Monetary Control Law

I. INTEREST RATES AND THE LAW: A HISTORY OF USURY

A. Introduction

Few practices have been so universally abhorred as usury. Through the ages it has been condemned by prophets, priests, philosophers, and poets of all nations. It has often been regarded as one of the vilest of crimes. The Hebrew prophet Ezekiel included usury with rape, murder, robbery, and idolatry in a list of "abominable things" that would receive the punishment of God.[1] Seneca considered it comparable to slow murder.[2] In the Middle Ages, Christian scholars debated whether usury should be considered extortion, a form of robbery, or a sin against charity and the Holy Spirit.[3] None doubted that it was an affront to God.[4]

Even when legal, money lending has generally been thought a disgraceful occupation. The Roman senator Cato reported that it was less disreputable to have your father considered a thief than a usurer.[5] Dante, reflecting similar attitudes, consigned usurers to the lowest ledge in the seventh circle of hell, deeper even than the murderers though still above the blasphemers.[6] A considerable part of the medieval detestation of Jews proba-

1. *Ezekiel* 18:10-13 (Revised Standard Version).
2. T. DIVINE, INTEREST 21 (1959).
3. *Id.* at 27-30; B. NELSON, THE IDEA OF USURY 9-10 (2d ed. 1969).
4. Fortunately, the usurer is easy to recognize:

> The usurer . . . is known by his very looks often, by his speeches commonly, by his actions, ever; he hath a leane cheeke, a meagre body, as if he were fed by the devill's allowance, his eyes are almost sunke to the backside of his head with admiration of money, his eares are set to tell the clocke, his whole carcass is a meere anatomy.

Comment, *Usury in the Conflict of Laws, The Doctrine of Lex Debitoris,* 55 CALIF. L. REV. 123, 127 n.19 (1967) (quoting John Blaxton as *quoted in* B. MURRAY, HISTORY OF USURY 23 n.1 (1866)).

5. T. DIVINE, *supra* note 2, at 21 (citing CATO, ON AGRICULTURE). Nonetheless, Plutarch says that Cato invested in loans, probably secretly. *Id.*
6. DANTE, THE INFERNO 149-54 (J. Ciardi trans. 1954).

bly stemmed from their activities as moneylenders.[7] Folk attitudes toward usurers and Jews are embodied in the character of Shylock, in Shakespeare's *The Merchant of Venice*.[8] Avaricious and vindictive, the lender mercilessly demands his pledge—a pound of flesh—when the debtor cannot repay the loan. Shylock's greed is so overmastering that he cannot decide which loss is worse: his daughter who ran off to marry a Christian or his ducats.[9] Shylock made such an impression on the popular imagination that his name has become a synonym for an extortionate creditor.[10] The inexorable creditor has remained a staple villain well into this century, oppressing heroines and outraging audiences in serial melodramas like "The Perils of Pauline" and popular westerns in the early days of the cinema.

This flood of invective has stimulated little rational legal analysis, but a great deal of legislative hysteria. Usury laws were often harsh. In eleventh century England, the taking of a single penny of interest could be punished by confiscation of all of the violator's lands and chattels.[11] Medieval canon law reserved for usurers its most terrible threat: excommunication.[12] Even under the moderate Romans, the penalty for usury was twice that of robbery.[13]

Despite such formidable opposition, usury has proven impossible to eradicate. After 4000 years of moralizing, philosphizing, and legislating, many of the same problems that troubled Hammurabi's Babylon continue to plague America today.

In the United States, the tradition of statutory limitation of interest rates dates back to Colonial times. Forty-six states still retain rate ceilings.[14] American usury laws were modeled on the Statute of Anne (1713),[15] itself derived from still earlier legislation and debate. Thus, American usury law represents a venerable body of legal, ethical, religious, and (sometimes) economic thought, reaching back through the

7. B. TIERNEY & S. PAINTER, WESTERN EUROPE IN THE MIDDLE AGES: 300-1475, at 231, 261 (3d ed. 1978).

8. THE RIVERSIDE SHAKESPEARE 250 (G. Evans ed. 1974) (introduction to THE MERCHANT OF VENICE).

9. W. SHAKESPEARE, THE MERCHANT OF VENICE, *reprinted in* THE RIVERSIDE SHAKESPEARE, *supra* note 8, at 266, 275.

10. WEBSTER'S SEVENTH NEW COLLEGIATE DICTIONARY 806 (1967).

11. Horack, *A Survey of General Usury Laws*, 8 LAW & CONTEMP. PROB. 36, 36-37 (1941).

12. S. HOMER, A HISTORY OF INTEREST RATES 70 (2d ed. 1977).

13. The penalty for theft was a fine of double the amount taken, for usury, quadruple. T. DIVINE, *supra* note 2, at 21.

14. Arizona, Maine, Massachusetts, and New Hampshire did not. [1980] 1 CONS. CRED. GUIDE (CCH) ¶ 510. Arizona repealed its law in 1980. *See* section II(F) *infra*.

15. Act to Reduce Rate of Interest, 12 Anne, c. 16 (1713); Horack, *supra* note 11, at 37.

Middle Ages to the foundations of western civilization.

Recently, interest rates have repeatedly risen above these usury ceilings,[16] inciting renewed debate on this ancient topic. Many proposals have been made to reform or abolish usury law.[17] The social goals, economic consequences, criticisms, and proposals for change cannot be fully understood without some acquaintance with their context: the legal and economic developments that produced them.

B. *The Ancient World*

1. Pastoral Societies

Lending at interest pre-dates writing and the coining of money by thousands of years. The earliest recorded loans date from about 3000 B.C., but the practice appears to have been ancient by then.[18] Interest probably originated during the beginnings of agriculture, about 8000 B.C.[19] Farming provided people with early forms of lendable capital: livestock, grain, and tools. Loans of seed-grain or breeding stock, in particular, produce their own increase and may have suggested the idea of interest. The fact that today such loans exist and bear interest in many primitive societies suggests that the practice is ancient indeed.[20]

The earliest loans were probably extended to people in immediate difficulty—what we would call personal or consumer loans.[21] The money was used to provide for urgent needs: food, clothing, and shelter. Since the loan funds are consumed, both principal and interest must be repaid out of the borrower's surplus earning capacity. When the borrower's livelihood was marginal, repayment was often a problem.[22] Another problem was the borrower's lack of bargaining power. A man whose family goes hungry will accede to almost any terms. Human nature being what it is, trouble must have developed quickly. The rich extracted hard bargains and grew richer; the poor fell into perpetual debt and forfeited their meager possessions.[23]

The social detriment was quickly apparent; early customary or religious

16. Note, *Usury Legislation—Its Effects on the Economy and a Proposal for Reform*, 33 VAND. L. REV. 199 (1980).

17. *See* notes 349-57 *infra* and accompanying text.

18. S. HOMER, *supra* note 12, at 17.

19. T. AFRICA, THE ANCIENT WORLD 3 (1969); S. HOMER, *supra* note 12, at 18.

20. S. HOMER, *supra* note 12, at 22-24.

21. A. MARSHALL, PRINCIPLES OF ECONOMICS 584 (8th ed. 1970).

22. *Id.*

23. *Id.*

rules sought to remedy the situation.[24] The feeling that loans to the needy should be charitable and interest-free is almost universal. In early Greece, such moral exhortations seem to have been the only restraint on interest.[25]

The ancient Hebrew tribes developed a unique attitude toward interest. As nomadic herdsmen, the ideal of tribal brotherhood demanded that loans to the unfortunate be charitable.[26] Upon entering Palestine, however, the Israelites found themselves surrounded by the already advanced and occasionally hostile civilization of the Philistines.[27] The area was a crossroad for trade, and interest had long been an established practice.[28] In this unusual situation, the Israelites adopted a dual usury standard, with one law for Hebrews and another for potentially dangerous foreigners.[29]

Interest was entirely forbidden on loans to others within the community. Exodus 22:25 states: "If thou lend money to any of my people that is poor that dwelleth with thee: thou shalt not be hard upon them as an extortioner, nor oppress them with usuries."[30] Leviticus 25:35-37 repeats the prohibition: "If thy brother be impoverished, and weak of hand, and thou receive him as a stranger and sojourner, and he live with thee, take not usury of him nor more than thou gavest: fear thy God, that thy brother may live with thee."[31] Clearly, these commands contemplate "consumer" loans to meet immediate wants. To exact interest from the needy is extortion. Among tribal "brothers" mercy and charity are the ideal.[32]

Foreigners did not receive this protection. Deuteronomy 23:20-21 provides: "To a foreigner you may lend upon interest, but to your brother you shall not . . . . "[33] In charging interest to foreigners, the Hebrews were only following local custom. The special solicitude for tribal brothers did not extend to foreign idolators. Indeed, interest may have been seen as a political weapon, a kind of fiscal guerilla warfare hopefully weakening the foe in preparation for inevitable conflict.[34] As long as charity prevailed among Hebrews, the law was satisfied.

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24. *Id.*

25. Goldschmidt, *Origin of Commercial Institutions*, in 2 EVOLUTION OF LAW 413 (A. Kocourek & J. Wigmore ed. 1915).

26. T. DIVINE, *supra* note 2, at 7.

27. T. AFRICA, *supra* note 19, at 63.

28. *Id.* at 58.

29. *See* notes 30-34 *infra* and accompanying text.

30. *Exodus* 22:25 (King James Version).

31. *Leviticus* 25:35-37 (King James Version).

32. T. DIVINE, *supra* note 2, at 7.

33. *Deuteronomy* 23:20-21 (Revised Standard Version).

34. B. NELSON, *supra* note 3, at 4.

The attempt to proscribe interest within the community seems to have met with little success, however. The demand for loans cannot be legislated away; yet lenders are understandably reluctant to risk their capital in interest-free loans when profits can be obtained elsewhere. Doubtless, there were always some high-minded people who lent to the needy out of a spirit of brotherhood. Generally, though, self-interest is highly corrosive of moral principle. Needy borrowers found that they must either pay interest or do without the loan. The number of times usurers are denounced in the Old Testament[35] suggests that the taking of interest from brothers must have been common indeed. Thus, by 500 B.C., the lands—and even the children—of the poor were being forfeited to creditors.[36] The law was apparently powerless to remedy the situation. The prophet Nehemiah gathered the people and charged them with "exacting interest, each from his brother."[37] In the face of his moral wrath, pledges were restored and interest cancelled.[38] It cannot have lasted long.

2. Early Commercial Societies

As trade develops in any given society, merchants begin to seek loans to finance their ventures. These new borrowers differ substantially from consumers. For the commercial borrower, repayment is not so arduous a task. He does not consume the loan, but invests it to produce gain. Since the principal retains value in the form of merchandise or capital goods, the debtor need earn only enough to pay the interest. From expected profits, he has a natural source for repayment. In addition, the commercial borrower occupies a better bargaining position than the consumer. His needs are not so desperate; if the rate is too high, he can choose not to borrow. For these reasons, the commercial borrower does not seem to need the same kind of protection as the consumer.

The benefits of trade are quickly apparent: it provides revenue for the state and profitable investments for the influential classes. These advantages create a strong incentive for permitting the interest charges that stimulate commercial activity. Attitudes in commercially active societies reflect these factors.

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35. *E.g., Ezekiel* 18:13, 17; *Jeremiah* 15:10; *Psalms* 72:13, 109:11, 112:5; *Proverbs* 28:8; *Job* 22:6-9.

36. *See* T. DIVINE, *supra* note 2, at 8; T. AFRICA, *supra* note 19, at 70.

37. *Nehemiah* 5:7 (Revised Standard Version).

38. *Id.* 5:12.

a. *The Fertile Crescent*

The first written laws come from the Sumerians, a culture already advanced commercially. On the banks of the Tigris and Euphrates rivers, the Sumerians built the world's first urban civilization in the fourth millenium B.C.[39] Living in large cities such as Ur, they pioneered irrigated farming, architecture, and commerce.[40] The river plains of Mesopotamia provided rich farmland, but metal and timber had to be imported from other areas. Sumerian merchants traded as far away as Egypt and India, carrying textile products to exchange for their needs.[41] About 3000 B.C., Sumerian priests invented cuneiform writing—perhaps in order to keep track of temple accounts and commercial transactions.[42] Of surviving Sumerian writings, 90% are commercial accounts and contracts that contain some of the earliest recordings of loans repayable with interest.[43]

In about 2350 B.C., Urukagina, a king of the Sumerian city of Lagash, had his scribes record for posterity his exploits and legal reforms (he freed persons imprisoned for debt), thus producing the earliest legal code.[44] Other rulers adopted the practice, recording changes in a body of unwritten, customary law administered by Sumerian judges.[45] Only small portions of these codes survive, but all of them show a strong concern with commercial matters.[46]

In about 1750 B.C., the Babylonian king Hammurabi compiled, systematized, and expanded upon the earlier systems, creating his famous legal code.[47] Like the Sumerian codes, Hammurabi's was probably a set of changes and additions to an unwritten "common law," rather than an attempt to set forth all of the laws of the land.[48] The Code is relatively well preserved; of approximately 280 laws, 247 remain legible.[49] Hammurabi's Code contains the earliest surviving usury law:

> [§ L] If a merchant has given corn on loan, he may take 100 sila of

39. S. KRAMER, THE SUMERIANS 33 (1963).
40. *Id.* at 73-74, 104.
41. T. AFRICA, *supra* note 19, at 6.
42. *Id.*
43. S. KRAMER, *supra* note 39, at 165.
44. *Id.* at 79-82.
45. T. AFRICA, *supra* note 19, at 6-7; S. HOMER, *supra* note 12, at 25-31. Records of single judgments date back to 2408 B.C. G. DRIVER & J. MILES, THE BABYLONIAN LAWS 23 (1952).
46. About 2250 B.C., Bilalamo, King of Esnunna, promulgated the earliest surviving written laws. G. DRIVER & J. MILES, *supra* note 45, at 23. In about 1850 B.C., King Lipit-Ishtar of Isin created another code. Thirty-seven laws, many similar to Hammurabi's Code, remain legible. S. KRAMER, *supra* note 39, at 83-87.
47. S. KRAMER, *supra* note 39, at 87; T. AFRICA, *supra* note 19, at 10.
48. G. DRIVER & J. MILES, *supra* note 45, at 11.
49. J. MACQUEEN, BABYLON 60 (1965).

> corn as interest on 1 gur; if he has given silver on loan he may take 1/6 shekel 6 grains as interest on 1 shekel of silver.
>
> [§ M] If a man who has raised a loan has no silver to repay it but has corn, [the merchant] may then take corn for his interest (at a rate) in accordance with the ordinances of the king; but, if the merchant has increased his interest above [100 sila of corn] on 1 gur [or] over 1/6 shekel 6 grains [on 1 shekel of silver] and has taken (it), he forfeits whatever he has given (on loan).[50]

These measures amount to 20% on loans of silver and 33% on loans of grain.[51] The rates were apparently customary in the area, dating back for centuries.[52]

Since the Code required contracts to be written, much evidence of Babylonian lending practice remains today. Competition was apparently keen, for many loans were transacted at well below the legal rate.[53] As trade became more widespread, the rates set by Hammurabi were adopted generally throughout the Middle East. These basic rates remained fairly constant for about 1200 years.[54]. After the Persian conquest of 539 B.C., Babylon declined as a commercial center.[55] Normal rates rose towards 40%, and the old legal or traditional limits were ignored.[56]

Less is known about other ancient commercial societies. In India, the laws of Manu (circa 1000 B.C.) set 25% as a standard rate, though it is unknown whether this was treated as a maximum rate.[57] Money lending was apparently regarded as ignoble, for the upper castes were discouraged from charging interest except to "wicked persons."[58] The Phoenicians, the greatest merchants of the ancient Mediterranean, apparently set no limit on interest rates, although little more is known of their laws and customs.[59]

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50. G. DRIVER & J. MILES, *supra* note 45, at 39. The Code also deals with other lending abuses such as wrongful retention of security or use of force in collection. One section excuses the debtor from payment for a year in case of drought. M. JASTROW, CIVILIZATION OF BABYLONIA AND ASSYRIA 285-87 (1915).

51. S. HOMER, *supra* note 12, at 30.

52. *Id.*

53. *See* S. HOMER, *supra* note 12, at 30.

54. *Id.* at 27.

55. *Id.* at 31.

56. *Id.*

57. *Id.*

58. Frierson, *Changing Concepts of Usury: Ancient Times Through the Time of John Calvin*, 7 AM. BUS. L.J. 115, 116 (1969).

59. Goldschmidt, *supra* note 25, at 413.

b. The Greeks

The Greeks apparently never prohibited interest entirely.[60] In the earliest times, custom and kinship ties served to moderate the interest charge. Later, the customary rates were established as maximum legal limits, usually between 16% and 18%.[61] During the seventh and eighth centuries B.C., the Greek economy underwent great changes.[62] Spurred by the recent invention of coined money and improved navigation, the importance of trade grew rapidly.[63] The economic changes caused great distress to the existing subsistence farming economy. Fluctuating prices, inflation, and competition from slave labor made small farming only a marginal living.[64] One bad crop could push the citizen farmer into debt from which he might never recover.[65]

By 594 B.C., a large portion of the Athenian population was deeply in debt.[66] Many citizens lost their land and were sold into slavery to pay their creditors.[67] The city was threatened with revolt. In this crisis, the poet-orator Solon was called upon to restore the situation and given extraordinary powers. Solon cancelled existing land debt, prohibited the practice of debt slavery, used state funds to redeem Athenians already enslaved, and abolished the legal limits on interest rates.[68]

For several centuries, interest rates in Athens were set solely by the market. Trade prospered. Whether attributable to the free interest or to other factors, Athens rapidly outstripped the other commercial cities of Greece.[69] After the fifth century B.C., Greece's commercial history is largely a history of Athens.[70] Even without regulation, competition caused Athenian interest rates to decline from the 16% to 18% range of 594 B.C., down to 6% to 10% during the first and second centuries B.C.[71] Although benefiting commerce, the uncontrolled interest rates were a hardship on consumer debtors. Professional lenders made small, personal loans, generally at 36%.[72] Some lenders, however, were able to exact very high rates from borrowers. One record survives of a charge of 25% per day (over

60. T. DIVINE, *supra* note 2, at 11.
61. S. HOMER, *supra note* 12, at 40.
62. *Id.* at 34.
63. *Id.*
64. *Id.*
65. T. AFRICA, *supra* note 19, at 99.
66. *Id.* at 110.
67. *Id.*
68. *Id.*; S. HOMER, *supra* note 12, at 34.
69. S. HOMER, *supra* note 12, at 35.
70. *Id.*
71. *Id.* at 40.
72. *Id.* at 42.

9000% per year).[73]

Greek philosophers also considered the question of usury—though more from a moral than economic perspective. Plato felt that the role of the State was to instill virtue into its citizens; he thought wealth interfered with the attainment of such goodness.[74] To encourage virtue, none should possess more than they need; none less. Plato condemned userers for not only ignoring the poor, but for "planting their own stings into any fresh victim who offers them an opening to inject the poison of their money; and while they multiply their capital by usury, they are also multiplying . . . the paupers."[75] Thus, according to Plato, lending at interest increases the gap between the rich and the poor, breeds disharmony and turmoil in the citizenry, and should therefore be prohibited by law.[76]

Aristotle agreed with his teacher's appraisal of the bad moral effects of usury.[77] In addition, he believed that interest was inherently unnatural and unjust.[78] This conclusion was based upon Aristotle's analysis of economics. Aristotle stated that the goal of economic activity was to satisfy physical requirements such as food and clothing.[79] The production of goods to fill these needs is the commendable, "natural" form of money-making. Farming, stock raising, and manufacturing fall into this category.[80] They produce their own "increase" in a natural and beneficial way. Money functions properly as a medium of exchange to facilitate the transfer of goods.[81] Commerce, hire, and usury, on the other hand, produce nothing that helps satisfy these wants. Of the three:

> The most hated sort, and with the greatest reason, is usury, which makes a gain out of money itself, and not from the natural use of it. For money was intended to be used in exchange, but not to increase at interest. And this term usury (*tokos, i.e.*, offspring, produce) which means the birth of money from money, is applied to the breeding of money because the offspring resembles the parent. Wherefore of all modes of money-making this is the most unnatural.[82]

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73. *Id.*

74. PLATO, THE REPUBLIC 280 (F. Cornford trans. 1945).

75. *Id.* at 281.

76. *Id.* at 280-81. Although disapproving of interest on commercial loans, Plato believed that men should pay their debts. He prescribed penalties for default of 200% annually. T. DIVINE, *supra* note 2, at 14.

77. T. DIVINE, *supra* note 2, at 15.

78. *Id.* at 17.

79. *Id.*

80. *Id.*

81. *Id.* at 18.

82. ARISTOTLE, POLITICS 23-24 (B. Jowett trans. 1964).

Money is "barren." It cannot produce an increase in valuable goods, but only higher stacks of silver. Aristotle singles out the usurer who "lends out small sums at a high rate" for special censure.[83] Not only is he guilty of injustice, but of pettiness as well, sinking to the vilest practices for the sake of small gains.[84]

c. The Romans

The practical Romans refused to let such philosophizing interfere with the conduct of business. They generally steered a middle course, neither forbidding interest entirely nor letting the rate go unrestricted. The earliest written Roman laws, the Twelve Tables of 443 B.C., reduced the previous rate of interest by setting legal limits.[85] The Tables provided for a rate of 8⅓%, and a penalty of fourfold damages for violation.[86]

A nation of citizen-farmers, the Romans became suspicious of clever notions like interest. Several attempts were made to abolish it. In 342 B.C., a new law was passed which forbade the taking of interest by Roman citizens.[87] The law was easily evaded, however, by the use of foreign agents, and was soon repealed.[88]

After the defeat of Hannibal in 202 B.C., Rome rapidly became the dominant power in the Mediterranean.[89] Commerce, especially sea-trade, became an important and lucrative activity. The Roman aristocracy, traditionally founded on land wealth, considered commerce a demeaning source of income. Roman finances were largely left in the hands of Greeks.[90] Profit was still profit, though. Plutarch reports that even the respectable Cato made secret investments in marine trade.[91]

In 88 B.C., the dictator Sulla raised the usury limit to 12%, an official rate that endured for over 500 years.[92] The efficacy of the interest ceiling, however, seems to have been slight. During peaceful periods, competition kept the rates at 4% to 6%, well below the limit,[93] but during troubled times the rate limits were simply ignored.[94] In 44 B.C., Cicero berated

83. T. DIVINE, *supra* note 2, at 16.
84. *Id.*
85. S. HOMER, *supra* note 12, at 45.
86. *Id.*
87. T. DIVINE, *supra* note 2, at 20; S. Homer, *supra* note 12, at 41.
88. T. DIVINE, *supra* note 2, at 20.
89. T. AFRICA, *supra* note 19, at 308.
90. T. ARFICA, *supra* note 19, at 326-27; S. HOMER, *supra* note 12 at 46.
91. T. DIVINE, *supra* note 2, at 21.
92. S. HOMER, *supra* note 12, at 47.
93. *Id.* at 53-54.
94. T. DIVINE, *supra* note 2, at 23; S. Homer, *supra* note 12, at 47-48, 53-54.

Brutus, "the noblest Roman of them all," for charging 48% on loans to the city of Salamis.[95]

The final expression of Roman usury law was the Code of Justinian (533 A.D.) issued from Constantinople after the fall of the Roman Empire in the West.[96] It set a graduated scale of maximum rates ranging from 8% on loans made by banks, to 6% on loans made by ordinary citizens, to 12% on maritime loans.[97] This scheme represented a considerable advance in the economic sophistication of the law, for it recognized the fundamental difference between commercial and consumer loans, at least to the extent of permitting banks to lend at higher rates than ordinary citizens, who would presumably make mainly personal loans.

The Code also made explicit allowance for risk, another element that is ignored by any unified rate ceiling. In any era or commercial setting, a few loans will inevitably prove to be uncollectable. This is a normal expense of the lender's business; it must be considered in computing his overall profit. Part of the charge made on each collectable loan goes merely to compensate for lost principal. If a $100 loan had a 1% chance of loss, then about $1 of the interest charge must be allotted to cover this risk. When $100 is uncollectable by debtor default, the loss is balanced by the risk-charge of the many loans that are repaid. As the risk increases, an increasingly greater portion of the loan-charge must be used merely to restore losses. Thus, any single rate ceiling penalizes risky loans. Since a larger portion of the interest charge merely covers risk of loss, less remains as "pure interest," the lender's rate of return.

If Roman lenders were to be motivated to make more hazardous loans, the rate limit had to be correspondingly higher. As long as the rewards for success remained high, as in sea-trade, then the merchant whose ship came in would be able to profit despite a high interest rate; the lender could receive a fair return and also be covered for his risk of loss. Although not taking account of risk in all situations, or of all elements of risk, the law of Justinian did at least permit "hazard" rates in one important type of lending. The multi-tiered system proved quite durable, lasting over 1000 years until the end of the Byzantine Empire (1543).[98] The various rates were changed occasionally, finally rising to 16⅔% on maritime, 11⅛% on bank, and 8⅓% on ordinary citizen loans during the troubled ninth and tenth centuries.[99]

95. S. HOMER, *supra* note 12, at 47.
96. *Id.* at 55.
97. *Id.*
98. *Id.*
99. *Id.* at 56.

C. *Christianity and the Middle Ages*

The early Christian church vigorously condemned usury. Nevertheless, the New Testament was equivocal on interest. It required charity toward the poor: "Give to him who begs from you, and do not refuse him who would borrow from you,"[100] and "if you lend to those from whom you hope to receive, what credit is that to you? For even sinners lend to sinners, to receive as much again. . . . Lend, expecting nothing in return."[101] Yet, in parable, the "slothful servant" is chastised for permitting his master's money to lie idle, rather than putting it out at interest to produce gain.[102] The Old Testament prohibitions, however, remained solid scriptural foundations for condemning usury.[103]

The early church fathers condemned interest taking as a sin against Christian charity.[104] That these writers were considering loans for personal consumption is obvious from their frequent references to the oppression of the poor. St. Basil is typical:

> The griping usurer sees, unmoved, his necessitous borrower at his feet, condescending to every humiliation, professing everything that is villifying; he feels no compassion for his fellow-creatures; though reduced to this abject state of supplication, he yields not to his humble prayer; he is inexorable to his entreaties; he melts not at his tears . . . .[105]

The exception of Deuteronomy 23, which permitted Jews to lend at interest to foreigners, caused some controversy. Jews took advantage of this exemption to lend to Christians, and Christians to justify lending to Saracens.[106] The orthodox position, expounded by St. Jerome in about 400 A.D., was that since the coming of Christ all men were brothers.[107] The Old Testament exception for foreigners, therefore, no longer applied to anyone. The condemnation of usury became official in 325 A.D., when the Council of Nice forbade interest to clerics.[108] Although discouraged by religious leaders, the use of interest by the laity was permitted in the late Roman Empire.[109]

The collapse of the Roman Empire (usually dated 475 A.D.) destroyed

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100. *Matthew* 5:42 (Revised Standard Version).
101. *Luke* 6:33-35 (Revised Standard Version).
102. *Luke* 19:23, *Matthew* 25:27.
103. *See* notes 30-32 *supra* and accompanying text.
104. T. DIVINE, *supra* note 2, at 27-28.
105. Commonwealth v. Donoghue, 250 Ky. 343, 351, 63 S.W.2d 3, 6 (1933).
106. S. HOMER, *supra* note 12, at 71.
107. B. NELSON, *supra* note 3, at 3.
108. T. DIVINE, *supra* note 2, at 35.
109. *Id.*

the commercial network that had bound the Mediterranean together.[110] During the next several hundred years, Western Europe largely regressed to a local subsistence economy in which capital was scarce and trade almost unknown.[111] Viking raids and petty warfare among nobles made life, even on the most modest scale, a hazardous proposition.[112] Roman institutions were gradually submerged by the tide of barbarian conquerors.[113] For centuries, the church provided the primary unifying force and almost the only source of education and law.[114]

Political turmoil, or simply a bad harvest, could reduce the medieval farmer to desperation. Conditions were right for the most extortionate lending practices. The plight of impoverished debtors caused concern among religious and temporal leaders.[115] Charlemagne outlawed interest throughout his empire in 800.[116] During the next century, various synods and councils extended the prohibition to all Christians under threat of excommunication.[117]

Nevertheless, usury was always present in Medieval Europe.[118] Pawnshops, generally operated by Jews (who were unaffected by excommunication), were tolerated as a necessary evil.[119] These pawnshops provided needed funds to borrowers and a lucrative source of revenue to the state in the form of license fees and special taxes.[120] The rates were high: legal limits varied from 30% to 300%.[121] The traditional hatred of moneylenders was augmented by racial prejudice and superstitions, including the belief that Jews kidnapped Christian babies for sacrifice in diabolic rites.[122] Periodically, hatred turned to violence. Whole towns would rise up against the local pawnbrokers, looting their houses, destroying records

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110. T. AFRICA, *supra* note 19, at 480.
111. B. TIERNEY & S. PAINTER, *supra* note 7, at 480.
112. S. HOMER, *supra* note 12, at 84-85.
113. B. TIERNEY & S. PAINTER, *supra* note 7, at 53-63.
114. S. HOMER, *supra* note 12, at 82-88.
115. Favre described the situation to the Council of Paris in 829:

> The usurers, certain of impunity by reason of the succession of civil wars and of Norman invasions, take advantage of these misfortunes to lay hands on the partrimony of their victims. The rate of interest surpasses anything that one could imagine of infamy and extortion—100, 200 and even 300 per cent. For a bushel of wheat or a measure of wine, the lenders demand three of four in return at the time of harvest.

T. DIVINE, *supra* note 2, at 35 n.43.

116. S. HOMER, *supra* note 12, at 70.
117. *Id.*
118. *Id.* at 71.
119. *Id.* at 72.
120. *Id.*
121. *Id.*
122. B. NELSON, *supra* note 3, at 19.

of debt, and perhaps putting the occupants to death. These pogroms became traditional before the crusades.[123]

The ninth century marked the nadir of the European "dark ages."[124] In the following century, warfare diminished and a general economic recovery began.[125] Venice became a commercial power in the Mediterranean, trading with Constantinople and the Arab world.[126] The crusades accelerated this growth, establishing Christian control of the seas and opening the markets of the East to European merchants. As overland travel grew safer, commerce spread across Europe. Flanders became the commercial center of the North and dominated trade in cloth, wine, and timber.[127] Towns grew and manufacture increased.[128]

The growth of commerce brought new demands for credit. Pawnshops were unable to provide the quantity or type of loan required by merchants.[129] Christian financiers stepped in to meet the demands for commercial credit.[130] Free from the moral opprobrium associated with charging usury of the needy, the use of interest-bearing loans in trade grew rapidly. The Third Lateran Council complained in 1179 that "almost everywhere has the practice of usury become so notorious that many, giving up other forms of business, traffic in usury as through this were a legitimate occupation."[131] The usury question, which had seemed settled for centuries, was open once more.

The grounds of the debate, however, were new. Previous condemnations had focused mainly on oppression of the poor. In commercial lending, however, the borrower was no longer a helpless destitute but another profitmaking merchant. Emphasis shifted from the social consequences of usury, to the intrinsic "immorality" of interest itself.[132]

St. Thomas Aquinas (1225-1274)[133] produced the most influential analysis of the interest question. His condemnation of interest, a reformulation of Aristotle's idea of the "sterility" of money,[134] became the basis for later Catholic doctrine. Aquinas divided goods into two classes: "fungible" and "non-fungible." With non-fungible goods, the use of the loan can

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123. B. TIERNEY & S. PAINTER, *supra* note 7, at 231.
124. *Id.* at 245.
125. *Id.* at 245-46.
126. *Id.*
127. *Id.* at 248.
128. *Id.* at 251.
129. T. DIVINE, *supra* note 2, at 40; S. HOMER, *supra* note 12, at 73.
130. B. TIERNEY & S. PAINTER, *supra* note 7, at 261.
131. T. DIVINE, *supra* note 2, at 36-37.
132. *Id.* at 40-41.
133. 9 ENCYCLOPEDIA BRITANICA 962 (1974).
134. *See* notes 77-84 *supra* and accompanying text.

be separated from the thing itself.[135] Thus, the use of a farm could be lent, the profits taken, and the farm returned undiminished. Since the use was separable from the farm, a charge for this use was justified.[136]

Fungible goods, on the other hand, were products such as wine or grain in which the intended use consumed the product.[137] Thus, unlike the use of a farm, the use of a fungible good was its sole value, its essence. Charging once for the goods themselves (return of the principal), and again for their use only was to charge twice for the same thing—obviously unjust.[138] Aquinas, like Aristotle, viewed money as merely a medium of exchange. Hence, it was a fungible good; its use consumed it.[139] It followed that, by their very nature, loans of money at interest were unjust.[140] A price is just only if there is equivalence of value exchanged: return of the principal in exchange for loan of the principal.

Aquinas's analysis was more subtle than Aristotle's, but rested on essentially similar grounds. In practice, his "independent use" was similar to Aristotle's "natural increase." The influence of Aquinas's thought was widespread. For example, the Fifth Lateran Council in 1515 defined usury as "gain sought from the use of a thing not fruitful in itself (as a flock or a field), without labor, expense or risk on the part of the lender."[141]

The proposition that interest on money loans was inherently immoral created a serious roadblock to further economic expansion. Unlike the Roman usury laws, which were widely ignored when inconvenient,[142] medieval religious sanctions were taken very seriously by merchants.[143] It was a time of faith; sin was feared, and excommunication dreaded. The problem was not how to evade legal restrictions, but how to trade without sinning.

To provide spiritualy acceptable commercial capital, investment schemes were developed which provided for a rate of return without formally relying on a loan or interest charge. There was considerable debate concerning the morality of these avoidance techniques, but at least enough of the clergy approved them to quiet the consciences of the merchants. The "triple contract," a form of partnership, was a common

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135. T. DIVINE, *supra* note 2, at 46.
136. *Id.*
137. *Id.*
138. *Id.*
139. *Id.* at 47.
140. *Id.*
141. *Id.* at 58.
142. *Id.* at 23.
143. S. HOMER, *supra* note 12, at 71-72.

means of avoidance.[144] The lender was designated as the investing partner in a venture. The active partner, in separate contracts, guaranteed full repayment of the investment even if the venture failed and stipulated a fixed share of profits for the investor.[145] Together, the three contracts essentially created a loan at interest, but since profits from actual trade were permissible, the transaction was not considered usurious.[146]

Another very common form of investment was the sale of "annuities," also called "rentes" or "census."[147] The seller received a sum of cash, and in exchange the purchaser received the profits from a designated piece of productive land (usually a farm) for a period of time.[148] Frequently, the annuity was to last for the purchaser's life. Originally, the profits were actually collected in produce. Later, annual payments of money were fixed.[149] The annuity was an important means of support for widows and disabled people.[150] Sellers were frequently governments or landed nobles who needed to raise quick cash.[151]

Merchants could also use "bills of exchange" to produce the effect of interest.[152] The bill of exchange was essentially a personal check used to make purchases in foreign trade.[153] The seller who took the bill was extending credit for the time (usually months) required to send the bill back to its source for redemption.[154] Normally, the transaction involved conversion of one form of currency to another. By setting an artifically high rate of currency exchange, the seller could receive a profit on his extension of credit.[155]

A spinoff from the medieval pawnshop[156] was the "mons pietatis."[157] Subsidized by the state or charitable contributions, the mons pietatis was a pawnshop run for the benefit of the poor.[158] The interest charge was a low 6%.[159] Despite clerical misgivings, Pope Paul II approved the scheme on the theory that the charge was not profit but only enough to cover the

144. *Id.* at 75.
145. *Id.*
146. *Id.* at 74-75.
147. *Id.* at 76.
148. *Id.*
149. *Id.*
150. T. DIVINE, *supra* note 2, at 70.
151. *Id.* at 76.
152. S. HOMER, *supra* note 12, at 77-78.
153. *Id.* at 77.
154. *Id.*
155. *Id.*
156. *See* notes 119-21 *supra* and accompanying text.
157. S. HOMER, *supra* note 12, at 79.
158. *Id.*
159. *Id.*

cost of operation.[160] The institution spread throughout Europe, gradually expanding its sphere of activity to include business loans and even deposit banking.[161]

A Christian lender could obtain profit from overt loans through the Roman Law doctrine of "interesse."[162] Interesse was not a charge for the loan itself but compensation for damages resulting from late repayment. Originally, a showing of actual loss was required (the doctrine of "damnum emergens"), as when livestock was lost because the lender had counted on repayment to buy feed.[163] Soon, however, interesse was extended to cover the loss of a potential profit (lucrum cesssans) that the lender could have made if the loan funds had been repaid on time.[164] The uncertainty of this lost potential was avoided by specifying the amount of interesse in the original contract. Lenders could manipulate these doctrines to provide a fixed rate of return. The loan would be made, as Christian charity required, free of charge. It would be made payable the next day, and a rate of interesse agreed upon in case of late payment. Since neither the borrower nor lender intended repayment in one day, "interesse" had become interest.[165]

Although avoidance techniques were condemned by many, the pressure to keep trade flowing was irresistible in the long run. Gradually, the Papacy upheld enough of the avoidance techniques to permit commercial activity. The sale of annuities was sanctioned in 1425,[166] and the triple contract in 1567.[167]

D. *The Reformation*

When Martin Luther rejected the trappings of the Papal church, Catholic doctrine came up for review as well. At first, Luther was content to retain the traditional attitude toward interest. In early tracts he condemned interest energetically: "The greatest misfortune of the German nation is easily the traffic in interest. . . . The devil invented it and the Pope, by giving his sanction to it, has done untold evil throughout the world."[168] At the same time, he recognized that annuities filled a need by providing revenue for the new church and support for widows and elderly

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160. *Id.*
161. *Id.*
162. T. DIVINE, *supra* note 2, at 53.
163. *Id.* at 53-54.
164. *Id.* at 54.
165. *See* T. DIVINE, *supra* note 2, at 52.
166. S. HOMER, *supra* note 12, at 76.
167. *Id.* at 75.
168. T. DIVINE, *supra* note 2, at 69.

people.[169]

The spectre of social revolution caused Luther to moderate his views. Radical reformers were stirring up the mobs by preaching a return to a non-commercial Christian communism. Some taught that paying interest involved the debtor in sin and incited the peasants to take matters into their own hands.[170] Luther, dependent on the protection of German princes, preached submission to the temporal powers. He reassured debtors that paying interest was no sin, for Christians were not to resist oppression.[171] Ultimately, Luther declared that "interest which does not exceed 4 or 5 percent" is not immoral.[172]

A more important attack on the Papal doctrine of interest came from Switzerland. John Calvin's analysis was more influential than Luther's because it justified interest in principle, not merely as a necessary evil.[173] Calvin made it unnecessary for lenders to use the deceptive devices of the middle ages; lending at interest could be open as long as the rate was not "oppressive."[174]

Calvin's Geneva was a busy commercial center. Many of his staunchest followers were devout Protestant businessmen who considered interest a normal and indispensable part of the modern world. Calvin recognized that in the commercial setting, where both parties profit, the oppressive factor of interest is absent.[175] The prohibition of interest in commerce did not help the poor; it only injured trade.[176]

From this viewpoint, Calvin examined the traditional reasons for banning interest. He began with a refutation of the argument that interest was intrinsically unjust under the old "sterility" doctrine. Calvin asserted that money was barren only if unused.[177] If used productively—invested in land or trade—the borrower is not defrauded when he pays a portion of his profits for the use of money. Thus, natural justice does not require condemnation of all interest.[178] Neither do the scriptures prohibit a reasonable charge for the use of money, Calvin claimed. Observing that the Hebrew word for interest, *neshek,* meant "to bite," Calvin argued that the Bible prohibits only "biting" interest which oppresses the poor.[179] The

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169. *Id.* at 69-70.
170. B. NELSON, *supra* note 3, at 37-38.
171. *Id.* at 41.
172. *Id.* at 49.
173. H. SPIEGEL, THE GROWTH OF ECONOMIC THOUGHT 80 (1971).
174. B. NELSON, *supra* note 3, at 75.
175. Frierson, *supra* note 58, at 123-24.
176. *Id.* at 124.
177. *Id.*
178. *Id.*
179. B. NELSON, *supra* note 3, at 75. According to Calvin, God prohibited interest among the

laws that applied to the Hebrew Commonwealth were not necessarily relevant to the sixteenth century Swiss:

> There is a difference in the political union, for the situation in which God placed the Jews and many other circumstances permitted them to trade conveniently among themselves without usuries. Our union is entirely different. . . . Therefore I do not feel that usuries were forbidden to us simply, except in so far as they are opposed to equity or charity.[180]

Calvin's analysis was momentous. For the first time, a noted religious leader had defended interest for its own sake, refuted the arguments of the scholastic philosophers, and marshalled biblical authority for his view.[181] His doctrines spread immediately to the Protestant countries, particularly developing commercial powers such as Holland and England.[182] For centuries, every pamphlet arguing for liberalized usury laws cited him, and every opposing tract had to assail his arguments.[183] Debate continued, but the battle was over. Interest became a permanent fixture in Western civilization. The usury debate began to assume its present proportions—discussion of when interest becomes excessive.

Calvin represents the modern world, at least as far as finance is concerned. The Catholic Church continued to stand by medieval thought, but it too bowed to the pressure of the emerging economies by validating, one by one, the techniques used to avoid the prohibition of interest.[184] Finally, in 1917, Canon law specifically accepted the taking of moderate interest.[185]

E. England—1500-1854

The sixteenth century was a time of change for England. The century opened with the flamboyant Henry VIII and the break from Roman Catholicism; it closed with the long reign of Queen Elizabeth and the defeat of the Spanish Armada.[186] When the century began, England was a feudal monarchy; when it ended, the country was a great power, a modern nation-state with only vestiges of its medieval past.[187]

Israelites in order to foster charity, not because it was always unjust. Otherwise, Hebrews would not have been permitted to take interest from foreigners. *Id.*

180. *Id.* at 78.
181. *Id.* at 73-74.
182. Frierson, *supra* note 58, at 124.
183. B. NELSON, *supra* note 3, at 82-83.
184. *See* notes 160-61 *supra* and accompanying text.
185. T. DIVINE, *supra* note 2, at 115.
186. D. WILLSON, A HISTORY OF ENGLAND 239-353 (1967).
187. *Id.* at 217.

In 1500, English commerce was on the rise. Wool was the great export, but home manufacture and export of finished cloth was growing in importance.[188] Money was being made in trade, and the new middle class was growing in size and wealth. The spirit of the renaissance and reformation encouraged this class.[189] Trade was less stigmatized as a base means of livelihood. Hard work and thrift were the ideals, and money was respected.[190] The communal ideal of the middle ages was giving way to individual enterprise.

The Tudor monarchs were allied to this rising commercial class.[191] The Tudors and their advisors recognized that foreign trade was an important factor in international politics.[192] In addition, customs and import duties provided an important source of Crown revenue.[193] Adopting a quasi-mercantile approach, the Tudor kings worked hard to foster English trade and win concessions from other nations.[194]

Under these circumstances, the medieval prohibition on interest came under increasingly heavy attack. Since at least the time of Alfred (871-899), usury had been prohibited in England by both canon law and a series of statutes.[195] During late medieval times, the standard means of avoidance had become prevalent in England.[196] By the mid-1500s, however, attitudes were changing. Respected religious leaders like Luther and Calvin had countenanced interest, and businessmen found the new doctrines very persuasive. When Henry VIII rejected the supremacy of the Pope in 1529,[197] Catholic dogma was reviewed as well.

Change was not long in coming. In 1545, an increasingly commercial Parliament passed a new law, cunningly titled "An Act Against Usury."[198] The Act permitted the charging of interest, up to a maximum of 10%.[199] Parliament explained that:

> where divers actes have bene made for the avoyding and punishment of usury, being a thing unlawful, and other corrupt bargaines, shifts, and chevisances, which be so obscure in terms, and so many questions

188. *Id.* at 232.
189. M. BRIGGS & P. JORDAN, ECONOMIC HISTORY OF ENGLAND 102-03 (12th ed. 1967).
190. *Id.*
191. *Id.* at 106.
192. D. WILLSON, *supra* note 186, at 231-34.
193. M. BRIGGS & P. JORDAN, *supra* note 189, at 113.
194. D. WILLSON, *supra* note 186, at 231-34.
195. Horack, *supra* note 11, at 36-37.
196. For a description of the standard means of avoidance, see notes 144-59 *supra* and accompanying text.
197. D. WILLSON, *supra* note 186, at 256.
198. 37 Hen. 8, c. 9 (1545).
199. *Id.*

growen upon ye same, and of so litle effect, that litle punishment, but rather incouragement to offenders that ensued thereby.[200]

Moralists were appalled that Parliament "should bee so voyde of God's Holy Spirit, that thei should allow for lawfull any thynge that God's worde forbeddeth."[201] Dozens of tracts appeared,[202] generally condemning the "damnable sin" of usury. These repeated familiar arguments, but with a new virulence.[203]

Amid a storm of controversy, the law was repealed in 1555.[204] The repeal drove interest underground once more and stimulated hot debate.[205]

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200. *Id., quoted in* Horack, *supra* note 11, at 37.

201. T. WILSON, A DISCOURSE UPON USURY 131 (R. Tawney ed. 1925) (manuscript originally written in 1572).

202. The invention of the printing press, introduced in England in 1477 by William Caxton, made it possible to produce books cheaply. W. LUNT, HISTORY OF ENGLAND 298 (1957). This led to a flood of poorly written religious and moral tracts. In the 1500s, 217 titles dealing with the usury dispute appeared. H. SPIEGEL, *supra* note 173, at 81.

203. Two arguments from a tract by Phillipus Caesar are illustrative:

> 6. From the effectes.
> The major Impossible is it that the effect should wholie bee worser than the cause.
> The minor The effecte of Usurie in respect of the giver are povertie, hunger, griefe, wretchedness, and beggarie, in respect of the receiver bee goodes gotten by subtiltie, or to speake more plainlie, heaped together by theeverie, the overthrowe of Commonweales, the vengeaunce of God, cursings, and evill conscience, subjection to Sathan, eternall damnation, and after the death of the scraper of them, a prodigall or tragicall wasting the these ill gotten riches.
> The conclusion Therefore is Usurie detestable.
> The Minor is easily confirmed, bothe by authoritie of scripture: and by daiely experience.
> 10. From the lesser to the greater.
> The antecedent If theft deserve death.
> The consequent Much more doeth Usurie. The consequent is good. For Usurers without neede, continuallie, without ceasing doe rape & scrape ritches together. Theeves do the same onely in tyme of necessitie, and many tymes driven thereunto by the crueltie, and unmercifullnesse of them in wealthe, whiche have no pitie on their miserie. And therefore doe Usurers deserve a greater punishment. Hence it is that among the Romans Usurie had a double punishment more than Thefte.

Caesar, *A General Discourse Against the Damnable Sect of Usurers*, in RELIGIOUS ATTITUDES TOWARD USURY 10 (L. Silk ed. 1972).

204. Byll Against Usurie, 1555, 5 & 6 Edw. 6, c. 20. The Act announced as its purpose:

> Usurie is by the worde of God utterly prohibited, as a vyce moste odyous and detestable, . . . which thing by no godly teachings and perswations can syncke into the harts of dyvers gredie, uncharitable and couvetous parsons of this Realme, nor yet by anny terrible threatenings of God; wrathe and vengeaunce that justly hangeth over this Realme for the great and open Usurie therein dailye used and practysed they will forsake such filthie gaine and lucre, onles some temporall punishment be provyded . . . .

Id.

205. L. CLARKSON, THE PRE-INDUSTRIAL ECONOMY IN ENGLAND 1500-1750, at 167 (1971).

The distinction between usury and interest, once considered synonymous, was gaining acceptance.[206] Interest was prohibited throughout the reign of the Catholic Queen Mary, but was legalized again under Queen Elizabeth in 1570.[207]

By the seventeenth century, interest was generally accepted. Francis Bacon viewed legal interest with a rate limitation as a means of balancing two requirements: "The one, that the *Tooth* of Usurie be grinded, that it bite not too much; The other, that there be left open a Meanes, to invite Moneyed Men, to lend to the Merchants, for the Continuing and Quickening of Trade."[208] Gradually, the maximum rate was reduced, probably following a fall in the market rate due to more available capital and greater confidence among merchants. In 1624 the limit was set at 8%,[209] in 1660 at 6%,[210] and finally at 5% by the Statute of Anne in 1713.[211] Although tracts condemning the taking of interest continued to appear well into the eighteenth century, the issue was really dead. In 1766 Blackstone could write of the prohibition of interest as the work of the "Dark Ages" and "monkish superstitions and civil tyranny," when "commerce was also at its lowest ebb."[212]

During the seventeenth century, the focus of debate shifted from the morality of interest to the question of what rate limit was most beneficial. In 1668, Sir Josiah Child, looking with envy at the prosperity of the Dutch, concluded that their dominance in trade must be due to the very low rate of interest that prevailed in Holland (3½%).[213] Child advocated reducing the legal limit from 6% to 4%, not to prevent oppression, but to encourage trade by guaranteeing a cheap supply of money.[214]

John Locke refuted Child's ideas in his tract "Some Considerations on the Lowering of Interest and Raising the Value of Money."[215] He pointed out that the Dutch had no legal limit on interest rates and that the low rates prevailing in Holland were due to the abundance of capital available

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206. *Id.*

207. 13 Eliz., c. 8 (1570), *cited in* Horack, *supra* note 11, at 37 n.13.

208. F. BACON, *Of Usurie*, in ESSAYES 171 (West ed. 1896), *quoted in* Comment, *supra* note 4, at 128 n.24.

209. Act Against Usury, 21 Jac. 1, c. 17 (1624).

210. Act Against Excessive Usury, 12 Car. 2, c. 13 (1660).

211. Act to Reduce Rate of Interest, 13 Anne, c. 15 (1713). This statute, the basis of American usury statutes, is quoted in part in Comment, 23 MD. L. REV. 51, 52 n.11 (1963).

212. 2 W. BLACKSTONE, COMMENTARIES* 455.

213. S. HOMER, *supra* note 12, at 129. Abundant capital, vigorous trade, and competition had lowered Dutch interest rates to as low as 3%, the lowest rates discovered by Sydney Homer. *Id.*

214. H. SPIEGEL, *supra* note 173, at 152-53.

215. *Id.* at 155.

for lending.[216] Locke recognized that a "natural" rate of interest is determined by supply and demand: "the want of money . . . alone regulates its price."[217] He opposed Child's plan for reducing the legal limit which, he felt, would only hamper trade and force merchants once more to use subterfuge to lend at the natural (market) rate.[218] On the other hand, Locke thought that there should be some legal limit on interest rates to prevent the needy and inexperienced from being "exposed to extortion and oppression."[219] Even this view was about to come under attack. As early as 1682 some commentators began arguing for abolition of the statutory maximum altogether.[220]

In 1787, the utilitarian philosopher Jeremy Bentham published his *Letters in Defense of Usury*, a landmark in usury debate.[221] Bentham's guiding principle was the greatest good for the greatest number.[222] A trained jurist and economist, he analyzed English institutions under this principle of utility. Bentham's ideas were very influential during the first three quarters of the nineteenth century. His followers reformed the harsh criminal code, improved the poor laws, and repealed the anti-trade union law.[223]

Adopting the laissez-faire attitude of the times, Bentham believed that individuals, choosing for their own greatest good, would benefit all. Applying this principle to lending, he states his theorem:

> [N]o man of ripe years and of sound mind, acting freely and with his eyes open, ought to be hindered, with a view to his advantage, from making such bargain, in the way of obtaining money, as he thinks fit; nor (what is a necessary consequence) any body hindered from supplying him, upon any terms he thinks proper to accede to.[224]

The general rule is freedom of contract, and Bentham saw no compelling reason for making interest rates an exception:

> Why a man, who takes as much as he can get, be it six, seven, or eight, or ten percent for the use of a sum of money should be called usurer, should be loaded with an opprobrious name, any more than if he had bought a house with it and made a proportionable profit by the

216. F. RYAN, USURY AND USURY LAWS 47 (1924).
217. H. SPIEGEL, *supra* note 173, at 157.
218. F. RYAN, *supra* note 216, at 46-47.
219. *Id.* at 47.
220. *Id.* at 46 n.5.
221. H. SPIEGEL, *supra* note 173, at 341.
222. *Id.*
223. M. BRIGGS & P. JORDAN, *supra* note 189, at 189-90.
224. F. RYAN, *supra* note 216, at 52.

house, is more than I can see.[225]

In his treatise on usury, Bentham ignored the scholastic or Aristotelian "sterility" arguments, for they no longer carried any weight in England.[226] Instead, he listed the common economic arguments in favor of statutory rate ceilings and purported to refute each one. First, citing the different rates of interest used over various times and places, Bentham asserted that no single rate is more "correct" than another.[227] Bentham next confronted the argument that the rate ceiling is needed to protect the needy from extortion. He pointed out that the borrower may pay a high rate of interest and still be better off for the borrowing as, for example, on a loan needed to prevent a loss.[228] If the rate is so high that the loan would be more costly than the loss, nothing compels acceptance of the loan. The individual is in the best position to evaluate his best course.

To the argument that usury laws are needed to protect the "simple", he replied that protection is more needed in credit buying (much more common and exempt from usury law) than lending.[229] Adam Smith had argued that legal limits were necessary to curb the excesses of entrepreneurs.[230] Bentham replied that both good and bad projects would be discouraged by limits on interest and that these enterprises, when successful, have greatly benefited society.[231]

Bentham also lists many ways in which usury ceilings are harmful to society. Among others: (1) Fixing the rate also fixes the required security, and persons lacking this security cannot get loans at all;[232] (2) the law is widely evaded, creating contempt for the law;[233] (3) the law is so easily evaded as to be ineffective;[234] and (4) other cases are not regulated where men may take high risks for high profits.[235]

Bentham's polemic was considered an unanswerable refutation of the desirability of usury limits.[236] Almost immediately, laws were passed limiting the existing usury statute. In 1854, England repealed all acts against usury.[237] Most of Europe soon followed suit: Denmark in 1855, Spain in

225. *Id.* at 53-54.
226. *Id.* at 52.
227. *Id.* at 53.
228. *Id.* at 54.
229. *Id.* at 55.
230. *Id.*
231. *Id.* at 55-56.
232. *Id.* at 56.
233. *Id.*
234. *Id.*
235. *Id.* at 56-57.
236. *Id.* at 57.
237. Usury Laws Repeal Act, 1854, 17 & 18 Vict., c. 90.

1856, Geneva, Holland, Norway and Sardinia in 1857, Saxony and Sweden in 1864, Belgium in 1865, and Prussia in 1867.[238]

F. America

Although young, the American Colonies were able to build upon the well-established legal and financial foundations of England. Reflecting seventeenth century English attitudes, lending at interest was always recognized as a normal part of business activity in America.[239] Borrowing for personal consumption, on the other hand, was considered imprudent and unthrifty.[240] Though legal, it was generally discouraged.

During the eighteenth century, all of the Colonies enacted usury laws patterned after the contemporary English Statute of Anne.[241] Many of the Colonies, however, set a higher maximum rate than the 5% prevailing in England. Eight Colonies set the limit at 6%, and some went as high as 8%.[242] The higher rates probably reflected a scarcity of capital and an attempt to encourage investment from England. In 10 of the Colonies, violators forfeited both principal and interest.[243]

The Colonies, having to import most manufactured goods, suffered a continuing drain of currency. The demand for credit was undoubtedly great, driving rates up.[244] The usury laws seem to have been widely evaded; Benjamin Franklin reported that normal interest rates were 6% to 10%.[245]

After the Revolution, the states retained their body of English law. New states, hoping to prevent oppression of the needy and insure the supply of low cost credit, copied their laws from existing states. By 1886, every state had some usury limit, generally 6%.[246]

The higher interest rates did attract foreign capital. The American economy, benefiting from this influx, grew rapidly.[247] Although prosperity was general, the first 60 years of the nineteenth century produced sharp recessions caused by speculation and uncontrolled growth.[248] During hard

238. F. RYAN, *supra* note 216, at 57.
239. S. HOMER, *supra* note 12, at 274.
240. *Id.*
241. Comment, *supra* note 4, at 131 n.45.
242. F. RYAN, *supra* note 216, at 27.
243. *Id.*
244. S. HOMER, *supra* note 12, at 275.
245. *Id.*
246. Benfield, *Money, Mortgages and Migraine—The Usury Headache*, 19 CASE WES. RES. L.J. 819, 824 n.28 (1968).
247. S. HOMER, *supra* note 12, at 280.
248. *Id.* at 280-81.

times, the usury limits were evidently ignored: average yields on commercial paper during these periodic crises were over 10%,[249] well above the prevailing 6% usury ceiling. These rates were made possible by a variety of subterfuges.[250] In 1834, a petition submitted to the Massachusetts Legislature described the situation:

> We would respectfully direct the attention of the Legislature to the numerous modes that have been devised for evading the laws; modes of transacting business, which, besides being circuitous and inconvenient, and besides taking away the sanction and protection of the law from those who engage in them, leaving no security but what is termed, thus increasing the risk, and of course the premium paid—besides these evils, which are loss of time, money, comfort and security—produce a fearful disregard of the laws, and establish a precedent of the utmost danger, while they tend to throw pecuniary negotiations in the hands of unprincipled and dangerous men. We need not specify the various methods by which the law is now evaded, and by which interest above six percent is taken, in defiance of law, under the various names of "premium," "exchange," and "commission"; for these are matters of notoriety, and need only be alluded to in order to secure the attention of the Legislature. So long as our laws remain unchanged, it is vain to hope for a better state of things.[251]

Spurred by the laissez-faire philosophy of the times, the writings of Jeremy Bentham, and the English repeal of its usury laws, the business community made efforts to abolish the usury laws.[252] The climax of this movement came in 1867 when Richard H. Dana persuaded the Massachusetts Legislature to repeal its usury law.[253] Dana argued that the market rate of interest was essentially beyond legislative control, and that usury limits were widely ignored whenever rates rose above them.[254] He also pointed out that a unified rate ceiling is absurd since it sets one rate for safe and unsafe, as well as secured and unsecured loans.[255] Contrary to the law's purpose, which was to assure a supply of cheap credit, the usury limits caused the supply of lendable funds to dry up whenever the market rate rose beyond permissible levels, since lenders could not afford to lend at the legal rate. As for the arguments that lenders will conclude

249. *Id.* at 318-19.
250. Benfield, *supra* note 246, at 825.
251. *Id.* at 825 n.33.
252. F. RYAN, *supra* note 216, at 60.
253. *Id.* at 60-62, 196. Dana was the author of the popular 1840 novel *Two Years Before the Mast.*
254. *Id.*
255. *Id.* at 61-62.

to set high rates, Dana replied that there was already keen competition among lenders.[256] Indeed, he argued that high interest rates are their own cure. They attract foreign funds, thus ending the scarcity which caused the high rates in the first place. Conversely, low limits cause capital to leave the state for markets where the return is greater.[257]

These arguments convinced the Massachusetts Legislature to repeal the state usury law.[258] A few states followed suit. By 1900, 11 states had no interest rate ceiling.[259] Many other states made usury laws less restrictive.[260] The Western States were particularly liberal. In an effort to attract capital, many set high limits, nine states permitted 10% to 12%.[261]

The mid-1800s also saw the creation of several important exceptions to the usury law. The first was a legislative creation: the "corporate exception." This legislation was a response to the scandal caused by the case of *New York Dry Dock Bank v. American Life Insurance & Trust Co.*[262] Faced with financial difficulties, the bank had negotiated a loan of £48,000 from an English lender and the trust company.[263] The bank promised to repay £50,000 in London at 6% interest.[264] When the bank failed to repay, the trust company brought suit. The bank raised the defense of usury, alleging that, with the reservation of £2,000, the loan exceeded New York's 7% usury ceiling.[265] The New York Court of Appeals held the contract usurious; hence, under New York law, the bank had no legal obligation to repay the loan, interest, or principal.[266]

The public and business communities were outraged. It seemed grossly unfair that a financially sophisticated borrower, like the bank, could use the usury law to defraud its creditors. The *New York Journal of Commerce* wrote:

> It shows more impressively than anything which has before come to our knowledge, the abominable injustice of the [usury] law which is a disgrace to our statute book, to the legislature which enacted it, and to the people which tolerate it. . . . It offers a standing premium for fraud, deception, ingratitude, and downright robbery; a premium, in

256. *Id.* at 62.
257. *Id.*
258. *Id.*
259. Comment, *supra* note 4, at 134 n.65. These states were: Arizona, California, Colorado, Florida, Maine, Massachusetts, Minnesota, Montana, Nevada, New Mexico, and Utah. *Id.*
260. *Id.* at 133.
261. *Id.* at 134 n.65.
262. 3 N.Y. 344 (1850).
263. *Id.* at 346.
264. *Id.*
265. *Id.* at 354.
266. *Id.* at 362.

> the case before us amounting to something like $400,000 [principal and interest].[267]

The *Dry Dock Bank* case brought out calls to reform state usury laws. In 1850, after heated debate, New York passed a new law which prohibited any corporation from pleading the defense of usury.[268] A few states did likewise.[269] Other states reduced the penalty for usury to forfeiture of the interest only.[270] By 1921, only six states still punished usurers with loss of the entire principal.[271]

The second major exception to usury law was created by judicial decision. Most usury laws applied to the "loan or forbearance of money."[272] The question was whether the credit sale was really a loan or forbearance. In *Beete v. Bidgood*,[273] an English court held that a seller can quote two prices, one for cash sale and a higher one for a sale on credit, without coming under the usury law. The price difference was not "interest," but a charge for the risks of the credit sale and the goods' price at a future time.[274] This came to be known as the "time-price" doctrine. It was adopted by the United States Supreme Court in *Hogg v. Ruffner*.[275]

The soundness of this distinction has been questioned repeatedly.[276] Its explanation seems to be that courts considered the credit buyer in less need of protection than the borrower. A Missouri court explained: "[A] purchaser is not like the needy borrower, a victim of a rapacious lender, since he can refrain from the purchase if he does not choose to pay the price asked by the seller."[277] Since consumer credit was not common at this time, credit buyers were generally businesses or sophisticated individuals. Both the *Beete* and *Hogg* cases involved land sales, where the buyer is presumed to be in a more equal bargaining position. The time-price doctrine was also applied when a credit seller immediately discounted a

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267. F. RYAN, *supra* note 216, at 59 (quoting N.Y.J. Com., Jan. 5, 1850). *The New York Evening Post* also expressed its censure: "Well may the business community look upon a law with horror and detestation which gives such advantages to knavery and dishonesty; and enables the fradulent and immoral debtor to exempt himself from the payment of a debt." *Id.* (quoting N.Y. Evening Post, Feb. 23, 1850).

268. N.Y. GEN. OBLIG. LAW § 5-521 (McKinney 1964).

269. F. RYAN, *supra* note 216, at 27-31.

270. *Id.*

271. *Id.* These states were Arkansas, Connecticut, Delaware, New York, Oregon, and Utah. *Id.*

272. Warren, *Regulation of Finance Charges in Retail Installment Sales*, 68 YALE L.J. 839, 840-41. (1959).

273. 7 B. & C. 453, 108 Eng. Rep. 792 (K.B. 1827).

274. Benfield, *supra* note 246, at 844.

275. 66 U.S. (1 Black) 115 (1861).

276. *E.g.*, Berger, *Usury in Installment Sales*, 2 LAW & CONTEMP. PROB. 148, 148 (1935).

277. General Motors Acceptance Corp. v. Weinrich, 218 Mo. App. 68, 77-78, 262 S.W. 425, 428 (1924).

loan to a finance company.[278] Together, these two exceptions removed a large portion of credit transactions from the control of usury law.

The rapid industrialization of America in the later 1800s brought many changes to American society. The population grew increasingly urban as people flocked to the jobs offered by new factories. For the first time, a large percentage of the population was composed of industrial wage earners.[279] Although working conditions were bad, real income rose during the 1870s and 1880s.[280] Workers began to have enough money to live at more than a mere subsistence level. The worker, however, was totally dependent on his weekly income. Unemployment or illness in the family could push the household into financial catastrophe.[281] To meet these emergencies, workers needed a source of small loans for personal consumption. Their ability to earn above a subsistence level gave them some capacity to repay at interest.[282]

Existing lenders were unable to satisfy this demand. Small lending could not be done profitably under the existing usury laws, which generally set 6%-12% limits on interest.[283] The personal loan was risky. If the lender could not charge enough to cover this element, then the loan was unattractive. Another factor was the cost of administering loans: checking credit, filling out forms, and doing the required bookkeeping.[284] These costs must be paid out of the interest charge. On large commercial loans this is no problem. The 6% interest on a $100,000 loan yields $6,000, and the administration cost would be only a tiny fraction of this sum. Administrative costs, however, are not directly related to loan size; it costs nearly as much to do the paper work on a $100 loan as on a $100,000 loan. But the $6 interest on the small loan may be entirely devoured by administrative costs.[285] Thus, small loans are more costly to make and require a higher rate of interest. The usury laws, in effect, made personal loans illegal.

Even in states without usury limits, banks failed to move into the field of personal loans. Personal debt was frowned upon as imprudent and indicative of moral weakness.[286] Wage earners' discretionary income was

278. Benfield, *supra* note 246, at 845.

279. M. CURTI, HISTORY OF AMERICAN CIVILIZATION 363 (1953).

280. *Id.* at 395.

281. *See* Kelso, *Social and Economic Background of the Small Loan Problem*, 8 LAW & CONTEMP. PROB. 14, 15-20 (1941).

282. Nugent, *The Loan Shark Problem*, 8 LAW & CONTEMP. PROB. 3, 4 (1941).

283. Benfield, *supra* note 246, at 838.

284. *Id.* at 829.

285. *Id.*

286. Haller & Alviti, *Loansharking in American Cities*, 21 AM. J. LEGAL HIST. 125, 127 (1977).

small and could be consumed by any financial setback. The factory worker seemed a bad risk.[287]

Into this vacuum, during the late 1800s, stepped the "salary lender"—a new and less reputable source of credit.[288] Although called "loan sharks" at the time, they were very different from the racketeer loan sharks of today. The salary lender operated under at least the guise of legality; he was not generally connected with criminal elements and did not use violence in collection.[289] Doing business from a public office, the salary lender advertised in newspapers and used specially prepared contracts and legal forms.[290] The transaction was commonly cast in the form of a cash purchase of a worker's future wages.[291] Intended to evade usury laws, such contracts were frequently considered the purchase of a chose in action, not an illegal loan.[292]

Salary lenders relied on the stigma of debt and threat of legal action to enforce repayment.[293] Once appeals to honor and public accusations had failed, the lender could threaten garnishment. Workers feared disclosure of their debts to employers, many of whom, to "protect" worker morals and prevent embezzlement, would fire employees who fell into debt.[294] Thus, creditors could effectively threaten debtors with loss of their jobs. If all else failed, the creditor would threaten legal action. Most debtors, poor and uneducated, believed the contracts enforceable, generally feared contact with legal processes, and lacked the resources to contest a suit.[295] Even if brought into court, the salary lender had little to fear from usury law. Many lower court judges would uphold the contracts on the basis of their legal form.[296] The occasional loss only meant forfeiture of interest.[297]

Rates were frequently high: on small loans 10% per month was common, and up to 33% per month was reported.[298] Unscrupulous lenders made it easy to continue or increase the debt. Very high late penalties also made repayment difficult.[299] Subjected to these ruinous rates, many workers fell into a never-ending cycle of debt. One Chicago streetcar

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287. *See* note 281 *supra* and accompanying text.
288. Haller & Alviti, *supra* note 286, at 125-27.
289. *Id.*
290. *Id.* at 129-31.
291. *Id.* at 125.
292. Collins, *Evasion and Avoidance of Usury Laws*, 8 LAW & CONTEMP. PROB. 54, 58 (1941).
293. Haller & Alviti, *supra* note 286, at 134-35.
294. *Id.* at 127.
295. *See id.* at 134-35.
296. *Id.* at 127.
297. Benfield, *sura* note 246, at 839.
298. *Id.* at 839 n.102.
299. Haller & Alviti, *supra* note 286, at 133.

driver still owed $307 on an original $50 loan, after already paying $360.[300] Constant harassment drove some debtors to theft or even suicide.[301]

By 1900, salary lending had become prevalent in large cities and was causing growing concern as a social problem.[302] The initial reaction was that personal debt was a bad thing and should be discouraged. Some states lacking usury laws enacted them, and existing laws were toughened.[303] These measures did nothing to help the problem; indeed they probably aggravated it.[304]

More perceptive reformers realized that, regardless of Horatio Alger's moralizing, a source of small loans was necessary to tide workers over times of hardship. Reformers began to look for ways to make credit available to workers on a less destructive basis than the salary lenders.

The first efforts were made by charitable organizations. Some made funds available to desperate debtors, paying debts or at least interest to avoid lawsuits.[305] Others went into competition with salary lenders, making small loans at the very low legal rates.[306] These efforts had only slight effects, however, for there was not enough charitable money available to meet more than a small fraction of the demand.[307]

A more significant source of personal loans was the industrial or "Morris Plan" bank. These banks were establised in the early part of the twentieth century to provide banking services and credit for consumers.[308] In order to make personal loans profitable under existing usury statutes, Arthur Morris devised a system involving puuchase of an "investment security" which increased the effective yield on consumer loans.[309] Under the Morris Plan, the customer would borrow a sum from the bank, repayable at a set time and at a legal rate of interest. In a separate, but simultaneous, transaction, the customer would "purchase" an investment certificate which obligated him to make periodic deposits into a special account. The investment certificate was of the same amount as the loan, matured at the same time, and was ultimately used to repay the indebtedness.[310] In es-

300. *Id.* at 133-34.
301. Nugent, *supra* note 282, at 5.
302. *Id.* at 6.
303. Hubachek, *The Development of Regulatory Small Loan Laws*, 8 LAW & CONTEMP. PROB. 108, 111 (1941).
304. *Id.* at 110.
305. Haller & Alviti, *supra* note 286, at 135.
306. Nugent, *supra* note 282, at 6.
307. F. RYAN, *supra* note 216, at 132.
308. B. CURRAN, TRENDS IN CONSUMER CREDIT LEGISLATION 53-54. (1965).
309. *Id.*
310. *Id.*

sence, the plan was an installment loan transaction, but many courts were willing to view the arrangement as separate transactions.[311] The installment nature of the transaction provided security and nearly doubled the bank's effective interest rate, since the borrower had the use of the full amount of the loan only until the first payment.[312]

Morris Plan lending was significant in the early decades of this century. The general usury limit of 6%, however, did not permit profitable lending to many consumers. As states raised the rate chargeable by finance companies and commercial bans, the industrial bank became less important.[313] In some states, they were granted general banking powers.[314] Despite these problems, industrial bank loans are still available in a number of jurisdictions.[315]

At the turn of the century, other reformers urged the creation of legal, regulated, but economically profitable lenders to replace the "sharks." The Russell Sage Foundation, a well endowed private institution for reform, provided the crucial leadership for this movement.[316] In 1907 the foundation funded economic studies of the problem and began making proposals for reform.[317] Working with some of the more responsible lenders, the legal scholars of the Russell Sage Foundation hammered out a compromise acceptable to both. This resulted in the proposal of the Uniform Small Loan Law in 1916.[318]

Economic analysis of the small-loan market convinced the drafters that, because of the high risk and administration cost, an interest rate of 3½% per month (42% annually) was necessary.[319] Although this rate shocked many, the drafters emphasized that it was the minimum rate that could yield a profit.[320] It was still much lower than the rates being charged by unregulated lenders.[321]

The small-loan rate was meant to be an exception to the general usury laws.[322] In order to take advantage of the higher rate, a lender would have to be licensed by the state and submit to a certain amount of state regula-

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311. *See id.* at 53.
312. *Id.*
313. *Id.*
314. *Id.*
315. *Id.*
316. Nugent, *supra* note 282, at 6.
317. Hubachek, *supra* note 303, 111-12.
318. *Id.* at 113.
319. Haller & Alviti, *supra* note 286, at 137.
320. F. RYAN, *supra* note 216, at 132.
321. *See* Benfield, *supra* note 246, at 839 n.102.
322. Hubachek, *supra* note 303, at 115.

tion.[323] The largest amount lendable at the small-loan rate was $300, and any discounting, service fees, or other charges were counted in calculating the interest.[324] Misleading advertising, liens on real estate, and confessions of judgment were prohibited.[325]

Enforcement of the new provisions was considered as important as the new rates. The small loan law would be ineffective if it could be avoided as easily as the existing usury laws. Therefore, the small loan law provided criminal penalties for infractions: stiff fines and possible imprisonment.[326] Enforcement was left to the state prosecutor rather than to the zeal of private citizens.

The Uniform Small Loan Law was well received; by 1923, 20 states had enacted similar versions of it.[327] In states which enacted effective small loan laws, the illegal salary lenders gradually disappeared.[328] Once the licensed lending business was established, business boomed. As of 1980, only Arkansas lacked a special provision for small loans.[329]

G. *Modern Trends*

Since 1945, the United States has experienced a "credit explosion." Mortgage debt outstanding increased from $18.6 billion in 1945 to $140 billion in 1960,[330] almost six-fold. Consumer credit expanded from $6 billion to $55 billion in the same period.[331] Many factors contributed to this growth. Discretionary income has risen at all levels of society,[332] and the increasing use of insurance has made these incomes more secure, protecting households against catastrophic losses from illness or unemployment.[333] Women have entered the work force in greater numbers, augmenting household income.[334]

Old ideals of personal economy have given way in the rush to "buy now and pay later." Credit is used to buy expensive durable goods, *e.g.*, cars, refrigerators, furniture, and TVs.

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323. *Id.*
324. *Id.* at 115-16.
325. *Id.* at 117.
326. *Id.* at 125.
327. *Id.* at 119.
328. Haller & Alviti, *supra* note 286, at 140.
329. Note, *supra* note 16, at 203.
330. Comment, *supra* note 4, at 135 n.74.
331. *Id.*
332. S. Ratner, J. Soltow & R. Sylla, The Evolution of the American Economy 463 (1979).
333. National Commission on Consumer Finance, Consumer Credit in the United States 6 (1972) [hereinafter cited as NCCF].
334. *Id.* at 7.

As the credit economy has expanded, it has also become more complex. New forms of credit have appeared, *e.g.*, check borrowing and revolving charge accounts. "Plastic money" has become common. In order to deal with the situation, usury laws became more complex.

Since colonial times, the history of American usury law has been a history of exceptions. By the 1950s, these exceptions threatened to overwhelm the rule. Although nearly all states retained a general usury limit, regulation was increasingly provided by a bewildering and disorganized array of statutory exceptions.[335]

Special legislation created exceptions for certain types of loans. Many states had provisions for commercial loans including either the corporate exception to pleading usury,[336] different rate limits on corporate loans,[337] or increased limits (frequently no limit) on loans over a certain amount.[338] Special laws in nearly every state set higher limits on small loans.[339] The time-price doctrine, which exempted credit sales from the usury limits, was universally recognized.[340]

Various lenders were also frequently excepted from the general usury laws. In many states, special laws regulated loans by credit unions,[341] savings and loan institutions,[342] and industrial banks.[343] In some states, bank loans were taken out of the control of the usury statute.[344] Pawnbrokers were generally covered by city or county laws.[345] As the number of exceptions grew, the proportion of the nation's credit that still fell under the control of usury statutes shrank. By 1968, less than half of America's credit was controlled by state usury statutes.[346]

1. Retail Sales

An important extension of credit regulation gathered momentum in the 1950s as many states began to enact legislation regulating credit charges in retail sales.[347] These had long been considered outside the scope of

335. Benfield, *supra* note 246, at 835.
336. *See* notes 262-69 *supra* and accompanying text.
337. Benfield, *supra* note 246, at 849.
338. *Id.*
339. *See* notes 279-329 *supra* and accompanying text.
340. *See* notes 272-75 *supra* and accompanying text.
341. B. CURRAN, *supra* note 308, at 45-52.
342. *Id.* at 60-65.
343. *Id.* at 52-60.
344. Warren, *Rate Limitations and Free Entry*, 26 BUS. LAW. 855, 857 (1971).
345. B. CURRAN, *supra* note 308, at 80.
346. Benfield, *supra* note 246, at 855.
347. *See generally* E. MCALLISTER, RETAIL INSTALLMENT CREDIT 4 (1964).

usury laws under the time-price doctrine.[348] In the nineteenth century, consumer credit was rare. The first large-scale use of installment credit for consumer sales was by the Singer Sewing Machine Company, starting in 1850.[349] The device became more widespread as other retailers adopted it in selling products such as pianos, books, and stoves.[350] The wage earner was becoming able to afford such luxuries, but saving for years might be beyond his willpower. Installment credit permitted him to enjoy the product immediately and increased the retailer's sales volume tremendously. The products sold in this way were durable goods that had substantial worth even second-hand so that the creditor's lien remained valuable.[351]

The retail installment business came of age with the advent of the automobile. The car's demand, price, and durable value made it ideal for generating installment sales. Auto sales grew rapidly: over half a million new cars were sold in 1914 and over one and a half million in 1916.[352] Prior to automobile loans, most retail installment credit had been carried by the seller. Automobile dealers, however, did not want their capital tied up for years in installment paper.[353] During the 1920s, sales finance companies multiplied to meet this need.[354] Once this occurred, the difference between the "finance charge" (time-price) and an interest rate almost disappeared. The retailer added to the cash price a sum recommended by the finance company. As soon as the deal closed, the paper was sold to the finance company at a discount—the retailer receiving the cash price and the finance company recovering the time-price differential through the payments.[355] Few consumers were aware that the charge they paid if they borrowed from a bank to buy the car was interest, but the charge paid to the finance company was not.[356] Yet in every state the finance charge was exempt from the usury limits under the time-price doctrine.

At first, the finance companies were generally free of the abuses that had plagued consumers loans. The automobile manufacturers and dealers were concerned with retaining the goodwill of their customers and were in a position to regulate the financing activity privately.[357] Nevertheless, as

348. *Id.* at 11-12.
349. *Id.* at 11.
350. *Id.* at 11-12.
351. *Id.* at 12.
352. *Id.* at 13.
353. *Id.* at 14.
354. *Id.*
355. Benfield, *supra* note 246, at 846.
356. B. CURRAN, *supra* note 308, at 19.
357. E. MCALLISTER, *supra* note 347, at 15.

more and more products came to be sold on credit, unscrupulous operators proliferated.[358] In 1935, Indiana and Wisconsin enacted the first laws limiting the finance charge in retail installment credit.[359] The need for regulation became more apparent as the volume of installment credit grew after World War II. By the early 1960s, most states had retail installment laws.[360] As of 1980, only Arkansas had none.[361]

2. Avoidance and Evasion

As in times past, usury laws were widely avoided in the post-war era. Lawyers and businessmen have expended a great deal of time and ingenuity devising legal methods of circumventing usury limitations. Probably the most common avoidance technique is the collection of commissions or fees beyond the interest charge. These are charges made to appraise collateral, run credit checks, do title searches, cover filing fees, and so on.[362] By paying for some of the lender's operating expense, however, they permit him a higher profit on the legal interest of the loan.[363]

Another very common tactic is the sale of insurance. The lender may require loss insurance on the collateral and perhaps disability insurance on the debtor as a condition for making the loan.[364] At certain times, insurance charges have represented a significant portion of some creditors profits.[365]

Deceptive computation can increase the yield without altering the stated interest rate. Two common methods are "discounting" and "add-on" interest. Discounting means prepaying the interest. On a $100 discounted loan at 10% interest, $10 interest would be immediately deducted from the loan funds. The borrower would receive only $90. Since he is paying $10 interest and has the use of only $90, the effective interest rate is not 10%, but 11.11%.[366]

"Add-on" installment interest produces much more dramatic results. Under this method, interest on the entire loan is added to the debt and the sum is repaid in installments. To see the effect, consider a $100 loan for one year at 8%, repayable in equal monthly installments. The interest

358. *Id.* at 15.
359. *Id.* at 45.
360. *Id.*
361. [1980] 1 CONS. CRED. GUIDE (CCH) ¶ 520.
362. Collins, *supra* note 292, at 59.
363. *Id.*
364. *See id.* at 60.
365. Study, *An Empirical Study of the Arkansas Usury Law: "With Friends Like That . . . "* 1968 U. ILL. L.F. 544, 575-76.
366. *See* section II, *infra*, notes 32-35 and accompanying text.

is prefigured as $8 and added on to the principal; $108 must be paid back. This is then divided into 12 monthly installments of $9 each. The trick is that the borrower does not have the use of the $100 for the whole year he has been charged for. He has $100 of the lender's money only during the first month of the loan, then he has only $91. By the latter part of the term he has only a small amount of the loan funds available, yet he is still paying interest as though he had the full amount all year. Conversely, the lender does not remain separated from his $100 for long, but soon has a sizable proportion back which he can lend out to others. On the average, over the course of the whole year, the borrower has in his possession only about half of the loan amount; but pays interest on the whole. Thus, this "add-on" almost doubles the annual percentage rate.[367]

Consumer advocates have often characterized the "Rule of 78ths," a precomputed interest method,[368] as unfairly increasing the creditor's yield above legal interest rates.[369] Under the Rule of 78ths, the creditor is entitled to the bulk of the interest early in the loan term;[370] if the debtor repays the loan ahead of schedule it appears at first glance that the creditor has retained "extra" interest.[371] This impression is rebutted, however, by the fact that the borrower has use of a larger sum of money early in the loan term and the creditor is therefore entitled to a larger "chunk" of the total interest early in the term.

There are many other ways of computing interest and repayment, some so complex that only mathematicians understand them. Their uniform effect is to increase the yield above the stated rate. This is countenanced by courts and legislatures because the lending would not be possible under low rate ceilings at "simple" interest. The unfortunate side effect is borrower confusion and bewilderment.[372]

One of the most important avoidances, in terms of dollar amounts, is the use of "points" in mortgage lending. Points are a cash charge required by the lender before he will make the loan.[373] Each point equals one percent of the loan amount, so three points on a $100,000 mortgage would be $3,000. In order to conclude a sale, the seller must pay these points. For the lender, this is like a partial prepayment of interest, since only $97,000

367. *See id.*, notes 27-31 and accompanying text.

368. Hunt, *The Rule of 78: Hidden Penalty for Repayment in Consumer Credit Transactions*, 55 B.U.L. REV. 331, 331 (1975).

369. Kripke, *Consumer Credit Regulation: A Creditor Oriented Viewpoint*, 68 COLUM. L. REV. 444, 454 (1968).

370. *See id.*

371. *See* section II, *infra*, notes 59-61 and accompanying text.

372. Benfield, *supra* note 246, at 861.

373. *Id.* at 859-61.

cash must be provided. The seller must pay the points or his buyer will not be able to get financing and his house will not sell. Since the seller rather than the buyer-borrower pays, points are not generally counted as interest. In practice, however, the price of the houses is merely raised in order to cover the points. The buyer bears the costs in the long run.[374]

Third parties can also be used to bypass restrictive ceilings. One method is for an agent to receive a separate commission for finding or negotiating the loan. Sometimes this fee is returned or kicked back to the lender as extra profit on the loan.[375] The lender may also require a loan guarantee by a third party. The guarantor will demand a fee which often will find its way back to the lender's pocket, directly or by reciprocal agreement.[376]

Since many usury statutes cover only contracts representing "unconditional" promises to repay, the law could be sidestepped by making repayment contingent on the non-occurrence of an event like "the total destruction of Manhattan Island."[377] High rate contingency loans have sometimes been upheld as compensation for increased risk.[378]

Lenders can sometimes take advantage of poorly drafted statutes. Many small-loan laws make provisions for a certain minimum charge regardless of the size of the loan. This is necessary to cover administrative costs of very small loans. But, if the statute does not prevent it, the unscrupulous lender may make a $100 loan in the form of 50 separate $2 loans, each bearing the minimum charge of $1. Thus, the lender receives $50 interest on a $100 loan.[379] Other loopholes always creep into statutes, and lenders are very adept at discovering them. Only vigilance and courts prepared to consider substance above form can prevent these abuses.

There are certainly many additional tactics used to avoid rate ceilings;[380] these are just a few of the most common. The prevalence of avoidance does not mean that all businessmen are vampiric usurers. Avoidance exists because educated lawmakers, judges, and businessmen discover that it is frequently beneficial. In most cases, it is better to permit credit to flow at high rates than to dry it up by enforcing a restrictive and irrational usury ceiling. But there is a cost in avoidance. It encourages violation of at least the spirit of the laws and leads courts into esoteric or

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374. *Id.*

375. Collins, *supra* note 292, at 61.

376. Benfield, *supra* note 246, at 873.

377. *Id.*

378. *Id.*

379. Collins, *supra* note 292, at 65-66.

380. Twenty methods of avoidance are described in Comment, *A Comprehensive View of California Usury Law*, 6 SW. U.L. REV. 166, 198-221 (1974).

spurious distinctions. The businessman worries that a court may declare his avoidance technique illegal. Finally, evasion is not selective; it permits lenders to take advantage of unsophisticated borrowers just as much as it permits arms length negotiators to secure beneficial credit. Avoidance may be better than the application of some laws, but is clearly less desirable than a rational law of interest rates.

3. The Uniform Consumer Credit Code

By the 1960s, dissatisfaction with the hodge-podge of state laws governing consumer credit and increasing awareness of the abuses in creditor practices created a demand for a uniform code to regulate the area.[381] The National Conference of Commissioners on Uniform State Laws addressed the problem and, after several years of frequently bitter debate, proposed the Uniform Consumer Credit Code (U3C) in 1968.[382] The U3C was intended to displace the patchwork of existing regulations with a single comprehensive statute covering all forms of consumer credit, from installment sales and loans to advertising to collection.[383]

The U3C differs fundamentally from traditional American usury laws; its central premise is that free market competiton will control interest rates better than governmental price fixing.[384] The prefatory note points out that price controls are the exception, rather than the rule, in the American economy.[385] It proposes to foster competition rather than fix the cost of credit as usury laws had done.[386] The U3C repeals existing usury limits on commercial credit, leaving interest rates in business transactions entirely to market determination.[387]

To encourage free competition in the credit market, the U3C provides easy entrance to the market for new lenders. In contrast to the Uniform Small Loan Law, the U3C does not require a showing of substantial assets nor that the license would operate to the "convenience and advantage" of the public.[388] In order to facilitate "credit shopping" by consumers, the disclosure provisions of the federal Truth in Lending law were

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381. Benfield, *supra* note 246, at 873-74.

382. UNIFORM CONSUMER CREDIT CODE, Foreword (Official Text 1969) [hereinafter cited as U3C]; Shay, *The U3C, An Economist's View*, 54 CORNELL L. REV. 491, 491 n.1 (1969).

383. Miller & Warren, *A Report on the Revision of the Uniform Consumer Credit Code*, 27 OKLA. L. REV. 1, 2 (1974).

384. *Id.* at 5.

385. U3C, Prefatory Note, at XIX.

386. *Id.*

387. *Id.* § 9.103 & Comment.

388. *Id.* § 2.201 & Comment.

incorporated.[389] All fees and charges (except credit card, delinquency, insurance, and "official" fees) are computed into the finance charge.[390] Rate computation is unified, and the charge must be reported as an Annual Percentage Rate to prevent deceptive calculation.[391] Another provision prohibits misleading advertising.[392] It was thought that these measures would stimulate competition in the credit marketplace and lead to lower rates.[393]

The drafters felt, however, that consumers required special protection.[394] Therefore, at the same time that they tried to promote competition, they retained the traditional approach in the United States of setting ceilings in consumer transactions.[395] The Code applies only to consumer credit transactions of less than $25,000.[396] Mortgage loans at less than 10% are also exempted.[397] These loans are limited by a graduated schedule of rate ceilings, depending upon the amount and type of credit. The general ceiling on consumer credit is 18%.[398] Alternatively, creditors can charge up to 36% on the first $300 credit, 21% on the next $700, and 15% on the balance above $1000.[399] Special rates were set on revolving credit: 24% on the first $500 and 18% above that for sales.[400] The drafters did not intend to fix the cost of credit with these rates, rather, they were meant as the "outer limits" of permissible interest, below which enhanced market competition would set actual rates.[401]

The U3C requires licensing of lenders (but not retail sellers) who want to lend at rates over 18%.[402] It limits creditor remedies and restricts the use of the holder in due course doctrine to protect consumer defenses.[403] Enforcement is provided by a State Administrator[404] and by private legal

389. Harper, *The Uniform Consumer Credit Code: A Critical Analysis*, 44 N.Y.U.L. REV. 53, 59 (1969).

390. *See* U3C § 3.109(1). "Official fees" include fees prescribed by law and paid to public officials for determining the existence of or for perfecting, releasing, or satisfying a security interest. *Id.* § 1.301(10)(a).

391. *Id.* § 3.304 & Comment.

392. *Id.* § 3.312.

393. *See id.*, Prefatory Note, at XIX; Jordan & Warren, *The Uniform Consumer Credit Code*, 68 COLUM. L. REV. 387, 391 (1968).

394. U3C, Prefatory Note, at XX.

395. *Id.*

396. *Id.* §§ 2.104(1)(e), 3.104(1)(d).

397. *Id.* § 3.105.

398. *Id.* §§ 2.201(2)(b), 3.508(2)(b).

399. *Id.* §§ 2.201(2)(a), 3.508(2)(a).

400. *Id.* § 2.207(3).

401. *See id.*, Prefatory Note, at XIX-XX.

402. *Id.* §§ 3.501-.503.

403. *Id.* §§ 2.403-.404.

404. *See id.* art. 6.

action.[405]

The U3C proved to be quite controversial. It raised the limit on most types of consumer credit to 18%, higher than permitted by many existing state laws.[406] State legislators and consumer advocates distrusted the U3C's reliance on competition, fearing that inaction would cause rates to rise to this new limit.[407] Many felt the U3C otherwise weak in consumer protection, objecting to its provisions regarding holder in due course, repossession, debtor's remedies, and deficiency procedures.[408] A few businesses opposed the ease of access provisions, predicting that increased competition would hurt, not help, consumers.[409]

Others complained that credit sellers could easily evade the U3C rate restriction.[410] Certain types of retailers rely almost wholly on installment sales. These sellers, frequently dealing with low income consumers, can simply raise their cash price to yield additional profits without adjusting the rate charged for credit. Unlike other retailers, they do not care if the cash price is too high to make cash sales; that is not their business in the first place.[411] For all of these reasons, the U3C has not met with an enthusiastic reception. As of 1980, only nine states had adopted it.[412]

4. Arkansas—A Test Case for Usury

Amid the postwar erosion of general usury regulation, one state, Arkansas, reversed the permissive trend and reaffirmed its faith in the unified rate ceiling. Until 1952, the Arkansas experience with usury was fairly typical. The state had enacted usury limits when still a territory and retained them upon statehood.[413] After the Civil War, a new state constitution set no limit on permissible interest rates.[414] In the troubled economic atmosphere of the reconstruction, rates ran high; 24% was usual, and 60% was not uncommon.[415] The distress caused by these rates

405. *See id.* art. 5.

406. Miller & Warren, *supra* note 40, at 6.

407. Fritz, *Would the Uniform Consumer Credit Code Help the Consumer?*, 25 BUS. LAW. 511, 512 (1970); Lo Pucki, *The Uniform Consumer Credit Code: Consumer's Code—or Lender's Code?*, 22 U. FLA. L. REV. 335, 336-39 (1970).

408. Boyd, *The Revised Uniform Consumer Credit Code as a Replacement for Piecemeal Consumer Credit Legislation: The Arizona Context*, 18 ARIZ. L. REV. 1, 2-3 (1976).

409. Harper, *supra* note 389, at 61-65.

410. Shay, *supra* note 382, at 498-500.

411. *Id.* at 499.

412. Colorado, Idaho, Indiana, Kansas, Maine, Oklahoma, South Carolina, Utah, and Wyoming. Note, *supra* note 16, at 204 n.31.

413. Study, *supra* note 365, at 546-47.

414. *Id.* at 547.

415. *Id.*

was at least partly responsible for the drafting of a new constitution in 1874, which provided that: "All contracts for a greater rate of interest than ten percent per annum shall be void, as to principal and interest . . . ."[416]

In Arkansas, as in most states, courts had proved receptive to various avoidances of the usury law as long as they were not considered oppressive. Lenders augmented their income by service charges and compulsory insurance,[417] and credit sales were exempt under the time-price doctrine.[418] Although Arkansas did not enact small loan legislation, "Morris-Plan" bank lending was permited.[419]

The first sign that the state supreme court was re-evaluating its interpretation came with *Hare v. General Contract Purchase Corp.*,[420] in 1952. The plaintiff in *Hare* purchased a car on credit, paying a charge denominated as the "time-price differential" which exceeded the 10% usury limit.[421] The retailer immediately sold the contract to the defendant finance corporation.[422] Although upholding the contract (and others made prior to *Hare*), the Arkansas Supreme Court gave clear warning that it considered such charges as cloaks to mask usury and that they would receive close scrutiny in the future.[423] A series of subsequent decisions whittled away at the time-price doctrine.[424] In *Sloan v. Sears, Roebuck & Co.*,[425] the court found a "carrying charge" usurious, even though it involved no sale to a finance company. The court explained:

> [I]f we should hold that this contract is not usurious, it would be a precedent by which all the sellers of merchandise of every kind and description could add any amount to the cash price as interest, carrying charge, differential or what not, that those whom the Constitution and statutes were designed to protect would of necessity agree to pay. And Art. 19, § 13 of the Constitution would amount to nothing more than a scrap of paper.[426]

416. ARK. CONST. art. 19, § 13. This provision has remained unchanged since it was enacted in 1874. Note, *Preemption of Arkansas Usury Law*, 31 ARK. L. REV. 325, 327 (1977).

417. *Id.*

418. Study, *supra* note 365, at 549-50.

419. *Id.* at 555-57. For a discusion of "Morris Plan" banking, see notes 308-15 *supra* and accompanying text.

420. 220 Ark. 601, 249 S.W.2d 973 (1952).

421. *Id.* at 602-04, 249 S.W.2d at 974.

422. *Id.*

423. *Id.* at 609, 249 S.W.2d at 978. The court stated: "Buying at a credit price, as distinguished from a cash price, has largely disappeared in fact, but is being used as a cloak for usury in many cases by such words as 'time price differential,' or some other such language." *Id.*

424. *See* Rebsamen Motors v. Morris, 229 Ark. 483, 317 S.W.2d 141 (1958).

425. 228 Ark. 464, 308 S.W.2d 802 (1957).

426. *Id.* at 473, 308 S.W.2d at 808.

Lender avoidance was curtailed as well. Common techniques, such as required insurance, broker "commissions," and various incidental fees, had been permitted by the courts.[427] In 1951, a state statute expressly approved these devices.[428] The Arkansas Supreme Court, on first impression, declared this new statute unconstitutional in *Strickler v. State Auto Finance Co.*[429] Subsequently, the burden of proving that "hidden" charges were not interest was shifted to defendant. In *O'Brien v. Atlas Finance Co.*,[430] the court announced that, in the future, the paired deposit and loan contracts of the Morris Plan would be considered a single transaction subject to usury law.[431] Finally, Arkansas courts became more willing to find that Arkansas law governed the loan transaction whenever the loan was solicited in Arkansas or had other contacts with the state.[432]

Arkansas had returned to the unitary rate ceiling. Judicial enforcement of the spirit of the constitutional limit accomplished the change. Exceptions were abolished, evasions penetrated. Arkansas citizens, unlike those of other states, enjoyed the full benefits of unimpaired usury law.[433]

The 10% limit was quite effective in protecting the citizens of Arkansas from high rates. Many finance companies left the state, seeking greener pastures;[434] consequently, Arkansas is served by far fewer lenders than other states.[435] Those that remain can afford to make only the safest of loans, even though high insurance charges augment the 10% rate somewhat.[436] The lower income, higher risk borrower enjoys the fullest protection from usury: credit is simply unavailable to him.[437]

The impact on the state economy was prompt. The clearest examples occur in border regions where Arkansas businesses must compete with those of other states. Texarkana is a prime example. The town lies about one third in Arkansas and two-thirds in Texas—so Arkansas consumers can obtain higher rate credit within a few miles. In 1968, the Texas side

427. Study, *supra* note 365, at 552-53.

428. Act of Feb. 28, 1951, 1951 Ark. Acts 472-75 (repealed 1973).

429. 220 Ark. 565, 578, 249 S.W.2d 307, 313 (1952).

430. 223 Ark. 176, 264 S.W.2d 839 (1954).

431. *Id.* at 179, 264 S.W.2d at 841.

432. Study, *supra* note 365, at 558-59.

433. B. CURRAN, *supra* note 308, at 87.

434. Study, *supra* note 365, at 573.

435. Lynch, *Consumer Credit at Ten Per Cent Simple: The Arkansas Case*, 1968 U. ILL. L.F. 592, 615.

436. Study, *supra* note 365, at 575-76; Giles, *The Effect of Usury Law on the Credit Marketplace*, 95 BANKING L.J. 527, 539 (1978). There is some evidence that Arkansas banks experience very low delinquency rates, apparently because only the best credit risks are even considered. Study, *supra* note 365, at 584.

437. Note, *supra* note 16, at 216.

had 20 small loan companies; the Arkansas side one.[438] By 1970, the Texas side had 40 car dealerships while the Arkansas side had but five.[439] Comparable disparity existed in furniture and appliance dealers.[440] Texarkana, Arkansas became a depressed economic area in comparison with Texarkana, Texas. Evidence also suggests that Arkansas' usury protection has generated high prices.[441] The permissible charge does not cover credit costs in Arkansas. These costs must be offset by higher cash prices. Prices of household appliances in Arkansas are 2% to 5% higher than prices in comparable cities outside the state.[442] In effect, the cash purchaser subsidizes the credit department.

The virtue of credit abstention was not limited to consumers. Risk and venture capital also became scarce as large insurance and mortgage companies moved their investments to more profitable climes.[443] Thus Arkansas is a capital-poor state.[444] Its per capita income level is the second lowest of all the states.[445] Although this situation cannot be attributed entirely to the state usury laws, Arkansas does not appear to have shared in the prosperity of sun-belt states in recent years.

Nevertheless, the 10% constitutional limit remained popular with Arkansas voters. Testimony given before the Arkansas Constitutional Revision Study Commission illustrates the general attitude:

> I don't want you to forget the little man that has to go to the bank to borrow money. . . . Now . . . remove this ten percent business from the competition of Arkansas, you are subjecting the little man to being forced to where he has to pay unlimited . . . [rates]. . . . [Y]ou just simply can't hardly [sic] pay more than ten percent interest and survive.[446]

Another witness explained: "It seems to me that high interest rates are one of the social evils in this country. . . . Arkansas has always been an oasis in this desert—in the financial desert, and I say let's keep it that way."[447] Nevertheless, the Commission recommended amending the usury

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438. Study, *supra* note 365, at 582-83.

439. Note, *supra* note 16, at 217 n.88.

440. *Id.*

441. *See* Lynch, *supra* note 435, at 599-605.

442. *See id.* at 601.

443. Note, *supra* note 16, at 217.

444. Study, *supra* note 365, at 584.

445. Mitchell, *Usury in Arkansas*, 26 ARK. L. REV. 263, 315 (1972).

446. Study, *supra* note 365, at 585 (citing *Hearings Before the Arkansas Constitutional Revision Study Commission* 129 (Aug. 1967)).

447. *Id.*

provision of the state constitution.[448] In 1970, the legislature defeated the proposition.[449]

During the 1970s, rising interest rates caused severe shortages of business and agricultural capital in states with low usury ceilings. Since the Arkansas rate limit was part of the state constitution, amendment was difficult; Arkansas had to depend on federal action to relieve the situation.[450] Congress conducted studies showing the detrimental effects of restrictive usury limits on business[451] and in 1974 passed "emergency" legislation which preempted state laws regulating business and agricultural loans over $25,000.[452] This law affected only three states: Arkansas, Tennessee, and Montana.[453] The other states already had exceptions or legislation permitting business loans at higher rates.[454] The federal law permitted banks to charge up to 5% above the Federal Reserve discount rate on these loans.[455] The law was temporary, designed to provide time to make changes in state law. It expired in July of 1977.[456] Attempts to remove the restrictive limits went before the voters of Arkansas in 1974. The proposal to raise permissible rates on certain types of loans was easily defeated, receiving only 13% of the vote.[457]

Congress acted again, in 1979, to bail Arkansas out of its own muddle by extending the 1974 Act until 1981.[458] The proposal to raise rates again came before Arkansas voters in the 1980 election, and again it was defeated.[459] Apparently Arkansas will continue to be an "oasis" in the desert of high interest rates.

5. Usury Law—1980

a. *Federal Legislation*

During the winter of 1979-1980, the prime rate charged by the nation's largest banks rose to unusually high levels. The prime rate eventually

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448. *See* Mitchell, *supra* note 445, at 319.
449. *See id.*
450. Note, *supra* note 16, at 204-05.
451. S. REP. NO. 93-1120, 93rd Cong., 2nd Sess. 18-19, *reprinted in* [1974] U.S. CODE CONG. & AD. NEWS 6249, 6260-61.
452. Act of Oct. 29, 1974, Pub. L. No. 93-501, § 202, 88 Stat. 1558 (repealed 1977).
453. Note, *supra* note 416, at 332.
454. *Id.*
455. Act of Oct. 29, 1974, Pub. L. No. 93-501, § 202, 88 Stat. 1558 (repealed 1977).
456. *Id.* § 206, 88 Stat. 1560.
457. Note, *supra* note 416, at 328.
458. Act of Nov. 5, 1979, Pub. L. No. 96-104, 93 Stat. 789.
459. Figures released by Elections Division, Arkansas Secretary of State (to be published in DIVISION OF ELECTIONS, ARKANSAS SECRETARY OF STATE, STATISTICS ON 1980 GENERAL ELECTION (1981)).

reached 20% in April 1980, the highest level in the nation's history.[460] These record rates played havoc with state usury laws since even liberal statutes never envisioned prime rates so high.

Home mortgage lending, the major source of funds still covered by general usury laws.[461] became impossible when rates rose past the statutory limit. Some states provided special corporate usury rates above their general usury statute.[462] In these states, business loans became unavailable when rates rose above even this higher ceiling.[463] States were faced with the prospect of unemployment and loss of capital as loan funds dried up.

On December 28, 1979, Congress enacted Public Law 96-161,[464] temporarily pre-empting state usury limits for business and agricultural loans in order to give the state legislatures time to revise their regulations.[465] Upon expiration, it was replaced by Public Law 96-221[466] which continued the preemption in slightly altered form.[467] This Act permanently replaces all state usury limits on most home mortagages, substituting rate limits set by the Federal Home Loan Bank Board.[468] Business and agricultural loans over $1000 also are pre-empted by a federal rate ceiling of 5% above the discount rate on 90-day commercial paper at the district Federal Reserve Bank.[469] This provision expires on March 31, 1983.[470]

460. Wall St. J., Apr. 3, 1980, at 3, col. 1.

461. Benfield, *supra* note 24, at 857.

462. *E.g.*, ALA. CODE § 8-3(a) (1975) (repealed 1980).

463. Wall St. J., Mar. 10, 1980, at 4, col. 1.

464. Act of Dec. 28, 1979, Pub. L. No. 96-161, 93 Stat. 1233 (repealed 1980).

465. *Id.* §§ 201-202, 93 Stat. 1235-36.

466. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132.

467. *Id.* §§ 511-512, 94 Stat. 164.

468. *Id.* § 501, 94 Stat. 161-63. In keeping with the Arkansas tradition of holding the legal interest rate below rates prevailing in the rest of the country, the Arkansas Supreme Court orginally declared Section 501(a)(1) of the Act unconstitutional. McInnis v. Cooper Communities, Inc., No. 80-254, slip op. at 4 (Ark. Dec. 29, 1980). The rationale for the decision was that the Act did not pertain to the regulation of interstate commerce. *Id.* Thus, the court found that Congress was without authority to pre-empt the state's constitutional limit of 10%. *Id. See* notes 413-59 *supra* and accompanying text for a discussion of the limit.

Three justices dissented, stating that "regulation of the flow of money between the states" is clearly within the commerce clause. McInnis v. Cooper Communities, Inc., No. 80-254, slip op. at 5 (Ark. Dec. 29, 1980). Within two months, the original opinion was withdrawn and the holding reversed by a new opinion which stated: "Congress has the power to . . . preempt our usury laws as to those areas covered by the Act." McInnis v. Cooper Communities, Inc., [1981 Current Developements] FED BANKING L. REP. (CCH) ¶ 98,652.

469. Pub. L. No. 96-399, § 324(d), 94 Stat. 1648 (1980) (amending Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 511, 94 Stat. 164, which had set the minimum usury-free loan at $25,000). Section 511 currently allows 5% plus any surcharges, thus the rate may be substantially higher. Notably, the surcharge increase available under § 511 does not exist under other sections. *See, e.g.*, Depository Institutions Deregulation and Monetary Con-

All other loans made by federally insured state banks,[471] savings and loan associations,[472] and credit unions[473] are subject to a rate ceiling of 1% over the discount rate on 90-day commercial paper at the district Federal Reserve Bank or to state usury regulation, whichever is higher.[474] A state may opt out of the federal regulations by enacting legislation which "states explicitly and by its terms that such State does not want" the amendments made by these sections to apply with respect to loans made in that state.[475]

Thus, the federal legislation sets a series of floating limits which can rise or fall within the market interest rate. Although the rates set provided relief for some states with restrictive ceilings, there were still problems. When the prime rate hit 20%, the business and agricultural limit (5% over the appplicable discount rate of 16%) was 21%.[476] Only the bank's best customers can borrow at the prime rate, so the 21% limit still prevented many businesses from obtaining credit.[477]

The new limit of 1% over the discount rate pre-empts state limits which are lower.[478] A state bank may take advantage of either the new federal ceiling or its own state usury regulations, whichever is higher. During the first 10 months of 1980 the discount rate on 90-day commercial paper varied from 8.41% to 16.81%,[479] thus the federal ceiling for depository lenders varied from 9.41% to 17.81%. In most states, lenders can make consumer loans under existing state, retail sales, small loan, or installment loan acts at rates above the federal rate.[480] The federal law, in effect, sets the minimum general usury ceiling allowable unless states specifically opt out of the federal regulation.

b. State Laws—1980

All but four of the states retain a general usury statute setting a maxi-

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trol Act of 1980, Pub. L. No. 96-221, §§ 521, 524, 94 Stat. 164, 166.

470. Pub. L. No. 96-221, § 512, 94 Stat. 164.

471. *Id.* § 521, 94 Stat. 164-65 (codified at 12 U.S.C.A. § 1831d (1980)).

472. *Id.* § 522, 94 Stat. 165 (codified at 12 U.S.C.A. § 1730g (1980)).

473. *Id.* § 523, 94 Stat. 166 (codified at 12 U.S.C.A. § 1785g (1980)).

474. *See* notes 471-73 *supra*.

475. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 501(b)(2), 94 Stat. 162.

476. Wall St. J., Apr. 3, 1980, at 3, col. 1.

477. *Id.*

478. *Id.* at 28, col. 1.

479. 66 FED. RES. BULL. A3 (Nov. 1980); *id.* at A3 (Aug. 1980); *id.* at A3 (June 1980).

480. *See* notes 326-30 *supra* and accompanying text. Most states permit higher annual percentage rates in these areas through the use of "add-on" interest. *See* section II, *infra*, notes 27-31 and accompanying text.

mum permissible rate.[481] At the time of writing, the limits vary from 7% in Michigan to 21% in Rhode Island,[482] with 12% as the most common ceiling.[483] Despite its prevalence, the general usury ceiling retains very little importance. Home mortgages, the last important form of credit not generally excluded from its coverage,[484] are pre-empted by federal legislation.[485]

Every state except Arkansas has some provision permitting businesses to borrow at higher rates. In some states, the old "corporate exception" permits lending at rates above the general usury limit to corporations.[486] Many states set no limit on business loans[487] or loans over certain amount (frequently $100,000).[488] A few states set a separate, higher ceiling for corporations.[489]

Forty-nine states have some form of small loan law regulating consumer loans by finance companies.[490] Most statutes specify the maximum amount which can be lent, generally $600 to $3000,[491] although some go as high as $50,000.[492] All small loan laws regulate maximum charges on loans. The most common scheme is a multi-tiered scale, permitting 30% to 36% on the first several hundred dollars with decreasing rates on higher amounts down to about 18% on the last portion.[493]

Twenty-two states have special legislation permitting consumer lending by industrial (Morris Plan) banks.[494] The provisions vary considerably. Arkansas provides that interest may be charged on investment certificates, but leaves the rate at the 10% simple required by the state constitution.[495] A common tactic is to retain a low (6%-12%) rate ceiling, but

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481. *See* [1980] 1 CONS. CRED. GUIDE (CCH) ¶ 510. These states are Arizona, Maine, Massachusetts, and New Hampshire. *Id.*

482. *See id.*

483. *Id.* Nine states have a 12% ceiling: Connecticut, Hawaii, New Jersey, North Carolina, North Dakota, South Dakota, Vermont, Washington, and Wisconsin; Iowa and Pennsylvania have 12¼%. *Id.*

484. *See* Benfield, *supra* note 246, at 857.

485. *See* notes 460-80 *supra* and accompanying text.

486. *E.g.*, LA. REV. STAT. ANN. § 12:703 (West Supp. 1980).

487. *E.g.*, MO. REV. STAT. § 408.035(2) (Vernon 1969).

488. *E.g.*, MINN. STAT. ANN. § 334.01(2) (West Supp. 1979).

489. *E.g.*, CONN. GEN. STAT. ANN. § 37-9 (West Supp. 1980).

490. [1980] 1 CONS. CRED. GUIDE (CCH) ¶ 540.

491. *See id.*

492. OR. REV. STAT. § 725.030 (1979).

493. *E.g.* KY. REV. STAT. § 288.530 (Supp. 1980). Kentucky allows 3% per month on the first $600, 2% per month on the amount from $600-$1500, and 1½% per month on the amount from $1500-$2000. *Id.*

494. [1980] 1 CONS. CRED. GUIDE (CCH) ¶ 560; *see* notes 308-15 *supra* and accompanying text.

495. ARK. STAT. ANN. § 67-1004 (1947).

permit the use of "add-on" interest to effectively double the rate.[496] Some states having the U3C apply its provisions to industrial bank loans.[497]

About four-fifths of the states have special legislation governing installment loans to consumers.[498] These were enacted after the Depression to permit banking institutions to make consumer loans.[499] Installment loan laws permit lenders a higher rate than the general usury statute, either by setting a special rate or by permitting discounts or add-on interest.[500] The laws generally regulate duration of the loan, maximum amount, and what other charges may be made and specify which lenders can take advantage of the provisions.[501] The use of the loans is controlled largely by the maximum amount permitted. In states which set low amounts, such as $1500,[502] the laws act as small loan legislation with low rate ceilings. Most states either set a much higher maximum dollar limit, or no limit at all.[503]

Finally, most states have statutes regulating the banking industry, saving and loan institutions, and credit unions.[504] Frequently, these laws provide specific regulation of permissible loans and rates.[505] Some states also have special legislation controlling check-credit plans and credit cards.[506]

H. Conclusion

Usury has persisted in the law. No commercial society has proved capable of ignoring it, at least as a topic of debate, and most have operated with some form of rate regulation on some forms of loans even at their most non-restrictive periods. Perceptions of the problem have progressed, however, past the earliest periods of calumny and vilification against money lenders.

Today, usury laws appear to serve two principal objectives in the minds

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496. *E.g.*, Iowa permits 10% add-on. IOWA CODE § 536.A23 (1974).

497. *E.g.*, Colorado and Utah. [1980] 1 CONS. CRED. GUIDE (CCH) ¶ 560, at 1805.

498. *Id.* ¶ 570.

499. Crandall, *It Is Time for a Comprehensive Federal Consumer Credit Code*, 58 N.C.L. REV. 1, 6 (1979).

500. *See id.* The most common rate is 6%-8% add-on. *See* [1980] 1 CONS. CRED. GUIDE (CCH) ¶ 570.

501. *See* [1980] 1 CONS. CRED. GUIDE (CCH) ¶ 570.

502. *E.g.*, Nevada sets $1500. NEV. REV. STAT. § 55-662.165 (1979).

503. [1980] 1 CONS. CRED. GUIDE (CCH) ¶ 570. It is noted that Minnesota limits loans to $35,000, and that Alabama, Georgia, Idaho, Kentucky, Maryland, Montana, Nebraska, New Mexico, North Carolina, South Carolina, Tennessee, Texas, Vermont, and West Virginia have no provisions on the maximum allowed installment loans. *Id.*

504. Crandall, *supra* note 499, at 5.

505. *Id.*

506. *Id.* at 6.

of legislators. First, they are viewed as a protective measure imposed to safeguard consumers from abuse and exploitation by sellers of credit. To serve that function, rate ceilings should be set above the competitive market rates to allow free play of supply and demand, but sufficiently close to the upper limits of the competitive market such that the legal rate represents the line beyond which abuse occurs. In this context the proliferation of special laws and multiple rate ceilings make good sense, as legislators attempt to tailor usury provisions for distinct markets.

The second major function discernible from the history might be classified as a disclosure function, carried out over time by identifying and foreclosing many of the evasive tactics utilized to charge extra interest. The Truth in Lending Law, with its unitary annual percentage rate, stands as one recent example of the unification of offers by moneylenders. Arguably, the first function of the annual percentage rate is to prevent evasion by using a common denominator for expressing interest. The borrower can then select knowledgeably among competing offers and the tendencies the lender might have to increase profits by evading interest limits or hiding credit charges should be forestalled.

Arizona manifests virtually all of the historical currents swirling around usury law. Given the rapid rhythms of commerce that have characterized the state's development in the last generation, that should not surprise the reader. Most of the general discussion of usury policies and laws echoes repeatedly through Arizona's specific case. Arizona has come to occupy a place on a far end of the spectrum, however. As Arkansas has exerted extreme (and we would argue misguided) constancy to the concept of a usury statute strict in its application, Arizona has shown extreme flexibility in removing much of the bite from its usury provisions. Most often the legislature has moved to open new rate ceilings or provide exemptions. In other instances, the courts have proved benign agents of application of the law.

Where Arkansas' single-willed dedication to its constitutional provision takes on a majestic madness as its impact on the state economy shows, Arizona has moved always to avoid impact of its usury laws. Sometimes, circumstances overtake the law and impact inevitably results. We have attempted to identify and qualify some of those instances. More recently, however, Arizona has removed its usury limits in so wholesale a manner that it now ranks in the free market vanguard of the state schemes for regulation of the money market. It was not always so, although the state's progression to its present status assumes a certain pattern and logic. The next section will sketch that pattern and demonstrate the logic of Arizona's current approach to usury.

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