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Superior Court Voids $1.8 Million Commercial Loan under Usury Statute

"Usury Savings Clause" Held Ineffective to Cure Violation of Usury Law

By:

EDWARD G. AVILA, ESQ.

DANIEL E. BURGOYNE, ESQ.

A $1.8 million loan, which was secured by a mortgage on commercial real estate in West Warwick, has been found in violation of Rhode Island's usury statute.[1] Under the usury statute, a lender may not "reserve, charge, or take interest on a loan" in excess of the maximum rate. The usury statute generally establishes a maximum allowable interest rate of twenty-one percent (21%), although there are exceptions to this maximum rate. [2]

In December 2009, a borrower and two guarantors sued their lender, claiming that the underlying loan agreement was usurious, and sought to restrain the lender from foreclosing its mortgage. The Court granted a preliminary injunction on January 20, 2010 and stopped the foreclosure. Then, in a December 16, 2011 Decision, [3] the Honorable Michael A. Silverstein, Associate Justice of the Rhode Island Superior Court, granted a summary judgment motion in favor of the borrower and guarantors. In the Decision, Judge Silverstein ruled that the loan was "usurious and void"—i.e., it need not be repaid. He further ruled that any liens securing the loan were invalid and that the underlying mortgage must be discharged from the land evidence records. The lender has appealed the ruling.[4]

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[1] R.I. Gen. Laws of 1956 § 6-26-1 to -10.

[2] For example, when the Wall Street Journal prime rate exceeds 12%, then the maximum allowable rate is equal to the prime rate plus 9 percent. Also, there is no maximum interest rate for a loan in excess of $1 million if (1) the loan is made to a commercial entity, (2) the loan is not secured by the borrower's principal residence, and (3) the borrower has obtained a financial analysis, meeting certain requirments, which indicates that the loan is capable of being repaid.

[3] NV ONE, LLC, Nicholas E. Cambio, and Vincent E. Cambio v. Potomac Realty Capital, LLC, Alias, Capital Management Systems, Inc., C.A. No. PB 09-7159 (R.I. Super. Dec. 16, 2011) available at: http://www.courts.ri.gov/Courts/SuperiorCourt/DecisionsOrders/decisions/09-1759.pdf ("Decision").

[4] On January 20, 2012, the lender obtained a 45-day stay of the summary judgment ruling, to permit it an opportunity to seek appellate review of the ruling. It filed its notice of appeal on January 27, 2012. Thereafter, the Supreme Court denied the lender's request to stay Judge Silverstein's order. However, it did prevent the borrower from transferring the real estate without first obtaining approval from the Supreme Court.

The penalties for violating the usury statute vary depending on the nature of the lender. If a "regulated financial institution" [5] makes a usurious loan, then it forfeits the right to collect interest, and the borrower may sue the lender to recover twice the amount of any interest actually paid. For other lenders, however, the penalties are much more severe. The loan agreement, along with any mortgage or other collateral agreement, is deemed to be "void." Not only is the lender prohibited from collecting interest on the loan, but it cannot even recover the principal amount, and the borrower may recover from the lender any principal or interest payments previously made.

It is no defense for a lender that its borrower knew that the loan agreement was usurious. The usury laws were made to protect borrowers "who, because of economic circumstances, were forced to borrow money at interest rates that the legislature deemed so outrageous as to be contrary to sound public policy." Even if a lender makes "an innocent mistake, a minor violation, or a rate otherwise set in good faith," this is not defense to enforcement of the usury statute.

The West Warwick mortgage loan was problematic for a number of reasons. First, although the loan was nominally a $1.8 million loan, it was undisputed that no more than approximately $1 million was ever actually disbursed. Nevertheless, the lender charged interest of 10%, and later 12%, on the entire $1.8 million. When the actual interest charges were compared to the amount actually disbursed, Judge Silverstein found that the actual rate of interest exceeded the 21% maximum rate "essentially

[5] A "regulated financial institution" is a "financial institution and its subsidiaries, credit union, or bank holding company and its subsidiaries, organized under the laws of the state, any other entity regulated by the department of business regulation, a national bank and its subsidiaries, federal savings and loan association or federal credit union, or a bank, company, or association." R.I. Gen. Laws of 1956 § 6-26-4(d)

throughout the loan." Moreover, the default rate of interest stated in the note was 24%, and the lender actually charged this amount for a period of time after default.

Usury Savings Clauses Ineffective under Rhode Island Law

Judge Silverstein's Decision is noteworthy because it found that a "usury savings clause" in the underlying promissory note was ineffective to cure the usury violation. Many promissory notes, if not most of them, contain such clauses. The savings clause at issue in the Decision was a garden-variety usury savings clause which provided, in pertinent part, that:

> [i]t is the intention of the Maker and Payee to conform strictly to the usury and similar laws relating to interest from time to time in force, and all agreements between Maker and Payee … are hereby expressly limited so that in no contingency or event whatsoever … shall the amount paid or agreed to be paid in the aggregate … exceed the maximum amount permissible under the applicable usury or such other laws ….

The clause further provided that any payments in excess of the maximum permissible amount were either "deemed" to be a reduction of principal, or were "deemed" to be a payment made by mistake to be returned to the Maker.

Usury laws vary from state to state. However, as the Rhode Island Supreme Court has never addressed the effectiveness of a usury savings

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clause, Judge Silverstein looked for guidance to the law of other jurisdictions.

Texas and Florida, in particular, have extensive bodies of law interpreting their usury laws. Judge Silverstein described that in Texas, usury savings clauses were given effect "if possible and enforced in appropriate circumstances." However, even in Texas, the mere presence of a savings clause will not "save loans that are usurious on their face." "A lender cannot simply escape usury liability by disclaiming an intention to do that which they clearly did." Similarly, Florida courts look to a lender's intent in determining whether a usury violation has occurred. A savings clause can prevent a usury violation "[w]here the actual interest charged is close to the legal rate, or where the transaction is not clearly usurious at the outset but only becomes usurious upon the happening of a future contingency…." However, Judge Siverstein noted that Florida courts also recognize that "a savings clause cannot, by itself, absolutely insulate a lender from a finding of usury."

Comparing these jurisdictions to Rhode Island, however, Judge Silverstein found no indication that Rhode Island law distinguishes between "loans that are usurious on their face and loans that become usurious upon the occurrence of some future event or due to a variable interest rate." If there is a loan agreement, and a lender demands or receives payments above the maximum interest rate, then the loan is usurious. "Intent is not an issue as it is in other states."

In fact, other states such as Arizona, North Carolina, and New York decline to give any effect to usury saving clauses, finding them contrary to public policy. North Carolina courts reason that it is the lender's burden to

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comply with usury laws because "it is the lender's business to lend money and the lender is in the better position than the borrower to know and comply with the usury law." If the mere presence of a usury savings clause can prevent enforcement of the usury laws, then lenders will have an incentive to violate the usury laws "with impunity… relying upon the illegal rate's automatic rescission when discovered and challenged by the borrower."

Therefore, Judge Silverstein found that under the facts of the case before him, enforcement of the usury savings clause would thwart public policy, and would permit the lenders to take advantage of borrowers by exacting excessive interest, and only modifying the rate if questioned by the borrower. While usury savings clauses might be effective in Texas or Florida, where the courts consider a lender's intent, they are not enforceable in Rhode Island.

Guidance for Lenders Going Forward

As a result of Judge Silverstein's ruling in the NV ONE, LLC case, lenders—especially lenders who are not "regulated financial institutions"—should take special care to ensure compliance with the usury statute. The penalties for usury violations are severe, and the ruling makes it clear that a usury savings clause provides no protection to a lender who charges excessive interest, even inadvertently. Even if the Supreme Court later disagrees with Judge Silverstein on appeal, and adopts a view (like Texas or Florida) where lender intent can be considered, lenders would be prudent simply to avoid charging excessive interest. Even in those jurisdictions that consider lender intent, usury savings clauses do not "absolutely insulate" a lender from usury liability.

It is not always easy to ensure compliance with the usury laws, especially when loans go into default. Even if the stated default rate is less than the

21% maximum, there may be other charges (such as periodic late charges or prepayment penalties) provided under a promissory note. It is not always clear whether such fees will be excluded from the definition of "interest" for usury purposes. [6] If not, the combined charges could exceed the maximum rate. Also, when a transaction arguably involves the laws of two or more states, it may not be clear which state's usury laws will be applied to a transaction.

In the NV ONE, LLC case, the lender charged a default rate of 24%, which was clearly in excess of the maximum allowable rate. However, a large part of the lender's problems resulted from charging interest on the full $1.8 million loan, when a large portion of those funds were held back in "reserve" accounts that were never actually disbursed. There is a wide variety of lending arrangements used in commercial loans today, and an individual analysis of each may be prudent in order to ensure compliance with the usury laws.

The attorneys in the Banking Group at Roberts, Carroll, Feldstein & Peirce, Inc. have the experience and knowledge necessary to guide you, not only on usury issues, but any other issues that may arise in your lending transaction. We would be happy to discuss how we can assist you with your particular situation.

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[6] The usury statute states that certain charges—such as casualty insurance on mortgaged property, commercial loan commitment fees, certain attorneys' fees, title examination and insurance fees, and other customary and reasonable closing costs—are not considered interest for usury purposes. See § 6-26-2(c).

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