Recent Developments Regarding Interest Rate Regulation

*By Kathleen E. Keest, Jeffrey I. Langer and Scott A. Cammarn**

This annual survey of developments concerning federal and state usury laws discusses a number of recent noteworthy cases and one regulatory interpretive letter regarding interest rate regulation of depository institutions and other lenders.

"INTEREST" UNDER SECTION 85 MAY INCLUDE UNAUTHORIZED INSURANCE PREMIUMS

In *Kenty v. Bank One, Columbus, N.A.*[1] the Federal District Court for the Southern District of Ohio concluded that, in some situations, charges for excess insurance premiums may constitute "interest" for purposes of 12 U.S.C. § 85 (section 85), the federal statute regulating the rate of interest that may be imposed by national banks.[2] In *Kenty*, the plaintiff, Kenty,

*Ms. Keest, a member of the Iowa bar, is a lawyer with the National Consumer Law Center (NCLC) in Boston. She is chair of the Subcommittee on Interest Rate Regulation. The views expressed are not necessarily those of the NCLC. No legal services funds were used in the preparation of this Article. Mr. Langer, a member of the Ohio and Illinois bars, is vice-chair of the Subcommittee on Interest Rate Regulation. Mr. Cammarn is a member of the Ohio bar. Messrs. Langer and Cammarn practice law with Jones, Day, Reavis & Pogue in Columbus, Ohio.

1. No. C2-90-709, 1992 WL 170605 (S.D. Ohio Apr. 23, 1992).
2. Section 85 provides in pertinent part:

> Any association may take, receive, reserve, and charge on any loan or discount made, . . . interest at the rate allowed by the laws of the State, Territory, or District where the bank is located, or at a rate of 1 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal reserve bank in the Federal reserve district where the bank is located, whichever may be the greater, and no more, except that where by the laws of any State a different rate is limited for banks organized under State laws, the rate so limited shall be allowed for associations organized or existing in any such State under this chapter. When no rate is fixed by the laws of the State, or Territory, or District, the bank may take, receive, reserve, or charge a rate not exceeding 7 per centum, or 1 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal reserve bank in the Federal reserve district where the bank is located, whichever may be the greater. . . .

12 U.S.C. § 85 (1988).

obtained a purchase money loan secured by an automobile from Bank One, Columbus, N.A. (Bank One), a national bank located in Ohio. The loan agreement obligated Kenty to maintain insurance on the automobile in the amount of the outstanding balance of the loan. The agreement authorized Bank One to obtain or "force-place" insurance covering Bank One's interest in the automobile if Kenty failed to maintain sufficient insurance herself and permitted Bank One to add the amount of the premiums to the balance of the loan. After Kenty failed to maintain sufficient insurance herself, Bank One procured insurance from Transamerica Premier Insurance Company (Transamerica), an unaffiliated insurance company, and added a charge for the premiums to the balance of the loan. The amount of the charge then accrued interest, along with the unpaid balance of principal, at the 11.5 annual percentage rate stated in the agreement.

Kenty then brought a class action on behalf of herself and all other similarly situated consumers, alleging several claims against Bank One and Transamerica, including a claim that Bank One had imposed excess charges for insurance and therefore had committed usury under section 85.[3] Kenty alleged that Bank One had committed usury because it received a rate of interest well in excess of the stated rate of 11.5%. In particular, Kenty contended that Bank One received excess interest in the form of (i) rebates received from Transamerica that were not credited to Kenty's account so that she was charged higher premiums than Bank One paid to Transamerica, (ii) premiums for insurance in excess of the insurance authorized by the agreement, and (iii) interest that accrued on the excess premiums.[4] In denying Bank One's motion to dismiss, the court examined whether the facts, as alleged, could support a claim for usury under section 85, and in particular, assuming the allegations were true, whether the charges caused the rate to be usurious.[5]

The court first declared that it did not need to determine the maximum rate of interest permitted by Ohio law and incorporated by section 85.[6] Rather, the court stated that "[t]he issue for purposes of this motion is whether the alleged unauthorized premium charges constitute 'interest,' so that the plaintiff might prove that the interest charged by Bank One exceeded the applicable statutory rate."[7] Thus, in the court's view, the

3. Kenty also raised claims under the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. §§ 1961-1968 (1988 & Supp. III 1991), and the Bank Tying Act, 12 U.S.C. §§ 1971-1978 (1988 & Supp. III 1991).

4. Kenty alleged that the insurance that Bank One obtained provided more than the typical coverage against damage to motor vehicle collateral. The insurance policies also provided coverage for conversion, embezzlement, mechanics' liens, premium deficiencies, repossession expense, repossessed vehicle storage expense, and repossessed vehicles. *Kenty*, 1992 WL 170605, at *1-2.

5. *Id.* at *2-4.

6. *Id.* at *3.

7. *Id.*

sole issue for determination was whether the alleged excess insurance charges were "interest" for purposes of section 85.[8]

The court noted that neither section 85 nor the applicable Ohio statutes defined the term *interest*.[9] Without deciding whether the definition of *interest* is properly a question of federal law or Ohio law,[10] the court looked to several other authorities for a definition of *interest*.[11] The court concluded:

> Charges that are unauthorized and unnecessary to protect the collateral must be considered compensation to the bank for the extension of credit. Thus, the court holds that any unauthorized charges for unauthorized insurance added to a loan balance must be considered "interest." To the extent that interest is charged on unauthorized premiums added to [sic] loan balance, that is also interest.[12]

The court further concluded that the rebates Transamerica paid to Bank One also constituted *interest* because the rebates caused the amount paid by Bank One to Transamerica to be less than the amount Transamerica charged Kenty.[13] The court stated: "[I]f the plaintiff can prove that Bank One received 'kickbacks' or 'rebates' on the premiums added to her loan balance, which funds were not discounted from her loan balance, that would also constitute interest."[14]

Although *Kenty* did not address whether the definition of *interest* is a matter of state or federal law, it suggested that any loan charge imposed by a national bank may be interest if not otherwise authorized by applicable

8. *Id.*

9. *Id.*

10. *See* Greenwood Trust Co. v. Massachusetts, 971 F.2d 818 (1st Cir. 1992) (concluding that late charges are "interest" under both federal law and Delaware law and therefore not deciding whether the definition of *interest* for purposes of section 85 is derived from state or federal law), *rev'g* 776 F. Supp. 21 (D. Mass. 1991), *cert. denied*, 61 U.S.L.W. 3478 (Jan. 11, 1993).

11. *Kenty*, 1992 WL 170605, at * 3. The court quoted the Black's Law Dictionary definition of *interest*—"the compensation allowed by law or fixed by the parties for the use or forbearance or detention of money." *Id.* With respect to Ohio case law, the court cited two Ohio trial court decisions. *Id.* (citing Allshouse v. Bank & Trust Co., 30 Ohio N.P. (n.s.) 17 (C.P. 1932); Russell v. Lumbermen's Mortgage Co., 27 Ohio Misc. 171 (C.P. 1966)). The cases addressed the definition of *interest* for purposes of Ohio's civil usury statute, now codified at OHIO REV. CODE ANN. §§ 1343.01-1343.05 (Anderson 1979 & Supp. 1991). Bank One, however, was imposing interest on the basis of Ohio's banking statutes, OHIO REV. CODE §§ 1107.26-1107.265 (Anderson 1988 & Supp. 1991). The court's approach seems to assume that the definition of *interest* is the same under both statutes.

12. *Kenty*, 1992 WL 17065, at *4. Other courts have held that unauthorized charges may be *interest*. *See, e.g.*, Vander Weyst v. First State Bank of Benson, 425 N.W.2d 803, 811 (Minn.) (holding "interest" includes "all charges . . . incident to the loan"), *cert. denied*, 488 U.S. 943 (1988); *see generally* NATIONAL CONSUMER LAW CENTER, USURY AND CONSUMER CREDIT REGULATION § 7.4.2 (1987 & Supp. 1991) (discussing excessive cost).

13. *Kenty*, 1992 WL 17065, at *4.

14. *Id.*

law or the loan agreement. *Kenty* also suggested that if charges imposed on a borrower for services provided or procured by the lender exceed the lender's actual costs, such excess may constitute interest as well.

MOST FAVORED LENDER DOCTRINE: REGULATIONS PROTECTING STATE-CHARTERED LENDERS' SAFETY AND SOUNDNESS MAY NOT BE "MATERIAL TO THE DETERMINATION" OF A NATIONAL BANK'S INTEREST RATE

In a recent letter from Eugene A. Marsico, Jr., Senior Attorney for the Southwestern District of the Office for the Comptroller of the Currency (OCC) (Marsico Letter),[15] the OCC addressed the scope of the "most favored lender doctrine." Under that doctrine, first announced by the United States Supreme Court in *Tiffany v. National Bank of Missouri*[16] and now codified by the OCC in an interpretive ruling, a national bank is permitted to charge the rate of interest permitted to any competing state-chartered or licensed lending institution under the law of the state in which the national bank is located.[17] When a national bank uses the state interest rate, however, it must also comply with those provisions of state law that are "material to the determination of the interest rate."[18] The purpose of the most favored lender doctrine was to prevent state discrimination against national banks and to preserve competitive equality between state-chartered or licensed lenders and national banks located in that state.[19]

The Marsico Letter addressed whether certain provisions of Texas' credit union regulations were "material to the determination of the interest rate" and therefore applicable to a Texas-based national bank using the rate of interest authorized by the Texas credit union law under the most favored

15. Letter from Eugene A. Marsico, Jr., Senior Attorney, Southwestern District, Office of the Comptroller of the Currency, to Mark D. Morris (Feb. 18, 1992) (on file with *The Business Lawyer*, University of Maryland School of Law) [hereinafter *Marsico Letter*].

16. 85 U.S. (18 Wall.) 409 (1874).

17. 12 C.F.R. § 7.7310(a) (1992). Section 7.7310(a) provides:

> A national bank may charge interest at the maximum rate permitted by State law to any competing State-chartered or licensed lending institution. If State law permits a higher interest rate on a specified class of loans, a national bank making such loans at such higher rate is subject only to the provisions of State law relating to such class of loans that are material to the determination of the interest rate. For example, a national bank may lawfully charge the highest rate permitted to be charged by a State-licensed small loan company or morris plan bank, without being licensed.

Id. For further discussion of the most favored lender doctrine, see Jeffrey I. Langer & Jeffrey B. Wood, *A Comparison of the Most Favored Lender and Exportation Rights of National Banks, FSLIC-Insured Savings Institutions, and FDIC-Insured State Banks*, 42 CONSUMER FIN. L.Q. REP. 4 (1988).

18. 12 C.F.R. § 7.7310(a) (1992); *see supra* note 17 (text of § 7.7310(a)).

19. *See Tiffany*, 85 U.S. (18 Wall.) at 412.

lender doctrine.[20] The OCC began by noting that provisions of state law setting forth the size or maturity of loans and the classes of borrowers to which a given category of loans may be made are "material to the determination of the rate" and thus would apply to the national bank.[21] The OCC also stated that state laws establishing the manner in which the numerical rate is calculated or affecting the ultimate yield on loan proceeds also are material and therefore applicable to a national bank.[22] With respect to the Texas credit union regulations at issue, the OCC reasoned that the regulations were not "material to the determination of the interest rate"—and therefore not binding on a national bank—because the *purpose* of the regulations was to protect the safety and soundness of Texas credit unions.[23]

The Marsico Letter evidences a novel approach by the OCC towards the most favored lender doctrine. State laws or regulations are not "material to the determination of the interest rate" and therefore are not binding upon a national bank if the objective of the state law or regulation is to protect the safety and soundness of the state-chartered or licensed lending institution, regardless of the law's or regulation's impact on the interest yield or the class of loan being made. In order for a national bank to determine whether it must comply with state laws, the national bank therefore must inquire whether the purpose of the provisions is to protect safety and soundness. State provisions that are otherwise material will apply

20. *See* TEX. ADMIN. CODE ANN. § 91.701 (West 1985). The Texas regulations govern secured and unsecured loans, commercial loans, personal loans, and "member business loans" made by a credit union, and impose limitations regarding security, terms, insurance, aggregate loan limits, and maturity. *Id.*

21. *See Marsico Letter, supra* note 15, at 3 (citing Commissioner of Small Loans v. First Nat'l Bank of Md., 300 A.2d 685 (Md. 1973); Northway Lanes v. Hackley Union Nat'l Bank & Trust Co., 464 F.2d 855 (6th Cir. 1972)).

22. *See id.* (citing American Timber & Trading Co. v. First Nat'l Bank of Or., 511 F.2d 980 (9th Cir. 1973), *cert. denied,* 421 U.S. 921 (1975); Evans v. National Bank of Savannah, 251 U.S. 108 (1919); Northway Lanes v. Hackley Union Nat'l Bank & Trust Co., 464 F.2d 855 (6th Cir. 1972)).

23. The OCC stated:

> You describe the Texas Credit Union Commission's regulation in question as imposing certain restrictions on state credit unions relating to the aggregate dollar amount of their long-term, fixed rate loans, the maximum permissible maturity of certain loans and a requirement that such loans be amortized at a rate sufficient to ensure repayment within specified maturity limits, and restrictions regarding loan-to-value ratios, insurance, and escrow relating to second-lien mortgage loans. Relying on this description and other information you obtained from the preamble to the regulation and conversations with the Commission's staff concerning the objectives and purposes of those regulatory provisions, that is, that they are designed merely to address certain safety and soundness concerns regarding the institutions regulated by the Commission, I agree with your determination that those provisions would not be "material to the determination of the interest rate". . . .

Marsico Letter, supra note 15, at 3.

to a national bank only if it is shown that the provisions serve some purpose other than protecting safety and soundness, e.g., providing consumer protection. For example, the Marsico Letter illustrates that while provisions governing loan maturity typically are material and therefore applicable to national banks,[24] the Texas credit union regulations regarding loan maturity were intended to protect the safety and soundness of Texas credit unions and thus were not "material to the determination of the interest rate." The Marsico Letter, therefore, creates a competitive advantage for national banks because it renders inapplicable to national banks certain restrictive state laws and regulations that are binding upon the national banks' state-chartered or licensed competitors.

PREEMPTION OF STATE USURY RATES ON RESIDENTIAL FIRST MORTGAGE LOANS: INTERPLAY BETWEEN SECTION 85 AND SECTION 501

In *Moore v. United National Bank,*[25] the Texas Court of Appeals was faced with a novel argument regarding the interplay of section 85, which provides that a national bank may charge the rate of interest of the state in which it is located,[26] and section 501 of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA),[27] which preempts state laws regulating the rate of interest that may be charged by qualified lenders on loans secured by a first lien on residential real estate.[28] United National Bank, a national bank located in Texas, granted a loan secured by a first mortgage on residential real estate to the appellants. The appellants later brought a usury claim against the bank, contending that the rate charged by the bank exceeded the rate permitted by section 85.

The appellants argued that because the loan was secured by a first mortgage on residential real estate, section 501 acted to preempt any Texas usury rate applicable to the loan. Because no Texas usury rate applied to

24. *See, e.g.*, Attorney Gen. of Md. v. Equitable Trust Co., 450 A.2d 1273, 1293-94 (Md. 1982) (maturity one of factors included as "material"); OCC Interpretive Letter No. 333, [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,503 (Mar. 20, 1985).

25. 821 S.W.2d 409 (Tex. Ct. App. 1991).

26. 12 U.S.C. § 85 (1988); *see supra* note 2 for text of § 85.

27. Pub. L. No. 96-221, 94 Stat. 132 (1980) (codified at scattered sections of 12 U.S.C.).

28. Section 501 of the DIDMCA provides in pertinent part:

> The provisions of the constitution or the laws of any State expressly limiting the rate or amount of interest, discount points, finance charges, or other charges which may be charged, taken, received, or reserved shall not apply to any loan, mortgage, credit sale, or advance which is—
>
> (A) secured by a first lien on residential real property, . . .
>
> (B) made after March 31, 1980; and
>
> (C) described in section 527(b) of the National Housing Act (12 U.S.C. 1735f-5(b) [a "federally related mortgage loan"]). . . .

12 U.S.C. § 1735f-7a(a)(1) (1988).

the loan, appellants contended that there was no "rate . . . fixed by state law" and that section 85 therefore mandated that the maximum lawful rate on the loan could not exceed the greater of seven percent or one percent over the discount rate.[29]

The court first noted that Texas law provides an unlimited ceiling on loans secured by residential real estate, and therefore, according to *Hiatt v. San Francisco National Bank*,[30] there is indeed a rate fixed by Texas law applicable to first mortgage loans.[31] Nonetheless, the court did not stop there. Instead, the court addressed the appellants' argument that section 501 preempted any applicable Texas law and therefore there was no rate fixed by state law for purposes of section 85.[32]

Acknowledging that the appellants presented "a compelling argument that a literal reading of section 85 would require" that the rate of interest on first mortgage loans be limited to the greater of seven percent or one percent over the discount rate,[33] the court nonetheless concluded that the appellants' argument was inconsistent with one of the purposes behind the DIDMCA (of which the court stated section 85 was a part).[34] The court stated that one of the DIDMCA's purposes "was to make sure federally insured institutions were not at a competitive disadvantage as a result of state usury laws."[35] If the appellants' argument were given effect, Texas-chartered lenders could charge a greater rate of interest on first mortgage loans than could Texas-based national banks because the rate charged by national banks would be limited to the greater of seven percent or one percent over the discount rate.[36] Accordingly, the court concluded that the appellants' construction of sections 85 and 501 was incorrect and that first mortgage loans made by national banks are not subject to the interest rate limitations of section 85.[37]

CREDIT CARD LATE FEES/OVERLIMIT FEES SUCCESSFULLY CHALLENGED

In *Beasley v. Wells Fargo Bank, N.A.*,[38] Wells Fargo Bank lost a $5 million argument[39] in the California courts that its credit card late fees and ov-

29. *See* 12 U.S.C. § 85 (1988); *see supra* note 2 for text of § 85.

30. 361 F.2d 504 (9th Cir.), *cert. denied*, 385 U.S. 948 (1966); *see also* Daggs v. Phoenix Nat'l Bank, 177 U.S. 549 (1900).

31. Moore v. United Nat'l Bank, 821 S.W.2d 409, 410-11 (Tex. Ct. App. 1991).

32. *Id.*

33. *Id.* at 411.

34. *Id.* at 410-11.

35. *Id.*

36. *Id.*

37. *Id.*

38. 1 Cal. Rptr. 2d 446 (Ct. App. 1991), *review denied*, 1992 Cal. LEXIS 1219 (Cal. Sup. Ct. Mar. 12, 1992).

39. Wells Fargo's total loss actually was closer to $11 million, as the outcome of a companion case was riding on the outcome of this case, and the fee award was significant as well.

erlimit fees represented a reasonable effort to compensate for losses resulting from late payments and overlimit charges.[40] Critically, *Beasley* entailed a close scrutiny of the accounting used by the bank in establishing those fees, so the issues were more economic than legal.[41]

California law prohibits liquidated damages provisions in contracts unless it is "impracticable or extremely difficult to fix the actual damage" for a breach and the damaged party makes a "reasonable endeavor" to estimate a "fair average compensation" for its loss.[42] Wells Fargo began at a disadvantage with the jury[43] when it appeared that a task force created by the bank to study a fee increase approached the task with the attitude that an increase was a way to maximize profits, rather than to estimate a fair compensation for loss.[44] The plaintiffs used an expert witness, a certified public accountant, to evaluate Wells Fargo's cost analysis. As the California standard is measured, the borrowers would be liable for "actual damages *resulting*" from their late payments or overlimit activity.[45] In its analysis, the bank included indirect costs, but in some instances failed to define a causal connection between the cost and default,[46] and failed to justify its valuation of those costs.[47] For example, the bank factored into its estimate of indirect costs the expense of such items as telephone preapproval for charges, account maintenance, customer service, canceling stolen cards, and responding to Fair Credit Billing Act[48] inquiries. The plaintiffs' expert asserted, and the court agreed, that not only did some of these costs have no link to any given late payment or overlimit charge, they had nothing to do with any late or overlimit activity.[49]

40. Beasley v. Wells Fargo Bank, N.A., 1 Cal. Rptr. 2d 446, 457-58 (Ct. App. 1991).

41. *Id.*

42. CAL. CIV. CODE § 1671(d) (West 1985); *see* Garrett v. Coast & So. Fed. Sav. & Loan Ass'n, 511 P.2d 1197, 1202 (Cal. 1973).

43. Whether the case appropriately was tried before a jury was one of the issues on appeal. The appellate court determined that the validity of the late charge should not have been a jury question, although once the validity issue was decided, the issue of damages was a jury question. The appellate court decided, however, that the error was not reversible as there was no showing of prejudice. *Beasley*, 1 Cal. Rptr. 2d at 447-48.

44. The task force's records described fees as a "good source of revenue," and pursued a strategy of "maximizing fee income." The fees were raised to an amount greater than a cost study recommended. The minimum late fee was raised to three dollars (compared to the recommendation of the greater of two dollars or 10% of the minimum payment due); and the overlimit fee was increased to ten dollars (compared to the five dollar recommendation). *Id.* at 448.

45. *Id.* at 457 (quoting *Garrett*, 511 P.2d at 1204) (emphasis added).

46. *Id.* ("overhead . . . attributable to the bank's maintenance of an 'in place' infrastructure for dealing with late and overlimit activity generally"). As the court noted, those costs exist even if there are no breaches. *Id.*

47. *Id.* at 457-58.

48. 15 U.S.C. § 1666 (1988); *see also* 12 C.F.R. § 226.13 (1992).

49. *Beasley*, 1 Cal. Rptr. 2d at 457.

The practice of imposing percentage-based collection fees also failed to pass muster as actual damages arising from an individual default.[50] The fees in *Beasley* were set to compensate for uncollected debts as well as collected debts. Consequently, even though Wells Fargo actually paid the collection agency fees, there was no evidence to relate the percentage fee to the actual expense of collecting an account.[51]

Beasley also produced significant developments regarding lawyers' fees and costs. In a companion decision,[52] the court, for the first time, interpreted California's private attorney general statute[53] to permit a court to authorize a separate fee award, payable apart from the damage award.[54] In this case, the court noted that the lopsided balance between the cardholder's counsel (a three-person firm), and Wells Fargo, with far greater resources, diminished the plaintiff's likelihood of success and therefore affected the fee award.[55] Moreover, it recognized that consumer protection cases are "vital to the public interest," and therefore justified a private attorney general award.[56] Finally, the court interpreted the statute to allow reimbursement for expert witness fees, thus distinguishing it from the Supreme Court's contrary interpretation of 42 U.S.C. § 1988.[57]

MORE ON LATE CHARGES: IF YOU CANNOT DO IT RIGHT, YOU CANNOT DO IT AT ALL

In *Swindell v. Federal National Mortgage Ass'n*,[58] a five percent contractual late charge was deemed excessive under a state imposed four percent limitation.[59] Because the statute was silent as to the consequence, however, determining the remedy for the violation was more difficult. The Court of Appeals and the North Carolina Supreme Court both believed that the appropriate remedy for violating the limitation was forfeiture of the right to collect the late charges.[60] The two courts approached the issue differently, however, and the divergent views present an interesting glimpse into judicial reasoning.

The borrowers had argued simply that late charges in excess of the legally authorized rate constitute "interest" and that the general usury penalty

50. *Id.* at 458-59.

51. *Id.* at 459.

52. Beasley v. Wells Fargo Bank, N.A., 1 Cal. Rptr. 2d 459 (Ct. App. 1991), *review denied*, 1992 Cal. LEXIS 1220 (Cal. Sup. Ct. Mar. 12, 1992).

53. CAL. CIV. PROC. CODE § 1021.5 (West 1980).

54. *Beasley*, 1 Cal. Rptr. 2d at 462.

55. *Id.* at 464.

56. *Id.* at 465.

57. *Id.* at 468; *see* West Virginia Univ. Hosp. v. Casey, 111 S. Ct. 1138 (1991) (interpreting 42 U.S.C. § 1988 (1988) to preclude expert witness fees).

58. 387 S.E.2d 220 (N.C. Ct. App. 1990), *modified*, 409 S.E.2d 892 (N.C. 1991).

59. *See* N.C. GEN. STAT. § 24-10.1 (1991).

60. *Swindell*, 387 S.E. 2d at 222, *modified*, 409 S.E.2d at 896.

therefore applied. In North Carolina, the usury penalty is a forfeiture of all interest.[61] Neither court viewed that as an acceptable result. The Court of Appeals viewed the usury penalty as inapplicable because the late charges were not "interest."[62] Noting, however, that "[p]ublic policy demands that there be something to discourage wrongful or erroneous assessment of late charges," it created a remedy analogous to the interest forfeiture penalty of the general usury statute—forfeiture of the late charge.[63]

On appeal, the North Carolina Supreme Court would not countenance such judicial activism: "The entire subject of the rate of interest and penalties for usury rests in legislative direction, and the courts have no power other than to interpret and execute the legislative will."[64] It found, however, a statutory remedy in the general usury statute.[65] Each loan, the court reasoned, "contemplate[s] interest for two separable monetary transactions"—the primary for the money borrowed, and the secondary for money delayed (i.e., late payments).[66] Because late charges are the interest on the secondary transaction, the general usury penalty of forfeiture of interest as it applies to this secondary debt requires forfeiture of the late charges applicable to the late payments.[67]

The two decisions present more than a novel glimpse into judicial thinking; they signal a willingness to find a remedy for a wrong. Although the note, a multistate Federal National Mortgage Association Uniform Instrument, had a savings clause,[68] neither decision gave the clause effect.[69] The North Carolina Court of Appeals simply noted that it is important that

61. N.C. Gen. Stat. § 24-2 (1991).

62. *Swindell*, 387 S.E.2d at 221. Traditionally, that is the most common view. *See generally* National Consumer Law Center, *supra* note 12, § 5.2.4. Where usury statutes apply to the "detention" of money, as well as to loans or forbearance, however, late charges or default charges may well be within their scope. *Cf.* Scarr v. Boyer, 818 P.2d 381, 382-83 (Mont. 1991); Hardwick v. Austin Gallery of Oriental Rugs, Inc., 779 S.W.2d 438, 443 (Tex. Ct. App. 1989). It may well be that the federal preemption cases that interpret late charges as being encompassed by federal statutes preempting state interest rates will now start eroding that doctrine. To that extent, cases such as Greenwood Trust Co. v. Massachusetts, 971 F.2d 818 (1st Cir. 1992), *cert. denied*, 61 U.S.L.W. 3478 (Jan. 11, 1993), may be a double-edged sword for both borrowers and lenders.

63. *Swindell*, 387 S.E.2d at 222.

64. *Swindell*, 409 S.E.2d at 894 (quoting Smith v. Old Dominion Bldg. & Loan Ass'n, 26 S.E. 41, 42 (N.C. 1896)).

65. *Id.* at 894-95.

66. *Id.* at 895.

67. *Id.* at 896.

68. The savings clause provided that if the contractual charges exceeded applicable law, the charge would be reduced to the proper limit and any amounts already collected would be refunded. *Id.* at 893. The creditor in fact did reduce the charge it assessed upon learning of the four percent limit, and in fact never actually collected any late charges from the borrowers. *Id.*

69. *Swindell*, 387 S.E.2d at 221-22, *modified*, 409 S.E.2d at 896.

lenders be encouraged to determine applicable law.[70] The North Carolina Supreme Court was stronger in its view that a savings clause cannot shield a lender from the consequences of usurious charges:

> The usury statutes codify "the idea of protecting the borrower against the oppression of the lender." The statute relieves the borrower of the necessity for expertise and vigilance regarding the legality of rates he must pay. That onus is placed instead on the lender, whose business it is to lend money for profit and who is thus in a better position than the borrower to know the law. . . . A lender cannot charge usurious rates with impunity by making that rate conditional upon its legality and relying upon the illegal rate's automatic rescission when discovered and challenged by the borrower.[71]

VIRGINIA SUPREME COURT RAPS THE WRAP-AROUND LOAN

In one of the few cases to address the fundamental concept of a wrap-around loan,[72] the Virginia Supreme Court found the loan usurious. In *Skinner v. Cen-Pen Corp.*,[73] the creditor advanced less than $4,300, but wrote a wrap-around note and mortgage for $50,000 at a rate of 13.25% per annum. For twelve months, the borrowers were to pay $589.24 a month to Cen-Pen, which would forward a $472.31 payment to the senior lienholder.[74]

The court viewed the transaction essentially as a $4,298.18 loan that was repayable in 122 monthly installments of $116.93, and which yielded an interest rate of 31.22% per annum.[75] In the court's view, the fact that the wrap-around lender took the "clerical responsibility" for forwarding the payments to the senior lienholder[76] did not justify treating a $4,300

70. *Id.*

71. *Swindell*, 409 S.E.2d at 896 (citation omitted).

72. A wrap-around note is one in which the principal consists of new advances made by a junior creditor plus the outstanding balance on an existing senior loan. The note does not pay off the senior loan, but the junior creditor is obligated to pay the installments on the prior loan. The interest on the second note is calculated on that full balance, though the junior creditor lent only a portion of the balance. NATIONAL CONSUMER LAW CENTER, *supra note* 12, § 5.4.3

73. 414 S.E.2d 824 (Va. 1992).

74. In the court's view, this was, in effect, a thinly-veiled second mortgage. *Id.* at 825-26.

75. *Id.* at 826.

76. For this service, Cen-Pen also charged the borrower three dollars per month.

advance as a $50,000 loan.[77] In Virginia, at the time the loan was made the maximum rate permitted by statute on a loan secured by a subordinate mortgage was simply the rate "stated therein."[78] Because the note did not state a 31.22% per annum rate, the loan was usurious.[79]

77. *Skinner*, 414 S.E.2d at 826.

78. VA. CODE ANN. § 6.1-330.16(F) (Michie 1983) (repealed). The maximum rate of interest that may be imposed by unregulated lenders on subordinate mortgage loans is still deregulated, provided that interest is imposed on the unpaid balance. *See* VA. CODE ANN. § 6.1-330.71(D) (Michie Supp. 1992).

79. *Skinner*, 414 S.E.2d at 826.