California Usury Law: A Search for Clarity around Compound Interest

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California usury law is addressed in multiple places: the California Constitution, statutes, case law, and initiative measures. Due to the patchwork nature of this body of law, differing interpretations and ambiguity are commonplace. In one recent case currently on appeal, the Ninth Circuit has asked the California Supreme Court to clarify California law in order to resolve a split in the federal district courts around the obligation of lenders that are otherwise exempt from California usury limitations to disclose compound interest terms as part of a lending transaction. The determinations of the California Supreme Court are likely to impact existing and future commercial loans governed by California law.

Exemptions from California Usury Limitations

The general rule is that professional lenders are exempt from limitations on usury under California law. An initiative measure enacted in 1918 (the “Initiative”), eventually included in California Civil Code Section 1916-1 through 1916-5, limits the amount of interest lenders may charge and Section 1916-2 provides that lenders may not charge compound interest “unless an agreement to that effect is clearly expressed in writing and signed by the party to be charged therewith.” This requirement is hereinafter referred to as the “Disclosure Requirement.”

Article XV, Section 1 of the California Constitution (“Article XV”) exempts certain lenders from some aspects of the Initiative. Since the enactment of Article XV, there have been a number of cases addressing the extent to which the Initiative applies to exempt lenders; the general position of the California Supreme Court has been that the portions of the Initiative that are not repugnant or actually inconsistent with Article XV remain in effect and apply to exempt lenders. Unsurprisingly, the question of when and to what extent the Initiative is repugnant or actually inconsistent with Article XV can foster uncertainty.

Conflict over the Disclosure Requirement

A 2016 decision, Wishnev v. Northwestern Mutual Life Ins. Co., 162 F.Supp.3d 930 (2016), ruled that, despite an incorporated, admitted insurer being a lender exempt from the Initiative, such exemption did not extend to the Disclosure Requirement. The decision conflicted with three prior decisions in federal district courts within the Ninth Circuit; accordingly, it is not clear at this time whether Article XV exempts certain lenders from the Disclosure Requirement. On January 18, 2018, as part of the appeal process, the Ninth Circuit asked the California Supreme Court to determine whether exempted lenders under Article XV are nevertheless subject to the Disclosure Requirement. The California Supreme Court granted the request on March 14, 2018 and the opening brief is currently due on or before June 12, 2018.
Before the Ninth Circuit, Northwestern Mutual Life Insurance Company ("Northwestern") put forth two primary propositions. First, Northwestern argued that Article XV supersedes the Disclosure Requirement because the state legislature's plenary authority over the regulation of exempt lenders means that exempt lenders are subject to no restrictions on interest rates (including, without limitation, any of the Initiative’s requirements) unless the state legislature exercises its exclusive powers under Article XV to require any restrictions. Second, Northwestern argued that even if exempt lenders are subject to some provisions in the Initiative, they are not subject to the Disclosure Requirement because such requirement is in direct conflict with Article XV. Conversely, Wishnev asserted that because Article XV does not directly address the Disclosure Requirement, it is not irreconcilable to the operation of Article XV. Wishnev also contended that, even if the state legislature has exclusive authority to regulate compound interest, such power does not include authority over the Disclosure Requirement because it is procedural rather than substantive in nature.

Satisfaction of the Disclosure Requirement

If the California Supreme Court determines that exempt lenders are subject to the Disclosure Requirement, another unsettled question materializes: What procedures constitute satisfaction of the Disclosure Requirement? As noted above, California Civil Code Section 1916-2 provides that lenders may not charge compound interest “unless an agreement to that effect is clearly expressed in writing and signed by the party to be charged therewith.” The California Supreme Court has addressed the question of satisfaction on two prior occasions. In McConnell v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 21 Cal. 3d 365 (1978), the court held that an agreement between a borrower and a lender stating “that interest would be charged in the usual custom” by the lender’s broker did not satisfy the Disclosure Requirement that the parties clearly express in writing the agreement to compound interest. In a later case involving the same broker, McConnell v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 33 Cal. 3d 816 (1983), the court held that even though the broker provided monthly statements to the borrower that compound interest was being charged, those statements did not satisfy the obligation of the borrower to agree in writing to pay compound interest.

Specific to the Wishnev case, the Ninth Circuit also asked the California Supreme Court to determine whether a signed application for insurance, together with an unsigned insurance policy that is subsequently attached to the application and includes compound interest terms, constitutes an “agreement” that satisfies the Disclosure Requirement. There is a split in the federal district courts as to whether the application, together with such insurance policy, constitutes an agreement for purposes of the Disclosure Requirement, or whether a signature is required on the document that actually contains the compound interest terms. It will be interesting to see whether the California Supreme Court, in answering this specific question, reinforces the McConnell cases described above in requiring execution of the document that provides for compound interest, or opens the door for the Disclosure Requirement to be satisfied through documents, signed and unsigned, that could collectively be construed to constitute one agreement.

Northwestern contends that the signed application, together with the unsigned insurance policy, should be construed as the entire contract between the parties in accordance with Section 10113 of the California Insurance Code. Wishnev, by contrast, argues that the Disclosure Requirement is to ensure that a borrower knows of a lender’s intent to charge compound interest before entering into an agreement with a lender, and this knowledge can be evidenced only by signing the document that actually contains the compound interest terms. Wishnev’s argument dovetails with a history of consumer concerns around compound interest terms that are not explicitly disclosed in an application, together with contentions that while the California Insurance Code was amended subsequent to the Initiative to exempt most incorporated, admitted insurers from California usury limitations, the amendments neither overrode the Disclosure Requirement altogether nor addressed it in a clear manner.

Conclusion

Regardless of how the California Supreme Court ultimately answers these questions, from a lender’s perspective, the conservative approach should be to have the borrower sign to acknowledge its agreement to any loan document governed by California law outlining compound interest terms to ensure satisfaction with the plain language of the Disclosure Requirement. From a borrower’s perspective, prudent due diligence should be undertaken at the outset to understand all terms and conditions of a given lending transaction, including, without limitation, any compound interest provisions. Additionally, if a borrower’s counsel is required to deliver an opinion to an exempt lender that the interest under a given loan will not violate California usury law, unless and until these questions are resolved, such usury opinion should at minimum note the split in the courts as to whether the lender exemption extends to the provisions of California Civil Code Section 1916-2.
Please look out for updates to the Mintz Levin Commercial Real Estate Blog for further discussion of this topic once the California Supreme Court answers the Ninth Circuit’s request, together with how the answers may affect existing and future commercial loans governed by California law from both a borrower and a lender perspective.

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