Doss Law, LLP's
Definitive Guide to Usury In California

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The practice of charging interest for the use of money has been in place for thousands of years. As a lender or broker, you have most likely heard of usury, and in particular, California laws restricting usury. California's usury laws are complicated and can be overwhelming. This Doss Law Guide is designed to provide you with a definitive summary of California Usury Law.

How did we get here and why is this important?

Interest is the "price" charged for the use of someone else's money. The law put in place a cap, i.e., usury limit, on how much one can charge in interest for borrowing money. That cap is a form of price control, designed to protect the public and under-privileged borrowers from being subjected to excessive costs of borrowing money. Usury is the charging of interest for a loan or forbearance on money in excess of the legal maximum. *Junkin v. Golden West Foreclosure Service, Inc.*, 180 Cal. App. 4th 1150, 1155, 103 Cal. Rptr. 3d 582 (1st Dist. 2010).

A brief history of California Usury Law

As part of California's legislators' effort to protect borrowers, they created constitutional provisions and statutes to regulate the cost of borrowing money. These laws together are known as the California Usury Law. The Usury Law in California began in 1918 with initial statutes establishing a maximum allowable interest rate of 12% per year. With some constitutional amendments, most notably the 1979 constitutional amendment, Article XV, Section 1, California's usury limit is now generally 10% per year with a broader range of exemptions.

What is Usury in California?

In California, absent an exception which we discuss in depth below, the maximum allowable interest rate for consumer loans is 10% per year. For non-consumer loans, the interest rate can bear the maximum of whichever is greater between either: i) 10% per annum; or ii) the "federal discount rate" plus 5%. Cal. Const. art. XV, § 1(2).

In the absence of an agreement between the parties as to what is the rate of interest, the law imposes a rate of 7%. Cal. Const. art. XV § 1. *See* Civ. Code, §§ 1916-1, 1916-2, 1916-3. For example, a mechanics lien claimant who had no direct contract with the owner brought an action to foreclose its mechanics lien. The court of appeal held that the applicable rate of interest was 7% because the claim was based on a statutory obligation rather than a contract. *Palomar Grading & Paving, Inc. v. Wells Fargo Bank, N.A.*, 230 Cal. App. 4th 686, 691, 178 (4th Dist. 2014).

Interest includes anything of value received by a lending entity from the borrower regardless of the specific type of consideration. This means that all borrower payments of any fees, bonuses,

commissions, discounts, other compensation, and similar charges could all be considered interest. Not counted are legitimate third party costs, such as legal fees, title insurance, recording fees, escrow fees and the like. *Lewis v. Pacific States Sav. & Loan Co.*, 1 Cal. 2d 691, 694, 37 P.2d 439 (1934) (normal closing costs); *Niles v. Kavanagh*, 179 Cal. 98 101-102, 175 P. 462 (1918) (title fees); *Ex parte Fuller*, 15 Cal. 2d 425, 434, 102 P.2d 321 (1940) (appraisal); *Taylor v. Budd*, 217 Cal. 262, 266, 18 P.2d 333 (1933) (attorney's fees). Unnecessary fees are counted the same as interest. *Klett v. Security Acceptance Co.*, 38 Cal. 2d, 779-780, 242 P.2d 873 (1952). Late charges do not count as interest since a late payment is a voluntary act by the borrower. *Smiley v. Citibank*, 11 Cal. 4th 138, 180, 900 P.2d 690 (1995). No case has applied the same logic to default interest (an increase in interest rate upon default).

When does the Usury Law Not apply?

Remember, the Usury Law only applies to a loan or forbearance. If a transaction is not a loan or forbearance, then the Usury Law does not apply. A forbearance is the extension of additional time for the repayment of an obligation or an agreement not to enforce a claim on its due date or releasing and extending the borrower's obligation for repayment. *Southwest Concrete Products v. Gosh Construction Corp.*, 51 Cal. 3d 701, 705, 274 Cal. Rptr. 404, 798 P.2d 1247 (1990).

Joint Venture Exception. The Usury Law does not apply to an at-risk investment transaction involving an investment of money, because such transactions are not considered loans. Courts have rejected any usury claims even if an investor receives a return on investment which exceeds the maximum usury rate. *Roodenburg v. Pavestone Co., L.P.*, 171 Cal. App. 4th 185, 194, 89 Cal. Rptr. 3d 558 (3d Dist. 2009).

Judgments. The Usury Law does not apply to judgments because a judgment is not a loan. A forbearance by a judgment creditor is also not subject to the Usury Laws because judgments are not loans. *Bisno v. Kahn*, 225 Cal. App. 4th 1087, 1103, 170 Cal. Rptr. 3d 709 (1st Dist. 2014).

Seller Carryback. An extension of purchase money financing from a seller to finance the bona fide sale of real property (i.e., seller carryback credit sale financing) is exempt from the Usury Law because the law regards the transaction under the time-price differential doctrine, meaning it is not a loan or forbearance at all, just an expression of the purchase price. *Southwest Concrete Products v. Gosh Construction Corp*. 51 Cal. 3d 701, 705, 798 P.2d 1247 (1990). Likewise, an extension of that original exempt transaction is also not subject to the Usury Law. It is not a forbearance, because it is considered a renegotiation of the original sale. *Ghirardo v. Antonioli*, 8 Cal. 4th 791, 795, 808, 883 P.2d 860 (1994).

Labor. The Usury Law does not apply to the consideration paid for the performance of work or services. *Lamb v. Herndon*, 97 Cal. App. 193, 200-201, 275 P. 503 (3d Dist. 1929).

Late Charges. A late charge imposed when an installment is not paid when due is not subject to the Usury Law. The late charge is not a forbearance because the lender is not agreeing to a delay in payment. Likewise, a late charge on a lump sum obligation is not subject to the Usury Laws. *Roodenburg v. Pavestone Co., L.P.*, 171 Cal. App. 4th 185, 192-194, 89 Cal. Rptr. 3d 558 (2009).

True Lease or Sale-Leaseback. A true lease is not considered a loan transaction. *Triple C. Leasing, Inc. v. All-American Mobile Wash*, 64 Cal. App.3d 244, 134 Cal. Rptr 328 (Cal. Ct. App. 1976). But a lease where the lessee was allowed to purchase the leased property at the termination of the lease for nominal consideration was considered to be a loan. *Blodgett v. Rheinschild*, 206 P. 674 (Cal. 1922); *Golden State Lanes v. Fox*, 42 Cal.Rptr. 568 (Cal. Ct. App. 1965). *See also*: *In re J.A. Thompson & Son, Inc.* 665 F.2d 941 (9th Cir. 1982). Also relevant is the guidance from the Department of Financial Protection and Innovation issued Release No. 56-FS on March 1, 2006 which lists the factors it will consider in determining whether a true lease or sale-leaseback constitutes a loan requiring a California Finance Lender License.

Prearranged Purchase of Installment Loan Contracts and Factoring. In Boerner v. Colwell Co., 21 Cal. 3d 38, 577 P.2d 200 (1978), the California Supreme Court found that a prearranged purchase of home improvement installment sale contracts by a lender was not a loan or forbearance for usury purposes. The Court struggled to reconcile its decision with its previous decision in *Glaire v. La Lanne-Paris Health Spa, Inc.* 12 Cal. 3d 915, 528 P.2d 357 (1974), where the purchaser of the paper was under common control with the seller of the contracts

What Lenders are exempt from the Usury Law?

The majority of California or federally licensed lending institutions involved in the business of making loans (e.g., banks, credit unions, California Finance Lenders, etc.) are exempt from California's Usury Laws. If a loan or forbearance is exempt when it was originally made, a successor of the lender is also protected by the exemption. *Montgomery v. GCFS, Inc.*, 237 Cal. App. 4th 724, 733, 188 Cal. Rptr 3d 446 (2015).

However, since a usury violation is determined at the time the loan or forbearance is made, the transfer or assignment of a usurious loan to an exempt lender will not cure the usury violation. The loan will remain usurious in the hands of the assignee and is not made exempt by the transfer to an exempt lender. *Thomas v. U.S. Bank Nat. Ass'n ND*, 575 F.3d 794, 801 (8th Cir. 2009).

"Made or Arranged" by a Real Estate Broker

The interest rate restrictions of the Usury Law do not apply to loans or forbearances secured by real property if they are "made or arranged" by a California licensed real estate broker for compensation or in expectation of compensation. Cal. Const., Art. XV, Section 1. California Civil Code Section 1916.1 specifically codifies this exemption to the Usury Law. The reason that this exemption exists is to increase the availability of non-consumer loans. Additionally, since there are numerous rules and regulations governing brokers' actions in lending money, there is enough protection against usury and other unfair lending practices.

To qualify for the exemption, the loan or forbearance must be secured by real property and must be "arranged" by a real estate broker "for compensation or in expectation of compensation." To satisfy the compensation issue, a broker must either:

(1) receive or expect compensation for soliciting, negotiating, or arranging the loan for another;

(2) receive or expect compensation for selling, buying, leasing, exchanging, or negotiating the sale, purchase, lease, or exchange of real property or a business for another ***and*** either arranges a loan to pay for the purchase or improvement to the property or business, or arranges a forbearance, extension, or refinancing of a loan in connection with the sale or improvement to the property or business; or

(3) arrange or negotiate a forbearance, extension, or refinancing of any loan secured by real property in connection with a past transaction in which the broker received or expected compensation.

A broker complies with the "broker made" exception if the broker lends money as a principal with his or her own money, not as an agent of the borrower. *Creative Ventures, LLC. v. Jim Ward & Associates,* 195 Cal. App. 4th 1430, 1442, 126 Cal. Rptr. 564 (2011). To satisfy the "arranged" requirement, the broker must have solicited, negotiated or arranged a loan for another as an agent. *Bock v. California Capital Loans, Inc.,* 216 Cal. App. 4th 264, 268, 156 Cal. Rptr. 3d 874 (2013). The exemption does not apply if the broker merely lends his or her license to the transaction or serves as a "scrivener." To qualify as a broker arranged loan, the broker must actively participate in the negotiation of the loan terms and either prepare or review the loan documents for compensation. *Gibbo v. Berger,* 123 Cal. App. 4th 396, 402, 19 Cal. Rptr. 829 (2004). The courts in California disagree upon the extent of the broker's involvement to qualify for the exemption. Compare: *Del Mar v. Caspe,* 222 Cal. App. 3d 1316, 1327, 272 Cal. Rptr. 446 (1990); with *Jones v. Kallman,* 199 Cal. App. 3d 131, 134-135, 244 Cal. Rptr. 609 (1988); with *Park Terrace Ltd. v. Teasdale,* 100 Cal. App. 4th 802, 807, 122 Cal. Rptr. 797 (2002).

Loans Made to Entities Exemption

Loans made to business entities are potentially exempt from California's Usury Laws if: 1) the debt is issued by an entity, or the debt is guaranteed by an affiliated entity, with assets of at least $2,000,000 on the day the debt is issued or guaranteed; 2) the debt has a total principal amount of at least $300,000 at the time it is issued; 3) the debt is not issued or guaranteed by an individual, a revocable trust with one or more individuals as trustors, or a partnership in which one or more individuals are general partners at the time of issuance; ***and*** 4) the lender and borrower either: i) have a preexisting personal or business relationship; ii) by reason of the business and financial experience of their professional advisers (e.g., attorney), could reasonably be assumed to have the capacity to protect their own interests in connection with the transaction; ***or*** iii) by reason of their own business and financial experience, could reasonably be assumed to have the capacity to protect their own interests in connection with the transaction. California Corporations Code § 25118.

Joint Venture Exception

One the of court-established exceptions to usury is a joint venture loan or investment. In *Junkin v. Golden West Foreclosure Service, Inc.*, 180 Cal. App. 4th 1150, 1155, 103 Cal. Rptr. 3d 582 (2010), the California trial court found the loan Bennett (defendant hard money lender) made to Junkin (plaintiff borrower) involved a joint venture, and therefore was exempt from California's Usury Laws. The California Court of Appeal affirmed, citing *Miller & Starr* that, "where the relationship between the parties is a bona fide joint venture or partnership, the advance by the partners or joint venturers is an investment and not a loan, and the profit or return earned by the investor is not subject to the statutory maximum limitations of the Usury Law." 8 Miller & Starr, Cal. Real Estate (3d ed. 2001) § 21:1, p.48.

Citing to *Miller & Starr*, the court identified several factors relevant to determining whether a transaction is a bona fide joint venture: 1) whether there is an absolute obligation of repayment (Junkin was obligated to repay the note in favor of Bennett), 2) whether the investor may suffer a risk of loss (Bennett assumed a risk of the loss of capital), 3) whether the investor has any right to participate in management (even though Bennett did not participate in the management, the court viewed this as his personal choice rather than anyone preventing him from doing so), 4) whether the subject property was purchased from a third party (as in this case), and 5) whether the parties considered themselves to be partners in the transaction (both Junkin and Bennett testified they considered themselves to be partners). Applying these factors, the court affirmed the judgment, holding that because a joint venture existed, the joint venture exception to the California Usury Laws applied.

Remedies for Violations

If a loan is usurious, borrowers have several remedies. A usurious obligation is not completely void; only the interest component of the loan is jeopardized. *Forte v. Nolfi,* 25 Cal. App. 3d 656, 692, 102 Cal. Rptr. 455 (1972). If installments are due, the borrower is obligated to pay them, even if the amounts are applied to principal. *Haines v. Commercial Mortgage Co.,* 200 Cal. 609, 254 P. 956 (1927). Once a loan has matured, the obligation bears interest at the prejudgment rate of interest of 10% per annum. *Mark McDowell Corp. v. LSM 128,* 214 Cal. App. 3d 1427, 1432, 263 Cal. Rptr. 310 (1989). A borrower can bring an action in court to recover money damages for past interest paid for two years. Cal. Code Civ. Proc., Section 339. The two year limit does not apply if the lender sues the borrower and the borrower pleads an offset. *Gibbo. v. Berger, supra*. In the discretion of a court, a borrower can recovery penalty damages of three times the interest paid for one year prior to filing the action. A borrower can also recover a judgment to cancel all future interest that will become due for the remainder of the term of the loan.

Estoppel

The Usury Law is designed to protect borrowers who, because of their economic circumstances, are forced to borrow money at rates higher than the legal maximum. A borrower can be aware that they are getting into a usurious loan, but their knowledge of it does not bar them from taking action to recover penalties. Additionally, even if a borrower suggests or solicits the usurious interest rate, *and* even prepares the documents to borrow at the usurious rate, he or she can still take action to recover penalties.

Courts have made it clear that the Usury Law is a shield and not a sword. *Haines v. Commercial Mortgage Co.*, 200 Cal. 609, 621, 254 P. 956 (1927). Usury may not be used to perpetrate an injustice. *Wooton v. Coerber*, 213 Cal. App. 2d 142, 150, 28 Cal. Rptr. 635 (2d Dist. 1963). In cases where the borrower knowingly and fraudulently places a usurious interest rate in the note or agreement with intent to defeat his or her own obligation to pay interest, courts have barred such borrowers from raising the defense of usury. *Stock v. Meek*, 35 Cal. 2d 809, 818, 221 P.2d 15 (1950) (dicta).

Criminal Penalties

Usury is also a crime. Any person who receives or takes usurious interest is guilty of a crime and subject to imprisonment for up to five years, or incarceration in the county jail for up to one year. Cal. Civ. Code 1916.3(b). If the lender is a corporation, its officer(s) or director(s) are not liable for *criminal* charges *unless* they actively and consciously participated in the usurious transaction.

Choice of Law: Which State's Laws Govern?

Generally, parties to a contract can choose which state's laws apply to the transaction. However, there must be a "reasonable relationship" between the transaction and the state whose law is chosen, *and* the application of law chosen cannot violate a fundamental policy of the state of chosen. *Washington Mutual Bank FA v. Superior Court,* 24 Cal. 4th 906, 914-919, 102 Cal. Rptr. 2d 320 (2001). If the parties do not indicate in the contract which state's laws apply, then the law of the state where the contract "has the most significant relationship to the transaction" will govern the contract.

A substantial relationship is determined by the following factors: 1) the domicile (permanent residence) of the borrower; 2) the state where the loan should be repaid; 3) the state that has a normal and natural relationship to the contract; 4) the state where the loan is made or negotiated; and 5) the place of business of the lender. The most significant relationship is generally defined by place of payment unless another state has a more significant relationship under the test above.

California Civil Code Section 1646.5 states that parties to a contract with an aggregate amount of $250,000 or more can use California as their choice of law regardless of whether the transaction has a reasonable relationship with the state, *unless* the transaction is for personal, family, or household purposes. This section also does not apply if the transaction is contrary to the choice of law provision of the Uniform Commercial Code. In such case, the parties can choose any state that has a reasonable relationship to the transaction.

Conclusion

California's Usury Laws are nuanced and the consequences of running afoul of them are severe. Doss Law, LLP has been helping its lender and broker clients avoid usury for decades. There are exceptions and exemptions, but you must know what you are doing to implement them correctly. Prudent legal advice comes from experience. We have over 50 years of it.