

California Usury Laws

By June Lin

Introduction

Imagine a private company that issues a non-investment grade promissory note with 11% interest—and needs to warn investors that the note may not be enforceable because it violates the California usury¹ laws. Or a company that lends another company \$200,000 with 10% compound interest, only to discover that, although both companies are sophisticated and able to protect their own interests, not only must the lender forfeit all interest received from the borrower, but it must also pay the borrower triple the amount of interest collected from the borrower.

As a practical matter, California usury laws do not seriously inconvenience most lenders, and offer little protection to most borrowers. Most creditors are either totally or partially exempt. But many commercial transactions are nevertheless caught by the usury laws. The harsh penalties for violating the California usury laws make it important for creditors to check the laws.

Penalties and Statute of Limitations

The originator of a usurious loan in California is subject to severe civil penalties. These include:

- forfeiture to the borrower of all interest on the loan, not just the usurious part; and
- payment to the borrower of triple the amount of interest collected in the year before the borrower brings suit (subject to the court's discretion).

¹ Usury is defined as the charging of interest in excess of that allowed by law. Interest is defined as any compensation or benefit received by the lender as part of a loan or forbearance, other than specific charges for services or expenses that are incidental to making the loan.

A lender who willfully receives interest in violation of the usury laws is guilty of loan sharking, a felony punishable by imprisonment for up to five years. It is, however, rare to have conviction of loan sharking.

The statute of limitations for recovering interest paid on a usurious loan is two years—and only the amount of interest paid within that two year period is recoverable. Exceptions include:

- cases where the statute does not begin to run until after the borrower repays the loan;
- if the lender sues to enforce a usurious loan contract, the borrower may assert a usury cross-complaint for all the interest paid on the loan as an offset without regard to the statute of limitations.

The statute of limitations for recovering treble damages on a usurious loan is one year, regardless of whether the loan has been satisfied or whether the lender is attempting to enforce a usurious loan.

Basic California Usury Laws

California usury law is not easily accessible. The relevant legislative provisions are scattered throughout various sections of the California Constitution, Civil Code, Financial Code, Corporations Code and Insurance Code. Federal statutes and regulations are also pertinent. Criminal penalties are provided in the Civil Code rather than the Penal Code.

The basic usury laws in California are in the state Constitution at Article 15. For consumer loans, the parties may contract for interest on a loan primarily for personal, family or household purposes at a rate not exceeding ten percent per year. A loan to be used primarily for

the purchase, construction or improvement of real property is not regarded as a loan for personal, family or household purposes.

For all other loans, the allowable rate is the higher of (a) ten percent; or (b) five percent over the amount charged by the Federal Reserve Bank of San Francisco on advances to member banks on the twenty-fifth day of the month before origination of the loan. As of October 1, 2009 the applicable Federal Reserve Bank rate was 0.50 percent, meaning that any non-exempt loan bearing interest at greater than ten percent would be usurious.

Caveat: Maximum interest rates refer to the simple interest rate on the unpaid balance.

Ways to Sidestep the Usury Trap

California does provide a large number of exemptions from its usury laws which informed lenders will seek to fall within.

Exemptions for certain evidences of indebtedness

Two of the most commonly used exemptions from the California usury laws for commercial transactions apply to evidences of indebtedness (*e.g.*, promissory notes or bonds) with face amount of at least \$300,000 at the time of issuance, or where the borrower has assets of at least \$2 million at the time of issuance. In order to qualify for these exemptions, neither the borrower nor a guarantor of the indebtedness may be an individual, the lender must have a pre-existing relationship with the borrower or guarantor or reasonably appear to the borrower to have the capacity to protect its own interests in the transaction, and the loan must not be primarily for personal, family or household purposes.²

The usury laws also do not apply to evidences of indebtedness:

² Corps. Code § 25116, 25117, 25118.

- rated by S&P as AAA, AA, A, BBB, or investment grade commercial paper or by Moody's as Aaa, Aa, A, Baa, or investment grade commercial paper;
- where the issuer has any security listed on a national securities exchange or NASDAQ;
- where the issuer is a reporting company under the Securities Exchange Act of 1934, had total shareholders' equity of at least \$1 million at the end of its most recent fiscal year, and had consolidated net income of at least \$500,000 for three of its last four fiscal years; or
- issued pursuant to a costly and time consuming "qualification", requiring a permit for the issuance of the securities from the California Department of Corporations.

Exemptions for certain licensed lenders

The usury laws do not apply to loans made or arranged by a California-licensed real estate broker and secured in whole or in part by a lien on real property, regardless of whether the real estate broker was acting in that capacity.³ The usury laws also do not apply to licensed securities broker-dealers acting pursuant to a certificate which is then in effect.

Exemptions for loans made by financial institutions and insurance companies

The usury laws do not apply to loans made by or obligations of most depository financial institutions such as banks, savings and loan associations, and credit unions.⁴ The California Financial Code applies this exemption to: (1) state banks and other states' banks and national banks with an office in California if the bank is authorized to engage in the trust business and is acting in its fiduciary capacity; (2) certain foreign banks with assets of at least \$100 million; (3) bank holding companies and their nonbank subsidiaries; (4) commercial finance lenders licensed to engage in the business of making commercial loans (*i.e.*, loans of \$5,000 or more which the borrower intends to use primarily for other than personal, family or household purposes); (5)

³ Calif. Const. Art. 15.

⁴ *Id.*

consumer finance lenders (*i.e.*, entities engaged in the business of making consumer loans) making loans with principal amount of \$2,500 or more; and (6) mortgage bankers making loans to corporations with principal amount of \$100,000 or more secured by a lien on real property.

The usury laws do not apply to “federally related” loans secured by a first lien on residential property. “Federally related” loans are loans made by any lender whose deposits are insured by any federal agency, loans made by any lender regulated by any federal agency, loans made by any lender approved by the Secretary of Housing and Urban Development (HUD) for participation in any mortgage insurance program under the National Housing Act, and loans made or guaranteed by HUD or eligible for purchase by the Federal National Mortgage Association, the Government National Mortgage Association, or the Federal Home Loan Mortgage Corp.

The usury laws do not apply to bank charges for third party credit cards (Visa, MasterCard, American Express, etc).

The usury laws also do not apply to loans made by insurance companies.

Miscellaneous exemptions

The California Constitution partially exempts certain lenders from the usury laws who are likely to lend to the most vulnerable borrowers. Consumer finance lenders making loans with a principal amount of less than \$2,500, personal property brokers (*i.e.*, persons in the business of lending money and receiving as security a contract calling for a forfeiture to the lender of rights in personal property), licensed pawnbrokers (*i.e.*, persons in the business of receiving goods as security for loans), and industrial loan companies are subject to higher interest rate restrictions than those imposed by the usury laws.

The usury laws do not apply to corporations or associations engaged exclusively in the business of marketing agricultural, horticultural, viticultural, dairy, livestock, poultry and bee products on a cooperative nonprofit basis when lending to members thereof or when securing credit from any federal intermediate credit bank.⁵

The usury laws do not apply to time payment contracts, *e.g.*, when a seller finances the purchase of real or personal property by extending payments over time. Other state laws may impose limits on the finance charges imposed by credit sellers (*e.g.*, a retail installment contract between a buyer and seller for the payment for consumer goods and services in installments, where the buyer pays a service charge).

The usury laws do not apply to bonds issued by a state or local government.⁶ The usury laws do not apply to any loans made by, or evidences of indebtedness purchased by, any licensee.⁷ The usury laws do not apply to pension funds and retirement systems subject to ERISA, as well as state or local public retirement systems. Lenders making shared appreciation loans (*i.e.*, secured loans giving the lender a right to receive a share of the appreciation in the value of the security property) from ERISA pension funds are exempt from the usury laws.⁸

The usury laws do not apply to funds held in trust by physicians' and surgeons' cooperative indemnity corporations for indemnifying members for medical malpractice claims. The usury laws do not apply to loans made by business and industrial development corporations (*i.e.*, California corporations licensed to provide financial and management assistance to business firms).

Conclusion

⁵ *Id.*

⁶ Gov. Code § 5906.

⁷ Corps. Code § 28405 and 31410.

⁸ Calif. Civil Code § 1917.067.

Although the California usury laws are vitiated in part by a myriad of exemptions and carve-outs, the harsh consequences of violating the usury laws make it important for lenders to look carefully at the usury laws and exemptions, especially as the exemptions are not always straightforward or intuitive. While most professional lenders are exempt from the usury laws, problems can arise when ordinary nonexempt companies or individuals make loans. And in some situations, including the two examples in the Introduction, there simply is no exemption even for corporation to corporation transactions.

This article is intended to provide a general summary of the California usury laws and should not be construed as a legal opinion nor a complete legal analysis of the subject matter. June Lin is an attorney at Niesar & Vestal LLP in San Francisco, a law firm specializing in business law and corporate finance.