Commercial Law

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of a danger of abuse, and may be burdened by being prohibited from appearing through one of its officers. That the court could not fashion a rule more precisely tailored to the situation is understandable. Less understandable, however, is the court's rejection, based upon speculative abuses which may or may not have materialized, of what may have been a workable attempt to make the courts more accessible to individuals whose business is in the corporate form.

COMMERCIAL LAW

MCConnell v. Merrill Lynch, Pierce, Fenner & Smith, Inc.:¹

VARIABLE RATE LOANS UNDER CALIFORNIA'S USURY LAW

The supreme court reviewed for the first time² the application of California's usury law³ to variable rate loans—i.e., loans in which the

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¹. 21 Cal. 3d 365, 578 P.2d 1375, 146 Cal. Rptr. 371 (1978) (Tobriner, J.) (6-1 decision).
³. Article XV, § 1 (West Supp. 1979) (formerly article XX, § 22) of the California Constitution provides:

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 per cent 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 not exceeding 10 per cent per annum.

No person, association, copartnership or corporation shall by charging any fee, bonus, commission, discount or other compensation receive from a borrower more than 10 per cent per annum upon any loan or forbearance of any money, goods or things in action.

However, none of the above restrictions shall apply to any [building and loan association, industrial loan company, credit union, pawnbroker, personal property broker, state or federal bank, or nonprofit cooperative association], nor shall any such charge of any said exempted classes of persons be considered in any action for any purpose as increasing or affecting or as connected with the rate of interest hereinbefore fixed. The
interest rate varies over the loan's term. The court held that the rate charged cannot exceed the maximum legal rate at any point during the term unless the agreement was "consummated in good faith and without intent to avoid the usury laws." 

This Note argues that McConnell was incorrectly decided. Part I of the Note briefly outlines California's usury law. Part II sets out the case and contends that the court misapplied precedent and misunderstood the economic realities of variable rate loans. Finally, Part III argues that consideration of the policies underlying the usury law would have led the McConnell court to a different result.

I

THE CALIFORNIA USURY LAW

Usury laws, which prohibit the charging of interest above a prescribed rate, have existed for thousands of years. The varying forms these laws have taken reflect intensely conflicting attitudes toward re-

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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, bonus, 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.

California Civil Code § 1916-3 provides:

Every person, company, association or corporation, 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 . . . may . . . recover in an action at law . . . treble the amount of the money so paid or value delivered in violation of said sections.

4. The interest usually varies according to some uniform commercial index, such as the prime rate. See generally Comment, The Variable Interest Rate Clause and Its Use in California Real Estate Transactions, 19 U.C.L.A. L. Rev. 468 (1972).

5. 21 Cal. 3d at 375, 578 P.2d at 1381, 146 Cal. Rptr. at 376.

6. Some commentators characterize this as "legal usury" to distinguish it from "moral usury." Moral usury is defined as taking advantage of a desperate or inexperienced borrower, even in the absence of a codified maximum rate. See, e.g., Horack, A Survey of the General Usury Law, 8 LAW & CONTEMP. PROB. 36, 39 (1941). The distinction was first made by Jeremy Bentham. J. BENTHAM, DEFENSE OF USURY 8 (1816).

7. Usury was prohibited in ancient Babylon, see G. DRIVER & J. MILES, THE BABYLONIAN LAWS: LEGAL COMMENTARY 173 (1956); Rome, see S. HOMER, A HISTORY OF INTEREST RATES 45 (2d ed. 1977); and China, see 22 ENCYCLOPEDIA BRITANNICA 908 (1963). Both Jewish and Christian strictures forbade usury as sinful. See 2 GANZFRIED & GOLDIN, CODE OF JEWISH LAW 41 (1963); AQUINAS, SUMMA THEOLOGICA 331-32 (2d ed. 1929). Usury was also prohibited from the earliest days in England, see Horack, supra note 6, at 36-37, and in the United States, see FARNAM, CHAPTERS IN THE HISTORY OF SOCIAL LEGISLATION IN THE UNITED STATES TO 1860, at 88-91 (1931). For a good survey of the history of usury laws, see Comment, Usury in the Conflict of Laws: The Doctrine of the Lex Debitoris, 55 CALIF. L. REV. 123, 127-37 (1967), and sources cited therein. See also F. RYAN, USURY AND USURY LAWS (1924); Bernstein, Background of a Gray Area in Law: The Checkered Career of Usury, 51 A.B.A.J. 846 (1965). For a history of market rates of interest here and abroad, see S. HOMER, supra.

8. The differences are significant even within the United States today. The variance is in terms of: a) maximum rate—e.g., Michigan's rate is seven percent, MICH. COMP. LAWS ANN. § 438.31 (1978); Rhode Island's 21%, R.I. GEN. LAWS § 6-26-2 (1970); while Massachusetts and
Restrictions on credit. California passed its first usury statute by initiative in 1918. The law limited the interest chargeable on all loans to twelve percent per annum and provided for civil damages of treble the entire New Hampshire have no limit; b) penalty—in North Dakota the lender forfeits 25% of the principal and twice the amount of interest paid, N.D. CENT. CODE § 47-14-10 (1978); but in Tennessee the lender forfeits only the interest in excess of the legal rate, TENN. CODE ANN. § 47-14-117 (1964); and c) exemptions—thirty-one states and the District of Columbia do not give corporations full rights to assert the usury defense, but California permits it, CONS. CRED. GUIDE (CCH) § 510 (1979); Ohio exempts all loans over $100,000, OHIO REV. CODE ANN. § 1343.01 (Page’s Supp. 1977); Illinois exempts loans made by any registered broker-dealer, ILL. ANN. STAT. ch. 74, § 4(g) (Smith Hurd Supp. 1978). See generally CONS. CRED. GUIDE (CCH) § 510 (1979); Lowell, A Current Analysis of the Usury Laws: A National View, 8 SAN DIEGO L. REV. 193, 236 (1971).

9. Criticism has been largely based on economic arguments. The seminal piece was written by Jeremy Bentham, see J. BENTHAM, supra note 6, who argued that a maximum rate forces lenders out of the high risk market and thereby denies loans to those who need it the most. Id. at 4-5. This argument and its corollary—that a usury law creates a market for loan sharks—was instrumental in the repeal of usury laws in France, England, and Massachusetts. See Shanks, Practical Problems in the Application of Archaic Usury Statutes, 53 Va. L. REV. 327, 329-30 (1967). The same thesis is still being advanced a century and a half later. See, e.g., High, Consumer Credit Regulation in Texas—A Rejoinder by an Economist, 50 TEX. L. REV. 463 (1972); Johnson, Regulation of Finance Charges on Consumer Installment Credit, 66 Mich. L. REV. 81, 106-09 (1967); Kawaja, The Case Against Regulating Consumer Credit Charges, 5 AM. Bus. L.J. 319 (1967); Oeltjen, Usury: Utilitarian or Useless?, 3 FLA. ST. U. L. REV. 169, 170 (1975); Shanks, supra note 9, at 329-30; Shay, The Uniform Consumer Credit Code: An Economist’s View, 54 CORNELL L. REV. 491, 495 (1969); Warren, Consumer Credit Law: Rates, Costs, and Benefits, 27 STAN. L. REV. 951 (1975); Note, An Ounce of Discretion for a Pound of Flesh: A Suggested Reform for Usury Laws, 65 YALE L.J. 105 (1955).

The defense, on the other hand, has ranged from reliance on ad hominum attacks on the character of lenders, see W. SHAKESPEARE, THE MERCHANT OF VENICE (1949), to the Bible, see EXODUS 22:25 (“Neither shalt thou lay upon [my people] usury”) and Deuteronomy 23:19-20 (“Thou shalt not lend upon usury to thy brother”). Adam Smith argued that without usury laws too much capital would flow to speculative businesses, causing more stable businesses to pay too high a rate to operate profitably. A. SMITH, WEALTH OF NATIONS, bk. II, ch. iv (1776). A more recent article asserts that low rate ceilings protect borrowers from “psychic” harms associated with default, discourage overreach and deception on the part of lenders, and help reallocate society’s resources. Wallace, The Uses of Usury: Low Rate Ceilings Reexamined, 56 B.U.L. REV. 451 (1976). For the justification California courts offer for the usury law, see text accompanying notes 80-83 infra.

10. From statehood in 1850 until 1918, California had no general usury law. There had been during this period frequent regulation of certain classes of lenders, such as pawnbrokers, albeit at extremely high maximum rates (e.g., four percent per month). Carter v. Seaboard Fin. Co., 33 Cal. 2d 564, 575, 203 P.2d 758, 765 (1949). This absence before 1918 of comprehensive regulation is probably traceable to the fact that in a rapidly expanding population and economy, California could ill afford restricted credit. One writer has documented a national “hands off” policy towards credit during that period. Comment, supra note 7, at 133-34.


12. A willful violation of the usury law is a felony punishable by up to five years in prison.
amount of interest actually paid. In this form, the law proved unsatisfactory. Lenders were unwilling to extend credit to high risk borrowers at the prescribed maximum rate. These borrowers—who, ironically, were the primary object of the law's protection—thus were forced to resort to loan sharks.

In response to this problem, the legislature proposed, and the voters adopted, a constitutional amendment which partially superseded the usury statute. The amendment lowered the maximum interest rate from twelve to ten percent and included as interest any “fee, bonus, commission, discount or other compensation.” In addition, the amendment exempted numerous financial institutions from any restrictions—including every major lender then affected by the law. Although the legislature was authorized under this provision to set maximum rates for exempt lenders, these rates were set at levels considerably higher than ten percent. Thus the exemptions ensured that the


14. Some landers attempted to “solve” this problem by adding various “fees” to the loan. See Carter v. Seaboard Fin. Co., 33 Cal. 2d 564, 577, 203 P.2d 758, 766 (1949); Project, Legislative Regulation of Retail Installment Financing, 7 U.C.L.A. L. Rev. 623, 648 (1960). Since borrowers could still not get loans, see text accompanying note 15 supra, this attempt was apparently unsuccessful.


16. See note 3 supra.


18. The following institutions were exempted: state savings and loan associations, state and national banks, credit unions, personal property brokers, pawnbrokers, industrial loan companies, and agricultural cooperatives.

19. The major nonexempt lenders of the present loan market were not previously affected. Some (e.g., real estate investment trusts) did not exist; others (e.g., out-of-state lenders) were not in the California lending market; and still others (e.g., mortgage bankers and the insurance companies who fund them) who lent on the security of land were not as big a force then and also lent at a rate below five percent per annum. For them, a 10% maximum rate was superfluous. See Committee Against Unfair Interest Limitations v. California, No. C158433, slip op. at 10 (Cal. Super. Ct. Feb. 6, 1978).

20. Banks and savings and loan associations have no maximum rates; personal property brokers have no maximum rates for loans over $10,000 ($5,000 for commercial loans), Cal. Fin. Code § 22053 (West Supp. 1979), and can charge at least 18% for loans under that, id. § 22451.1; industrial loan companies can charge at least 18%, id. § 18212(b); pawnbrokers can charge from 12% to 25%, depending on the amount of the loan, id. § 21200; and credit unions can charge 15%,
usury law's impact on California credit markets would be marginal.

Two developments since 1934, however, have made the usury law important again. First, lenders not exempted by the 1934 amendment are now major lenders in California loan markets.\(^1\) Second, prevailing interest rates have risen above ten percent.\(^2\)

Nonexempt lenders—prevented by the usury law from charging prevailing interest rates—are today at a great disadvantage in California markets. The ten percent maximum rate is making it unprofitable for them to loan money. Consequently, some have stopped making loans in California.\(^3\) Others have attempted to structure loan transactions which will not be subject to the usury law.\(^4\)

The usury law's revival has also created difficulties for courts. Cases which could effect enormous changes in loan markets are being decided. Plaintiffs and defendants are challenging old usury doc-

\(\text{id. } \S 14901.\)


2. The prime rate as of March 2, 1979 was 11.75%. *BARRONS*, March 5, 1979, at 91, col. 3.


4. Lawyers, of course, have played a prominent role in this. Business attorneys in San Francisco, for example, now write numerous opinion letters on usury, and the larger firms tend to have at least one attorney who is that firm's "expert" on usury problems. Interviews with E. Roy Eisenhardt, Partner, Farella, Braun & Martel, in Berkeley (Feb. 6, 1979); George A. Hisert, Partner, McCutchen, Doyle, Brown & Enersen, in San Francisco (Sept. 26, 1978); Thomas Unterman, Partner, Orrick, Herrington, Rowley & Sutcliffe, in Berkeley (Mar. 1, 1979).

Ironically, much of the pressure on attorneys to sidestep the usury law comes not from lenders but from sophisticated business borrowers. These borrowers can get needed capital from a nonexempt lender, but only if that lender is allowed to charge the market rate of interest. If the market rate is over 10%, a borrower cannot obtain the loan unless his attorney comes up with a solution. Interview with E. Roy Eisenhardt, Partner, Farella, Braun & Martel, in Berkeley (Nov. 1, 1978).

One solution is for the lender to characterize itself within an exempt class of lenders. Broker-dealers were successful at this. *See note 32 infra.* An out-of-state bank lending on the security of real estate was also successful. *Sondeno v. Union Commerce Bank*, 71 Cal. App. 3d 391, 139 Cal. Rptr. 229 (1st Dist. 1977) (California Financial Code § 1757 gives out-of-state banks secured by in-state real property the in-state bank exemption). Other attempts have been unsuccessful. *See, e.g.*, 59 Op. ATT'Y GEN. 515 (1976) (loans by commercial bank trust departments not exempt); 58 Op. ATT'Y GEN. 487 (1975) ("mortgage banking industrial loan companies" not within the industrial loan company exemption). Another solution where an out-of-state lender or borrower is involved is a clause in the loan agreement providing that the usury law of another jurisdiction will apply. *See Garner v. Du Pont Glore Forgan, Inc.*, 65 Cal. App. 3d 280, 135 Cal. Rptr. 230 (4th Dist. 1976). *See generally Comment, supra note 7.*

The most drastic solution to the usury problem has been the recent attack on the usury law's constitutionality. *See Committee Against Unfair Interest Limitations v. California*, No. C158433, slip op. (Cal. Super. Ct. Feb. 6, 1978), discussed at note 87 infra.
trines with loan devices unheard of when the usury law was passed. McConnell presented one such challenge.

II

McConnell

A. The Opinion

Merrill Lynch maintained "margin" accounts for its customers. Under this system, it loaned customers part of the cost of purchased stock. The rate charged pursuant to the margin agreements was the rate Merrill Lynch itself was charged by commercial lenders for these loans—the federal "call money" rate plus a service charge.

In 1973, prevailing interest rates, spurred by inflation and other factors, rapidly increased. The rate Merrill Lynch charged its customers increased correspondingly, so that after July 5, 1973 it was charging an effective total rate of over ten percent. On September 26, 1973, Merrill Lynch, pursuant to a newly enacted amendment to the Personal Property Brokers Law, obtained a license as a personal

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28. The call money rate has been slightly higher in recent years than the prime rate. See S. HOMER, supra note 7, at 373, 377.

29. The service charge varied from .50% to 1.50%, depending on the amount of the debit balance. 21 Cal. 3d at 370, 578 P.2d at 1377, 146 Cal. Rptr. 373.


31. 21 Cal. 3d at 370, 578 P.2d at 1377, 146 Cal. Rptr. at 373.

32. On September 18, 1973, the legislature, most likely in response to pressure by broker-dealers confronting a greater than 10% call rate, exempted broker-dealers from the usury law. This was done by amending the Personal Property Brokers Act to include licensed broker-dealers within the definition of personal property brokers. CAL. FIN. CODE § 22011(d) (West Supp. 1979). Since personal property brokers are exempted from the usury law by the California constitution, this was in effect a legislatively created exemption. See Gamer v. Du Pont Glore Forgan, Inc., 65 Cal. App. 3d 280, 284, 135 Cal. Rptr. 230, 232 (4th Dist. 1976).

While application of the usury law to variable rate loans is now moot as to broker-dealers, it is still an important issue to nonexempt lenders. Variable rate financing has become common, for example, in real estate lending. See Wellenkamp v. Bank of America, 21 Cal. 3d 943, 952 n.10,
property broker. The firm was thereafter exempt from the usury law.\textsuperscript{33}

Plaintiffs John and Marguerite McConnell filed suit individually and, in a class suit, on behalf of all California customers who maintained margin accounts with Merrill Lynch and were charged interest of more than ten percent before the firm obtained an exemption. They alleged that the charge in excess of ten percent violated California’s usury law.\textsuperscript{34}

The trial court held, as to the class suit, for defendant Merrill Lynch. The trial court stated that a loan’s “usurious character” must be tested by averaging the interest charged during the loan’s entire term—\textit{i.e.}, as long as the average interest rate remains below ten percent, the usury law is not violated. The court then determined that only those class members who had opened accounts close to July 5, when charges first exceeded ten percent, were charged an average rate in excess of ten percent. Thus they were the only class action plaintiffs, under the court’s rule, with standing to sue.

The California Supreme Court reversed.\textsuperscript{36} Following the reasoning of a recent appellate court decision,\textsuperscript{37} the court held that the average interest rate charged for the loan over its entire term is \textit{not} the proper indicator of a usury violation. The loan must instead be tested at each “period of forbearance.”\textsuperscript{38} If the interest rate exceeds ten per-
cent at any point during the term, the loan contravenes the usury laws. After distinguishing previous cases which had employed the averaging method, the court gave two reasons for rejecting the "average interest" rule. First, under a variable interest agreement, the parties have not agreed to a fixed total profit for the lender which can be averaged over the loan's entire term. The court viewed the interest payable for each "portion of the loan term"—i.e., a period in which the rate charged remains constant—as "compensation to the lender for his forbearance from requiring immediate payment of the principal sum during that specific portion of the term." Second, the court stated that there would be no way, under an averaging method, to determine whether an existing credit arrangement was lawful until the account was closed.

The court next considered whether a variable agreement in which the interest rate exceeds the ten percent maximum violates the usury law. The court held that such an agreement is legal if "consummated in good faith without intent to avoid the usury laws." In support of its holding, the court cited a series of cases involving contingent interest loans—loans in which the payment of interest is subject to a contingency. The loan agreements in these cases all charged interest in excess of ten percent, but they were upheld if made in good faith without intent to avoid the usury law. The court also believed that the "right" of the parties to contract in good faith for a variable rate agreement, even if the rate might exceed ten percent, was supported by "practical good sense." That good sense rested on two grounds of fairness. First, if the call rate had fallen instead of risen, plaintiffs would have been charged less than the maximum rate. Second, if the call rate had risen and the lender were not allowed to adjust its rate accordingly, the


40. Id. at 377, 578 P.2d at 1382, 146 Cal. Rptr. at 377.

41. Id.

42. Id.


44. 21 Cal. 3d at 377-78, 578 P.2d at 1382, 146 Cal. Rptr. at 378.

45. Id.
lender would be forced either to call back the loan or advance money for less than cost.\textsuperscript{46}

Justice Clark dissented. Agreeing with the trial court, he argued that variable agreements should be struck down only when the average interest computed over the loan's full term exceeds ten percent.\textsuperscript{47} He gave two reasons for a less stringent application of the usury law to these agreements. First, he saw variable agreements as economically valuable because they allow lenders and borrowers to "adjust interest rates to the changing conditions of the economy."\textsuperscript{48} Second, he believed that since Merrill Lynch could have charged the maximum ten percent rate for the full period of the loan, but did not do so, holding the firm liable would be unjust.\textsuperscript{49}

B. Analysis

1. The Rejection of the Average Interest Rule

The court's first argument\textsuperscript{50} supporting its rejection of the average interest rule and adoption of the every rate change\textsuperscript{51} rule to test transactions for usury was that each change in the interest rate under a variable agreement creates a different "period of forbearance."\textsuperscript{52} This conclusion indicates a misunderstanding of the term "forbearance." Under the court's own definition, "forbearance" means "the giving of further time for the repayment of an obligation or an agreement not to enforce a claim at its due date."\textsuperscript{53} A rate change under a variable agreement, however, is simply a change in the rate charged for money

\textsuperscript{46} Id.
\textsuperscript{47} Id. at 384, 578 P.2d at 1385, 146 Cal. Rptr. at 381.
\textsuperscript{48} Id. at 383, 578 P.2d at 1385, 146 Cal. Rptr. at 381.
\textsuperscript{49} Id.
\textsuperscript{50} Prior to this argument, the court correctly distinguished cases which had employed the averaging method. See note 39 supra. Free from precedent, the court could then decide which rule was best to apply to variable rate loans.
\textsuperscript{51} 21 Cal. 3d at 377, 578 P.2d at 1382, 146 Cal. Rptr. at 377-78.
\textsuperscript{52} Id. Two interpretations of what the court meant by "period of forbearance" are possible. A new period could be created with each billing. Arneill Ranch v. Petit, 64 Cal. App. 3d 277, 295, 134 Cal. Rptr. 456, 467 (2nd Dist. 1976), which originated the "period of forbearance" language, can be read as supporting this interpretation. Merrill Lynch does not, however, bill its customers on margin accounts until the security is sold. This leaves the change in the interest rate as the only possible "period of forbearance."

The fact that Merrill Lynch does not require payment until the security is sold renders incorrect the McConnells' assertion that "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." 21 Cal. 3d at 377, 578 P.2d at 1382, 146 Cal. Rptr. at 377. Since the "portion" of the loan term can only be the change in interest, and interest is not payable based on that change, the argument has little merit.

\textsuperscript{53} Boerner v. Colwell Co., 21 Cal. 3d 37, 44 n.7, 577 P.2d 200, 204 n.7, 145 Cal. Rptr. 380, 384 n.7 (1978).
lent during that period. It does not give any further time for the repayment of a previous loan, nor is it an agreement not to enforce a claim at its due date.

The court's treatment of the different periods of a variable rate loan as independent from one another also ignores economic reality. In a variable rate loan, even when the term is long, the lender is willing to charge the prevailing rate for short term loans. This is because the lender can change the rate it charges in response to market shifts during the loan's term. But in entering a loan agreement in which prevailing short term rates are expected to exceed the ten percent maximum rate, the lender must act differently. Unable to charge above the maximum rate in any given period, the lender would fix the initial rate at a level higher than the short term rate to account for this inflexibility. In other words, the variable agreement begins to resemble an inflexible long term agreement, with correspondingly higher rates. Thus the lender's ability to change the rate in one period affects the rate it charges in others, indicating that the loan periods are, in fact, interrelated.

The court's second argument to support its rejection of the average interest rule was that use of an averaging method does not permit a determination of the legality of an agreement until the agreement is closed. The court believed that the existence of a fluctuating balance due on the loan made this determination impossible. Lenders themselves, however, have long been able to compute average interest rates on loans with a fluctuating balance. To avoid violating the usury law, lenders have "capped" variable loans at ten percent—i.e., loan agreements have provided that the weighted average interest rate at any point during the loan would not exceed ten percent. To do this, it is

54. See generally Comment, supra note 4, at 474-79.
55. 21 Cal. 3d at 377, 578 P.2d at 1382, 146 Cal. Rptr. at 377.
56. Id.
58. The average interest charges are "weighted" to account for the fluctuating balance during the term of the loan. If $10 is loaned at 10% in one period and $100 at five percent in another period, the weighted average would give more "weight" to the second period in figuring an overall average because more money was loaned in the second period.
59. Interviews with E. Roy Eisenhardt, Partner, Farella, Braun & Martel, in Berkeley (Feb. 7, 1979); George A. Hisert, Partner, McCutchen, Doyle, Brown & Enersen, in San Francisco (Sept. 26, 1978). The lender could usually recoup its profit by using "catch-up" clauses. These clauses provided for greater interest in periods after the cap had been employed. If, for example, the interest rate to which the loan was tied rose to 11% in one period and fell to 9% in the next, both periods would be set at 10%. A copy of a form catch-up clause is on file with the CALIFORNIA LAW REVIEW.
necessary to compute average interest at each rate change. This has been a standard practice for years. Thus the court's argument that average interest on a fluctuating balance loan is incalculable is erroneous.

2. The Good Faith Standard

a. Is a Variable Agreement a Contingent Agreement?

*McConnell* also held that variable agreements which exceed the ten percent limit are lawful if "consummated in good faith without intent to avoid the usury law." The court said that the "majority of decisions" support this holding. Those decisions, however, involved the "contingent interest rule," which permitted "contingent interest agreements" to exceed ten percent if they met the good faith standard. A contingent interest agreement is an agreement where all or

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61. *Id.*

62. 21 Cal. 3d at 377, 578 P.2d at 1382, 146 Cal. Rptr. at 378. The intent to avoid a statute is not usually an element of a civil or criminal offense. *But see* I.R.C. § 269 (acquisitions made to evade or avoid income tax). This intent has been, however, a central component in the proof of some usury offenses. The law of intent in the usury area has traditionally depended on whether the agreement is "usurious on its face." First Am. Title Ins. & Trust Co. v. Cook, 12 Cal. App. 3d 592, 597, 90 Cal. Rptr. 645, 648 (4th Dist. 1970); Denny v. Hartley, 154 Cal. App. 2d 304, 306-07, 315 P.2d 893, 895 (2d Dist. 1957); Martin v. Ajax Constr. Co., 124 Cal. App. 2d 425, 432, 269 P.2d 132, 136 (2d Dist. 1954). If the agreement is "usurious on its face," the only intent required is the "conscious and voluntary" taking of more than the legal rate of interest. *But see* text accompanying notes 63-64 infra. Since it is presumed that one who performs an act intends to perform it, Wood v. Angeles Mesa Land Corp., 120 Cal. App. 313, 324 (3d Dist. 1932), proof of intent in cases where a transaction is deemed "usurious on its face" is in effect immaterial. *Id.* If, on the other hand, the agreement is not "usurious on its face," plaintiff must prove in addition a bad faith intent to avoid the statute. Sandell, Inc. v. Bailey, 212 Cal. App. 2d 920, 935, 28 Cal. Rptr. 413, 422 (5th Dist. 1963); Moore v. Deal, 117 Cal. App. 2d 89, 94, 254 P.2d 888, 892 (4th Dist. 1953); Lamb v. Herndon, 97 Cal. App. 193, 197, 275 P. 503, 505 (3d Dist. 1929). If holding that for variable agreements plaintiffs must prove bad faith intent to avoid the usury laws, the court was in effect holding that variable agreements, like contingent agreements, see text accompanying notes 63-64 infra, are not "usurious on their face."

63. 21 Cal. 3d at 377, 578 P.2d at 1382, 146 Cal. Rptr. at 377.

part of the interest payable by the borrower is contingent upon the occurrence of a designated event. A lender could, for example, take a share of the potential profits of a new business in lieu of interest.

Should the court have characterized variable interest agreements as contingent interest agreements? The contingent interest doctrine is premised on risk. The theory is that a lender who in fact hazards his lawful profit should, as a matter of fairness, be allowed to charge more than the legal rate, since the lender might be forced to accept less. The risk inherent in a variable interest agreement is, however, not significant enough to warrant the agreement's characterization as a contingent interest agreement. The interest contingency cases cited by McConnell that found a bona fide contingency involved situations where the failure of the contingency could have resulted in no interest accruing to the lender. Lenders using variable rate loans, by contrast, do not bear this risk. The rate they charge borrowers generally floats with the market rate, preserving the profit they would get on any loan.

b. Is the Good Faith Standard "Fair" to Lenders?

McConnell argued that its "good faith" holding is "fair" to lenders. Yet lenders will not benefit from this standard. Suppose, for example, that a lender estimates there is a sixty percent chance that the interest rate will rise above ten percent in the upcoming year. Is it "bad faith" under these circumstances for the lender to use a variable agree-

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No cases explore why bad faith or intent to avoid the usury statute should render an otherwise lawful transaction usurious. One plausible explanation, aside from the general moralistic tendency of the usury law, see note 79 infra, is that a showing of bad faith establishes the lack of a bona fide contingency. It would be possible, however, to have a bona fide contingency but still have an intent to avoid the usury law. Thus in an ideal world, the bad faith/intent to avoid test would be merely a factor in deciding whether a bona fide interest contingency agreement exists.

65. "In order to justify the application of the [interest contingency] rule stated in the authorities cited above, the hazard [to which the lender subjects his profit] must be something over and above the risk which exists with all loans (whether that risk be great or small), that the borrower will be unable to pay." Thomassen v. Carr, 250 Cal. App. 2d 341, 347, 58 Cal. Rptr. 297, 301 (1st Dist. 1967).

66. To ensure that the risk is bona fide, a good faith standard is employed. See note 64 supra.

67. See cases cited in note 43 supra.

68. In Jameson v. Warren, 91 Cal. App. 590, 267 P. 372 (1st Dist. 1928), the court held that the contingency (dividend declaration) was so likely to favor the lender as to be an attempt to evade the usury law. Id. at 595-96, 267 P. at 374.

69. The contingencies in these cases were: securing of loan (Lamb); profits (Schiff, Thomassen); success of a joint venture (Wooton); and striking oil (Miley).
ment without a "cap"? If it proceeds with the uncapped loan, did it "intend" thereby to "evade" the usury law? What if there is an eighty percent chance that the interest rate will rise above ten percent in the next three years? These questions are insoluble.

The good faith standard is thus commercially unworkable. Lawyers must guess whether the transactions they structure will be immune from the usury law. It is still possible after McConnell to draft loans without a ten percent cap. Lawyers who do so, however, can never be sure that the agreements are sufficiently in "good faith" to ward off a usury suit. Hence they will have to build "good faith files" containing, for example, lenders' projections of interest rates throughout the loan. Lawyers will also have to protect client lenders with choice of law provisions and other defenses in case of an adverse decision on the good faith issue. Finally, when interest rates exceed ten percent, lawyers might have to cap the loans or even advise clients against making them.

The most practical response to this situation is to opt for capped loans. Since most lawyers did so before McConnell, the only practical effect of the decision is to change the rate under the cap from an average ten percent to an absolute ten percent. Ironically, the court probably intended a liberal treatment of variable agreements. That the decision actually makes variable agreements less desirable demonstrates the extent of the court's misunderstanding of the economic realities of variable agreements.

72. Id.
75. These precautions add to legal fees. Lenders, of course, pass on to borrowers the added costs of legal advice. See Shanks, supra note 9, at 334.
77. "A strict construction of the usury law without consideration for the characteristics of variable rate loans would force defendant, whenever confronted by high call-money rates, to choose between calling in its margin loans or advancing money for less than cost . . . ." 21 Cal. 3d at 378, 578 P.2d at 1382, 146 Cal. Rptr. at 378.
III

VARIABLE AGREEMENTS AND THE POLICY OF THE USURY LAW

A. The Problem

Usury laws allegedly protect "necessitous borrowers"78 from morally unconscionable79 or economically unfair80 interest rates.81 McCon-


The prototypical case involves the desperate borrower and the Shylock-type lender:
[These statutes were made to protect needy and necessitous persons from the oppression of usurious and monied men who are eager to take advantage of the distress of others, whilst they on the other hand, from the pressure of their distress, are ready to come into any terms, and, with their eyes open, not only break the law, but complete their ruin. Browning v. Morris, 98 Eng. Rep. 1364, 1365 (K.B. 1778).]

Consistent with this prototype, one recent decision saw the legislative intent behind the usury law as consumer protection rather than general borrower protection. Committee Against Unfair Interest Limitations v. California, No. C158433 (Cal. Super. Ct. Feb. 6, 1978). See also Wooten v. Coerber, 213 Cal. App. 2d 142, 148, 28 Cal. Rptr. 635, 638 (2d Dist. 1963) (usury law designed primarily to protect the indigent). This reading of the legislative intent is supported by the fact that since commercial interest rates were around 1.5% when the exemptions were passed, see note 80 infra, the exemptions could only have been enacted to help consumers who were subject to much higher rates. That reasoning might equally apply to the maximum rate itself. There are, however, two problems with a consumer protection rationale for the California usury law. First, consumer loans make up a very small percentage of the total loan market. Committee Against Unfair Interest Limitations v. California, No. C158433, slip. op. at 10 (Cal. Super. Ct. Feb. 6, 1978) (consumer loans make up seven percent of loan market). Second, California, unlike other states, has no corporate exemption. See note 8 supra.

79. Strong religious and moral convictions underlie the usury proscription. See note 9 supra. See also Ex Parte Dickey, 144 Cal. 234, 240 (1904) ("usury laws . . . had their origin in the somewhat spiritual and theological notion that it was against the law of God that a thing which was by nature unfruitful should be made to bear fruit"); Hershman, Usury and the Tight Mortgage Market, 22 Bus. LAW. 333, 335 (1967); Comment, supra note 7, at 128-29. The significance of good faith in usury cases is the most important manifestation of those convictions. See, e.g., Claire v. La Lanne-Paris Health Spa, Inc., 12 Cal. 3d 915, 528 P.2d 357, 117 Cal. Rptr. 541 (1974); Milan v. Credit Discount Co., 27 Cal. 2d 335, 163 P.2d 869 (1945); Jameson v. Warren, 91 Cal. App. 590, 595, 267 P. 372, 374 (1st Dist. 1928). The good faith requirement imposed for contingent agreements, see text accompanying notes 62-64 supra, is part of that development. Courts seem to use the good faith of the parties as a way to distinguish between those who "deserve" the penalties provided by the usury law and those who do not. Compare Boerner v. Colwell Co., 21 Cal. 3d 37, 577 P.2d 200, 145 Cal. Rptr. 380 (1978) with Claire v. La Lanne-Paris Health Spa, Inc., 12 Cal. 3d 915, 528 P.2d 357, 117 Cal. Rptr. 541 (1974).

80. Johnson, supra note 9, at 90; Shanks, supra note 9, at 328; Warren, supra note 9, at 957; Note, An Empirical Study of the Arkansas Usury Law: "With Friends Like That . . . ," 1968 U. ILL. L. F. 544, 540 (1968). This "fair price for money lent" justification for the usury law is borne out by the fact that the maximum rates set by most usury statutes are above what was the competitive rate at the time the statute was passed. When the 10% rate was set for California in 1934, for example, the prime rate was 1.5%. Board of Governors of the Federal Reserve System, Banking and Monetary Statistics 1941-1970 707 (Sept. 1976).

There is a fundamental tension, however, between the economic "fair price" rationale and the moralistic notion that certain rates are somehow immutably excessive. Consider the famous speech of Richard Dana before the Massachusetts legislature:

The early laws had in view this object, to prevent the powerful lender getting more from
nall did not consider this rationale in its treatment of variable agreements. Closer analysis of the policies behind the usury law is

the needy borrower than—what? Six per cent? No; there is nothing in nature that points to six per cent,—from getting more than the fair value at the time. I coincide with that entirely. I agree that if you could pass a law which should not fix, but ascertain the market value of money every day, that would be right. In early, simple times, the value could be ascertained, nearly. But as business increased, the means for ascertaining the rates failed. It was found at last that fixed legal rates could not be adjusted to the real value of money. Can it be done now?

SPEECH OF RICHARD H. DANA, JR., IN THE HOUSE OF REPRESENTATIVES OF MASSACHUSETTS, FEBRUARY 14, 1867, ON THE REPEAL OF THE USURY LAWS 12 (1867), reprinted in Merriman & Hanks, Revising State Usury Statutes in Light of a Tight Money Market, 27 Md. L. Rev. 1 (1967). This speech was instrumental in the repeal of the Massachusetts usury statute. Shanks, supra note 9, at 329.

81. A second rationale, sometimes mentioned by commentators, is that the usury law attempts to redress monopolistic rate fixing by lenders. See, e.g., Kawaja, supra note 9, at 324. Yet those who have the most market power and hence ability to charge monopoly prices in the California lending market—state banks and savings and loan associations—are exempt. Hence, this rationale makes little sense in California. In other jurisdictions, setting a maximum rate does little to solve the market structure problem of monopoly power. Interview with Lawrence A. Sullivan, Professor of Law, University of California, Berkeley, in Berkeley (Feb. 2, 1979). Monopoly problems are, in any case, better left to antitrust laws. Id.

A third rationale occasionally given for usury laws is that excessive rates cause borrower defaults and insolvencies, which in turn threaten the economic life of the community. See, e.g., Note, supra note 80, at 562-63; Note, A Federal Usury Law—Uniformity At Any Rate, 4 U.C.D. L. Rev. 421, 435 (1971). A corollary notion is that borrowers need protection from the “psychic harms” associated with default. Wallace, supra note 9, at 459. These rationales rest on the premise that excessive rates cause more borrower defaults than lower rates. Yet high rates do not cause borrower defaults. High rates correlate with significant numbers of borrower defaults only because these rates are given to those who evidence a higher risk of default in the first place. See R. Lipsey & P. Steiner, supra note 30, at 376-77. It strains credulity to postulate that defaults of high risk borrowers, who have only a marginal effect on the credit market, threaten the economic fabric of society.

82. McConnell’s failure is typical. Few California courts have examined the policies of the usury law in deciding cases. This failure is partly because usury law doctrines are so old that courts feel bound by a web of precedent. The credit sales exception, reaffirmed in Boerner v. Colwell Co., 21 Cal. 3d 37, 577 P.2d 200, 145 Cal. Rptr. 380 (1978), for example, was established in a California case decided over fifty years ago, Verbeck v. Clymer, 202 Cal. 557, 261 P. 1017 (1927), and has roots in much earlier cases. See, e.g., Hogg v. Ruffner, 66 U.S. (1 Black) 115 (1861); Bette v. Bigwood, 108 Eng. Rep. 792 (K.B. 1827); Floyer v. Edwards, 98 Eng. Rep. 995 (K.B. 1774). Most other extant usury doctrines can be similarly traced to old American and English cases. See 39 CYCLOPEDIA OF LAW & PROEDURE 888-1097 (1912).

The failure to reexamine and apply the policy behind the law stems also, however, from the fact that the law’s purposes are often unarticulated or, indeed, nonexistent. Boerner was a good example of the latter problem. The case involved the transfer of deeds of trust and lien contracts from the seller to a financing institution. Plaintiffs launched a frontal attack on the longstanding credit sale exception to the usury law, under which vendor financing is characterized as part of the sale, and hence not a “loan” to which the usury law applies. See Milana v. Credit Discount Co., 27 Cal. 2d 335, 163 P.2d 869 (1945). The court conceded that there were “rational weaknesses” in the distinction between loans and credit sales, but concluded that subjecting sales finance companies to the usury law might be a “death blow” to this “vital” enterprise. 21 Cal. 3d at 46 n.11, 577 P.2d at 206 n.11, 145 Cal. Rptr. at 386 n.11 (quoting Warren, Regulation of Finance Charges in Retail Installment Sales, 68 Yale L.J. 839, 850 (1959)). The court’s implicit argument was that finance companies will not be able to supply needed credit at a 10% rate. The problem is that this argument applies with equal force to loans that are not part of a “sale”—i.e., to every usurious
necessary to determine whether that examination would have changed the result in *McConnell*.

The usury law's principal purpose is to protect borrowers from "excessive rates." Yet the exemptions from the law allow some lenders to charge interest of eighty percent or more. At least three rationales have been given for these exemptions. First, lenders who compete in "low risk" credit markets are thought not to need regulation because open competition in these markets provides a "natural restraint" on interest rates. Second, because the legislature can set different maximum rates for exempt lenders, exemptions are said to allow rates which are "appropriate" for each exempted class. Finally, the exemptions give high risk borrowers access to legitimate loan markets.

These rationales support the exemptions. But they also support a blanket exemption because they provide no principled basis for distinguishing between exempt and nonexempt lenders. First, there is no transaction. In other words, if helping finance companies and, through them, consumers is the central rationale for the credit sales exception, courts should enlarge the exception to exempt every "loan" as well as every "sale." Given this logical absurdity, the distinction between loans and sales is without substance, and courts in effect have no underlying purpose to which to refer in deciding loan versus sale cases. For a discussion of cases in other states attacking the credit sales exception, see Comment, *Service Charges for Revolving Charge Accounts: A Time Price Exemption or Usury?*, 71 COLUM. L. REV. 905 (1971).

83. *See note 89 infra.*
87. A California court has recently held that the exemptions to the usury law violate the equal protection and commerce clauses of the United States Constitution. Committee Against Unfair Interest Limitations v. California, No. C158433 (Cal. Super. Ct. Feb. 6, 1978). The court first held that since there is no rational basis for the distinction between exempt and nonexempt lenders with respect to nonconsumer loans, the exemptions violate equal protection. (As to the validity of the court's distinction between consumer and nonconsumer loans, *see note 78 supra.*). However desirable such a holding would be from a policy standpoint, the court's claim that the exemptions violate equal protection is not supported by the cases. The United States Supreme Court and California courts have consistently upheld exemptions in the face of equal protection challenges. Mutual Loan Co. v. Martell, 222 U.S. 225 (1911); Griffith v. Connecticut, 218 U.S. 563 (1910); Carter v. Seaboard Fin. Co., 33 Cal. 2d 564, 203 P.2d 758 (1949); Mission Hills Dev. Corp. v. Western Small Bns. Inv. Co., 260 Cal. App. 2d 923, 67 Cal. Rptr. 505 (1st Dist. 1968); Baruch Inv. Co. v. Huntoon, 257 Cal. App. 2d 485, 65 Cal. Rptr. 131 (1st Dist. 1967).

In addition, any number of "rational bases" support the exemptions, *see text accompanying notes 84-86 supra,* including allowing high risk borrowers access to the loan market. That these rationales support further exemptions, *see text accompanying note 88 infra* does not, as a constitutional matter, render the exemptions an irrational classification. Legislation can address only part of a problem and leave the rest unremedied. Railway Express Agency v. New York, 336 U.S. 106, 110 (1949) ("the fact that New York City sees fit to eliminate from traffic this kind of distraction but does not touch what may be even greater ones in a different category, such as the vivid displays on Times Square, is immaterial"). *See also* New York Transit Authority v. Beazer, 47 U.S.L.W. 4291, 4297 n.39 (1979) (state legislation does not violate the equal protection clause merely because the classifications it makes are imperfect).
reason to believe that competition would not work equally as well in high risk markets as it does in low risk markets. Indeed, the only reason that high risk markets are not presently competitive is because the usury law prevents nonexempt lenders from competing in them. Second, the legislature should be allowed to establish “appropriate” rates for all, not just exempt, lenders. Finally, blanket exemptions would allow high risk borrowers even greater access to legitimate loan markets. Under the present system of partial exemptions, these borrowers are served by uncompetitive markets and, consequently, are charged higher rates.88

The exemptions thus throw into question California’s commitment to its maximum ten percent rate.89 Basic economics casts doubt on the

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The court’s second holding—that the 10% interest limitation imposes an undue and discriminatory burden on interstate commerce—seems to be, surprisingly, the first time a court has so held. The United States Supreme Court has often struck down state regulation of incoming commerce when the statute either discriminates on its face against interstate commerce, City of Philadelphia v. New Jersey, 437 U.S. 617 (1978); Welton v. Missouri, 91 U.S. 275 (1876); or when there is a discriminatory impact against interstate commerce, Hunt v. Washington State Apple Adverting Comm’n, 432 U.S. 333 (1977); Great Atlantic & Pacific Tea Co. v. Cottrell, 424 U.S. 366 (1976); Dean Milk Co. v. City of Madison, 340 U.S. 349 (1951). Since only California state banks and savings and loan associations can qualify for the exemptions, an argument can be made that at least these exemptions are discriminatory on their face. It is also arguable that the usury statute has an impermissible discriminatory impact on out-of-state lenders, since its monetary impact is felt largely by out-of-state lenders. (The only significant in-state nonexempt lenders, mortgage bankers, are generally funded by out-of-state insurance companies.) See Committee Against Unfair Interest Limitations v. California, C158433 (Cal. Super. Ct. Feb. 6, 1978). Both of these arguments have been weakened by Sondeno v. Union Commerce Bank, 71 Cal. App. 3d 391, 139 Cal. Rptr. 229 (1st Dist. 1977), which held that an out-of-state bank which loans on the security of real property could claim the in-state bank exemption.

Whatever the merits of the constitutional arguments, Committee offers a fascinating look at both the structure of the California lending market and the tremendous stakes involved. Plaintiffs, representative nonexempt lenders (insurance companies, out-of-state banks, out-of-state savings and loan associations, real estate investment trusts, and pension fund trusts) seek to overturn the usury law. Representative exempt lenders (state banks, state savings and loans associations, industrial loan companies, personal property brokers) are intervenors, seeking to preserve, along with the State of California, the usury law with its current exemptions. At stake is an annual loan business in California of over 194 billion dollars. Committee Against Unfair Interest Limitations v. California, C158433, slip op. at 10 (Cal. Super. Ct. Feb. 6, 1978).

88. A higher interest rate might result from a decreased supply of capital, see P. Samuelson, supra note 30, at 602-04. It might also result from a monopoly profit exacted by exempt lenders. This monopoly is, of course, created by the usury law. Ironically, one of the asserted justifications for the usury law in the first place is the existence of a less than competitive money market. See note 81 supra.

The exemptions did serve after 1934 as a safety valve to relieve the pressure caused by the 10% maximum rate. Without the usury law, borrowers would not now be able to get loans. The resulting crises would surely have toppled the usury law—or at least the 10% maximum rate. See Shanks, supra note 9, at 329.

89. “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.” Ury v. Jeweler’s Acceptance Corp., 227 Cal. App. 2d 11, 20, 38 Cal. Rptr. 376, 382 (1st Dist. 1964). The cases bear witness to this. In one particularly flagrant example, an industrial loan company loaned money at
premise that a maximum rate, as applied to nonexempt lenders only, protects borrowers. When prevailing interest rates are lower than the maximum, the usury law is superfluous. At times like the present when prevailing rates exceed the maximum rate, the law’s effect is to force nonexempt lenders out of the loan market. This compels the “protected” borrower to approach one of two types of lenders. The borrower can approach exempt lenders, who, given the shortage of loan money, the requirement that their loans be secured and the lack of competition from nonexempt lenders, will charge a higher rate than if no usury law existed or will not loan the money at all. The borrower might then be forced to seek out unscrupulous lenders—loan sharks created by the usury law—whose interest rates are exhorbitant in large part because they must bear the risk of their illegal activity.

B. The Solution

Borrower “protection” would be best served by repealing California’s usury law. Because the law is part of the state constitution, however, any modification must be approved by the voters.

an 80% rate. The borrower defended a lender collection suit by alleging usury and arguing that this rate was unconscionable. The court agreed with the claim of unconscionability. The court held, however, that the usury law, which exempted the lender as an industrial loan company, was the “law of the land,” and that therefore not only the usury defense but also the unconscionability defense must be rejected. People’s Fin. & Thrift Co. v. Mike-Ron Corp., 236 Cal. App. 2d 897, 46 Cal. Rptr. 497 (4th Dist. 1965).

90. See note 23 and accompanying text supra.

91. See, e.g., Garino, Loans Are Hard to Get In Many Small Towns as Banks Lack Funds, Wall St. J., Apr. 4, 1979, at 1, col. 6. High interest rates now existing, even discounted for inflation, see note 30 supra, indicate that lenders do not have sufficient funds available to lend at interest rates that prevailed in the past.


93. This is a necessary corollary to the exodus of nonexempt lenders. See Committee Against Unfair Interest Limitations v. California, No. C158433 (Cal. Super. Ct. Feb. 6, 1978).

94. Regents of the Univ. of Cal. v. Superior Court, 17 Cal. 3d 533, 537 n.2, 551 P.2d 844, 847 n.2, 131 Cal. Rptr. 228, 231 n.2 (1976).

95. Oeljen, supra note 9, at 176; Shanks, supra note 9, at 330; Warren, supra note 9, at 952-53; Comment, Syndicate Loan-Shark Activities and New York’s Usury Statute, 66 Colum. L. Rev. 167 (1966).

96. Many have advocated this for other jurisdictions and usury laws in general. See, e.g., sources cited in the first paragraph of note 9 supra. The usury law would be replaced by a general unconscionability standard. See Note, supra note 9. See also Note, Review of Unconscionable Transactions, 8 U. QueenL. J. 45 (1973). Indeed, many jurisdictions have no usury law at all but still manage to protect borrowers with a general unconscionability standard. See, e.g., the states, cited in note 8 supra, having no usury law. See also Warren, supra note 9, at 954 (Germany and Sweden have never had a usury law; Great Britain currently has none).

97. CAL. CONST. art. XVIII, § 1 (amendment proposed by two-thirds of each house of the legislature must be approved by the electorate); CAL. CONST. art. XVIII, § 3 (voters themselves may amend the constitution by initiative).
efforts to make modest changes in the usury law have been rejected by California voters.98 Thus, as a realistic matter, it is unlikely that the law will soon be repealed.99

Hence courts are left with the disquieting task of adjudicating cases under a law having an effect opposite to its purpose. One solution is to ignore the usury law. Yet even if the law's justification is inadequate, judges are,100 and should be, reluctant to disrespect the expressed wishes of the people.101 The answer has to be found through interpreting the law. Courts often must interpret the law. The usury law itself does not, for example, make it self-evident whether a ten percent maximum is based on an average of interest charges over the term of the loan. Courts usually decide such issues by referring to the underlying policies of the law. In the usury context, however, courts trying to interpret the law are presented with a dilemma: strict application harms borrowers; liberal application, though better for borrowers, will be inconsistent with the strictness implied by the provision that rates should not exceed ten percent.102

98. In 1970, a proposition was put before the voters which would have exempted corporate and partnership borrowers from the usury law on loans over $100,000. It was defeated by a large margin. L.A. Times, Nov. 5, 1970, at 28, col. 2. In 1976, two propositions (prop. 12, June 8, 1976; prop. 5, Nov. 2, 1976) would have raised the 10% limit to about 12% on commercial loans. Both were defeated. See Boerner v. Colwell Co., 21 Cal. 3d 37, 54, 577 P.2d 200, 211, 145 Cal. Rptr. 380, 391 (1978). Various special interest groups support the continued existence of rate ceilings. See Warren, supra note 9, at 955. But as one writer has noted, the usury laws “probably owe their continued existence to a vague, inertial public belief that somehow they protect the needy.” Id. at 953-54.

99. Note, however, that in 1978, Tennessee voters repealed the state's 10% ceiling on interest rates, see Bus. Week, Mar. 20, 1978, at 40; thus, while the odds may be against repeal, they are not insurmountable.

That state's severe credit crunch was the probable reason for the voter's repeal of the ceiling. After an August 1977 court ruling enforcing the 10% ceiling, small companies virtually stopped making loans. Since the usury law's repeal, though, the availability of funds for consumer loans has soared. Id.

100. "The role of the judiciary is to carry out . . . decisions, not to substitute its judgment . . . for that of either of the co-equal branches." Hawkins v. Superior Court, 22 Cal. 3d 584, 607, 586 P.2d 916, 931, 150 Cal. Rptr. 435, 450 (1978) (Bird, C.J., concurring).

101. Ignoring the will of the voters can also be politically dangerous for judges, as attested by the recent near defeat of Chief Justice Rose Bird at the polls and the trend toward contested elections of state judges. See, e.g., Editorial, Elect the State Supreme Court, S.F. Chronicle, Mar. 4, 1979, at B2, col. 1.

The solution lies in an analysis of the degree to which the law appears on its face to cover the transaction in question. Since the interest of adherence to the usury law is one of faithfulness to the language of the statute, loans which by any common-sense interpretation exceed the ten percent per annum maximum rate should be subject to the usury law. If, on the other hand, the loan does not clearly appear to violate the usury law, the court should freely weigh the effect on borrowers of applying the usury law.

Under this analytical framework, an average interest rule should have been adopted. It is not readily apparent whether an average interest rule violates the usury law. In fact, practicing attorneys had long assumed the average interest rule was the law. Borrowers will be helped by such a rule since loans will be easier to obtain and interest rates on the loans lower if such a rule is employed.

On the other hand, since a variable loan which exceeds ten percent is by any common-sense interpretation a loan which exceeds ten percent, the court should have held that such loans are subject to the usury law whether or not entered into in good faith. As a practical matter, the court's decision probably did this. Yet the court should have forthrightly so held.

CONCLUSION

The court's approach in McConnell was flawed by two fundamental failures. First, the court did not grasp the underlying economic realities of variable rate loans. It ignored, for example, the availability and use of the capping procedure. The court also misperceived the limited extent to which a lender actually "risks" his profit and the effect of an ambiguous "good faith" standard on the structuring of future loan transactions. Second, the court's analysis of variable interest agreements ignored the policies behind the usury law. McConnell makes the


use of variable agreements less attractive for lenders. Borrowers, consequently, will face greater difficulties obtaining loans.

Courts should strictly apply the usury law to a loan transaction when this is dictated by a common-sense interpretation of the law. In all other cases, courts should examine the economic effect strict application will have on borrowers, and shape their decisions to produce the least harm consistent with the purposes of the usury law. This approach should provide sounder decisions in usury cases.

Robert Waterman*

* * *

Post Brothers Construction Co. v. Yoder. The court held that a materialman who endorses a check made payable jointly to the materialman and a subcontractor is deemed to have received full payment from the owner or general contractor.

The defendant, Shapell Industries, contracted with a subcontractor, West Pac Constructors, for West Pac to perform grading work on a specific site owned by Shapell. West Pac leased grading equipment from Post Brothers for use on this project and on other unrelated projects. Shapell paid West Pac by issuing joint checks naming West Pac, Post Brothers, and other materialmen as payees. The checks bore no instructions regarding the allocation of funds but were endorsed by all the named payees and deposited in West Pac’s bank account. Pursuant to an ongoing agreement between West Pac and Post Brothers, Post Brothers would apply payments from West Pac to West Pac’s earliest unpaid invoices, without regard to the job site named on the invoices or the source of the funds. After West Pac paid Post Brothers its portion of the Shapell checks, the Post Brothers books still showed amounts due on the Shapell tract. Post Brothers then brought an unsuccessful action to foreclose a mechanic’s lien and to recover on the owner’s surety bond for materials.

In affirming the lower court judgment, the supreme court reaffirmed the advantages of the joint check method of payment: the joint check allows the owner or general contractor to pay the subcontractor expeditiously while ensuring that the subcontractor will pay those with

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1. 20 Cal. 3d 1, 569 P.2d 133, 141 Cal. Rptr. 28 (1977) (Clark, J.) (unanimous decision).
whom he has contracted. A payee of the joint check, such as a materialman, may protect his interest, the court reasoned, by demanding immediate payment in exchange for his endorsement. The court thus placed a burden of self-protection on joint check payees. Because Post Brothers had routinely endorsed checks without adopting any self-protective measures, the court ruled that it had failed adequately to protect its interest in the joint checks. As a result, Post Brothers had no claim against Shapell.2

Further, although the intention of the parties determines whether a check is received in payment of a debt, the court found that the requisite intent was provided by the joint check rule: unless an agreement with the owner provides otherwise, the owner's intent to pay the debt owed to the materialman is shown by naming the materialman as payee of the joint check. This intent thus binds the materialman-payee, who must adopt self-protective measures in endorsing the check.

The court argued that the joint check rule would work as well in cases involving multiple payees or multiple job sites as it does in cases involving only two payees and one job site. Complicated divisions of joint checks may be accomplished by simple escrow, and the materialman is in a better position than the owner to determine and demand his proper share of the check. Given the materialman's better position, the simple need to resort to escrow should not shift to the owner the risk of nonpayment. Likewise, the owner should not bear the burden of ensuring that the materialman is paid on a particular job site in light of the materialman's practice of indiscriminately crediting the subcontractor's invoices from various job sites.

The court also found that Civil Code section 1479,3 providing for allocation of funds received from a debtor under multiple obligations to a creditor, does not apply to this case since Shapell was not a debtor of Post Brothers. The joint check demonstrates the owner's intent that the funds be divided among the payees, and section 1479 would govern the allocation of the funds only after division among the payees.

2. Post Brothers had been granted a default judgment against West Pac, which was insolvent. Id at 5 n.1, 569 P.2d at 135 n.1, 141 Cal. Rptr. at 30 n.1.

3. CAL. CIV. CODE § 1479 (West Supp. 1978). Section 1479 essentially provides that where a debtor under multiple obligations does an act of performance that is equally applicable to the several obligations, the performance should be allocated in accordance with the intention of the debtor if manifested; and if not manifested, the creditor may allocate in any manner he chooses within a reasonable time.