrimination," the balance of the language in such sections is nearly identical to the language in section 521, and insured savings and loan associations and insured credit unions should, therefore, be accorded the same privileges given to state-chartered banks under section 521. The language in sections 521-523 is also based on and is similar to the language in the National Bank Act considered by the Supreme Court in *Marquette*.[325] Consequently, the logical conclusion should be that all such lenders may now make loans at interest rates permitted by the laws of the state where such lenders are located, even though such rates may exceed the rates permitted by the state where the borrower is located. Although this result may surprise some members of Congress who may have been focusing solely on the provision permitting loans at rates not greater than 1% over the discount rate, it is consistent with both the language and purpose of sections 521-523. The Supreme Court in *Marquette* noted that if its holding were construed as an impairment of the ability of the states to enact effective usury laws or if it resulted in competitive inequalities, such arguments were better directed to the wisdom of Congress rather than to the judgment of the Court.[326] Congress seems to have reacted to such arguments by placing all such depository institutions on an equal footing.

324. Senator Proxmire, in discussing the intent of the proposed legislation, made the following statement: "What this would do would be to provide a national usury limit for everybody. We override all State laws as far as State banks are concerned—not just national banks." 125 CONG. REC. S15684 (daily ed. Nov. 1, 1979).

325. *See* notes 313-320 *supra* and accompanying text.

326. Marquette Nat'l Bank v. First of Omaha Serv. Corp., 439 U.S. at 319.

VI. Conclusion

This article has examined the significant changes in California Usury Law resulting from the enactment of Proposition 2 and the Depository Institutions Act. Despite some uncertainties and ambiguities (and notwithstanding the existence of mild frustration caused by some less-than-perfect draftsmanship), these two provisions, acting together, seem likely to achieve the objective of providing greater flexibility for California loan transactions, particularly real estate and commercial loans, thereby encouraging additional investment in California and, perhaps, reducing interest rates.

APPENDIX

Resolved by the Assembly, the Senate concurring, That the Legislature of the State of California at its 1979-80 Regular Session commencing on the fourth day of December, 1978, two-thirds of the members elected to each of the two houses of the Legislature voting therefor, hereby proposes to the people of the State of California that the Constitution of the state be amended by amending Section 1 of Article XV thereof, to read:

SECTION 1. The rate of interest upon the loan or forbearance of any money, goods, or things in action, or on accounts after demand, shall be 7 percent per annum but it shall be competent for the parties to any loan or forbearance of any money, goods or things in action to contract in writing for a rate of interest:

(1) For any loan or forbearance of any money, goods, or things in action, if the money, goods, or things in action are for use primarily for personal, family, or household purposes, at a rate not exceeding 10 percent per annum; provided, however, that any loan or forbearance of any money, goods or things in action the proceeds of which are used primarily for the purchase, construction or improvement of real property shall not be deemed to be a use primarily for personal, family or household purposes; or

(2) For any loan or forbearance of any money, goods, or things in action for any use other than specified in paragraph (1), at a rate not exceeding the higher of (a) 10 percent per annum or (b) 5 percent per annum plus the rate prevailing on the 25th day of the month preceding the earlier of (i) the date of execution of the contract to make the loan or forbearance, or (ii) the date of making the loan or forbearance established by the Federal Reserve Bank of San Francisco on advances to member banks under Sections 13 and 13a of the Federal Reserve Act as now in effect or hereafter from time to time amended (or if there is no such single determinable rate of advances, the closest counterpart of such rate as shall be designated by the Superintendent of Banks of the State of California unless some other person or agency is delegated such authority by the Legislature.)

No person, association, copartnership or corporation shall by charging any fee, bonus, commission, discount or other compensation receive from a borrower more than the interest authorized by this section upon any loan or forbearance of any money, goods or things in action.

However, none of the above restrictions shall apply to any obligations of, loans made by, or forbearance of, any building and loan association as defined in and which is operated under that certain act known as the "Building and Loan Association Act," approved May 5, 1931, as amended, or to any corporation incorporated in the manner prescribed in and operating under that certain act entitled "An act defining industrial loan companies, providing for their incorporation, powers and supervision," approved May 18, 1917, as amended, or any corporation incorporated in the manner prescribed in and operating under that certain act entitled "An act defining credit unions, providing for their incorporation, powers, management and supervision," approved March 31, 1927, as amended or any duly licensed pawnbroker or personal property broker, or any loans made or arranged by any person licensed as a real estate broker by the State of California and secured in whole or in part by liens on real property, or any bank as defined in and operating under that certain act known as the "Bank Act," approved March 1, 1909, as amended, or any bank created and operating under and pursuant to any laws of this State or of the United States of America or any nonprofit cooperative association organized under Chapter 1 (commencing with Section 54001) of Division 20 of the Food and Agricultural Code in loaning or advancing money in connection with any activity mentioned in said title or any corporation, association, syndicate, joint stock company, or partnership engaged exclusively in the business of marketing agricultural, horticultural, viticultural, dairy, live stock, poultry and bee products on a cooperative nonprofit basis in loaning or advancing money to the members thereof or in connection with any such business or any corporation securing money or credit from any federal intermediate credit bank, organized and existing pursuant to the provisions of an act of Congress entitled "Agricultural Credits Act of 1923," as amended in loaning or advancing credit so secured, or any other class of persons authorized by statute, or to any successor in interest to any loan or forbearance exempted under this article, nor shall any such charge of any said exempted classes of persons be considered in any action or for any purpose as increasing or affecting or as connected with the rate of interest hereinbefore fixed. The Legislature may from time to time prescribe the maximum rate per annum of, or provide for the supervision, or the filing of a schedule for, or in any manner fix, regulate or limit, the fees, bonuses, commissions, discounts or other compensation which all or any of the said exempted classes of persons may charge or receive from a borrower in connection with any loan or forbearance of any money, goods or things in action.

The rate of interest upon a judgment rendered in any court of this state shall be set by the Legislature at not more than 10 percent per annum. Such rate may be variable and based upon interest rates charged by federal agencies or economic indicators, or both.

In the absence of the setting of such rate by the Legislature, the rate of interest on any judgment rendered in any court of the state shall be 7 percent per annum.

The provisions of this section shall supersede all provisions of this Constitution and laws enacted thereunder in conflict therewith.