Vanderbilt Law Review

Volume 33
Issue 1 *Issue 1 - January 1980*

Article 6

1-1980

Usury Legislation - Its Effects on the Economy and a Proposal for Reform

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I. Introduction

Usury legislation historically has been the primary control imposed by states on the money market. The influence of such legislation on the operation of the money market has been particularly important in the 1970's because rampant inflation and steadily rising interest rates have caused the cost of borrowing money to approach and surpass the return permitted lenders by many states' usury laws.[1] At present, forty-seven states have general usury ceilings.[2] The degree of control placed on lenders, however, and thus the degree of impact on the credit market, differs dramatically among the states. Beginning in the late nineteenth century, American society became increasingly oriented to the widespread use of credit and debt financing. Today, leverage is often determinative of the success of a business venture. In addition, various methods of consumer credit have become routine practices and an integral part of many individuals' budgets.[3] In response to this, many states have been forced to amend their usury statutes to permit developing businesses and consumers to obtain financing. Many states, however, have not responded to this need or have not responded adequately and the usury ceilings remain important limitations on the availability of both business and consumer debt financing. This Note examines both the original and current purposes of general usury ceilings and evaluates the success of the ceilings in achieving these purposes. In addition, the Note considers the impact of the present form of usury legislation on the economy of those states that have such ceilings and proposes a model usury statute that attempts to accomplish the social policy objectives of the current legislation while also minimizing detrimental and unintentional effects on the economy.

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1. Giles, *The Effect of Usury Law On The Credit Marketplace*, 95 Banking L.J. 527, 527-28 (1978); Board of Governors of the Federal Reserve System, Federal Reserve Chart Book 72-73 (1979). This problem has accelerated rapidly in 1979 with the attempt of the Carter Administration to control inflation through significant increases in Federal Reserve rates. Time, Oct. 22, 1979, at 8.

2. National Consumer Finance Association, Summary of State Consumer Credit Laws and Rates (1979).

3. National Commission on Consumer Finance, Consumer Credit in the United States 5-21 (1972). This study documented that consumer credit outstanding rose from $21.5 billion in 1950 to $137.2 billion at the end of 1971. *Id.* at 5. *See also* Board of Governors, Federal Reserve System, Historical Chart Book 65-67 (1975).

II. Background

Most usury statutes in effect today can be traced to the American colonies, where legislative controls based on English precedent were adopted soon after the settlements' formation.[4] The controls were based on the historical view that certain definable evils arose out of the relationship of borrower and lender.[5] From before biblical times, the exaction of interest for the loan of money carried grave moral and religious connotations. The response to those views was the creation of a curious combination of legal and theological restrictions. The Romans considered money lending to be a dishonorable practice.[6] This view intensified during the early Christian era because of the Church's rigid opposition to the exaction of interest from a borrower.[7] Usury was deemed a sin and the fear of the practice weighed heavily on members of this Church dominated society. As the Church gained power, it imposed an absolute restriction on the practice.[8] The Church deemed interest charges sinful because it conceived of interest not as a profit-making device but more properly as a method to reimburse the lender for his loss or expenses in making the loan. In precommercial society, only destitute, oppressed persons who were forced to go into debt took out loans. Members of society with established livelihoods found it unnecessary to borrow and disapproved of voluntary debt. Consequently, charging interest for a loan was equated with taking advantage of impoverished members of society and deemed an unacceptable practice. These views continued in Europe throughout the Middle Ages and well into the Renaissance. As transportation, the money structure, and the European economy as a whole developed into a more complex commercial system, the prohibition on interest weak-

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4. Massachusetts adopted a legal maximum rate of eight percent in 1661 and Maryland a rate of six percent in 1692. The remainder of the colonies soon followed suit. These rates were a general legal maximum applying to all extensions of credit. S. Homer, A History of Interest Rates 274-75 (2d ed. 1977).

5. *See, e.g.*, R. Tyler, A Treatise on the Law of Usury 35-40 (1873).

6. Frierson, *Changing Concepts on Usury: Ancient Times Through the Time of John Calvin*, 7 Am. Bus. L.J. 115, 118 (1969).

7. *Id.* at 119-20. The Old Testament provides support for this view:

> He has lent on usury; he has taken interest; he shall surely not live . . . . He shall surely suffer death; his blood is upon him.
>
> *Ezekiel* 18:13.
>
> Thou shall not lend upon usury to thy brother; usury of money; usury of victuals; usury of anything . . . . Unto a stranger, thou mayest lend upon usury; but unto thy brother thou shalt not lend upon usury.
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> *Deuteronomy* 23:19-20.

Later, religious leaders interpreted brother to connote all people. Frierson, *supra* note 6, at 120. *See generally* S. Homer, *supra* note 4, at 71.

8. Frierson, *supra* note 6, at 119-29.

ened but the strong moral and religious objections remained. In 1545 under Henry VIII, England became the first of the modern European governments to adopt a legal maximum rate of interest.[9] This legislation differentiated between interest and usury as a question of degree. It shifted the focus of criticism from the taking of any interest to the exaction of unreasonable or excessive interest. By the seventeenth century, interest charges were considered an acceptable function of business as long as they were controlled by legislation. Thus, the American colonies inherited the belief that interest rates required strict control and in the late 1600's a six percent ceiling became the norm.[10] As settlers formed new states and wrote their constitutions and laws, they incorporated this standard. In rural areas, where agriculture rather than business dominated the economy, the ancient assumption that voluntary debt was sinful continued. Rural inhabitants believed that destitute and unfortunate persons were driven to borrow and needed protection from oppressive contracts with lenders who would take advantage of their necessitous condition.[11] In addition, usury legislation drew support in business communities because it was believed that setting the price of interest would insure the availability and affordability of credit.[12] The public and the credit industry voiced little objection to statutory ceilings when interest rates were low. As a practical matter, when rates were below the statutory ceilings, the statutes had no effect. Economic theorists, however, such as Jeremy Bentham in "Letters in Defense of Usury"[13] in the late 1700's, decried the absence of economic rationale for the legal restrictions. In the United States, Richard Henry Dana, Jr. delivered a speech based on Bentham's views to the Massachusetts legislature that persuaded that body to repeal all usury legislation in the state.[14] The drive to repeal

9. Hershman, *Usury and the Tight Mortgage Market,* 22 BUS. LAW. 333, 335 (1967). The law was entitled "A Bill Against Usury" and provided for maximum interest of ten percent. In 1713, the Statute of Anne was promulgated which lowered the ceiling rate to five per cent. This statute served as the model for the legislation enacted in the American colonies. *See also* R. TYLER, *supra* note 5, at 43-47.

10. *See* note 4 *supra* and accompanying text. The belief that six percent was the maximum reasonable interest rate and that any rate above that was usurious became firmly entrenched in the social and moral views of the American public. The vitality and longevity of this view is noted in Kripke, *Consumer Credit Regulation: A Creditor Oriented Viewpoint,* 68 COLUM. L. REV. 445, 446-47 (1968).

11. Shanks, *Practical Problems in the Application of Archaic Usury Statutes,* 53 VA. L. REV. 327, 329 (1967).

12. *Id.* at 328.

13. J. BENTHAM, *Defense of Usury,* in WORKS OF JEREMY BENTHAM (1843).

14. For a discussion of the address of Richard Henry Dana, Jr. to the House of Representatives of Massachusetts, see Shanks, *supra* note 11, at 330. *See also* F. RYAN, USURY AND USURY LAWS 60-62 (1924).

the statutes elsewhere, however, was short lived. In a similar speech in an unsuccessful attempt to persuade Congress to repeal the usury statute in the District of Columbia, Benjamin J. Danielle recognized that the lack of economic justification did not determine the outcome of this highly controversial issue:

> [I]nnovation in that branch of our laws would not be expected without difficulty. To attempt it would be to war upon one of the strongest legal prejudices of the country. Usury statutes are a fearful testimony of that power by which the superstition of a dark age may transmit its errors from generation to generation.[15]

Similarly, in his 1924 analysis of usury legislation,[16] Franklin Ryan concluded that there was no logical economic support for a general statutory ceiling on interest rates and that ancient prejudices concerning usury prohibited the honorable and decent lender from employing his capital for his and his borrower's advantage.[17] Despite this almost uniform criticism of general ceilings by economists, most states chose to create exceptions to, rather than repeal, their usury laws.

Beginning in the early twentieth century, the vast majority of state legislatures adopted special consumer credit laws that regulate particular types and amounts of loans and often remove them from the coverage of the usury laws.[18] The credit regulations promulgated by the states vary greatly; critics label them a confusing maze of overlapping regulations resulting from the piecemeal approach taken by the legislatures in response to particular demands.[19] The first such consumer credit legislation considered and adopted by numerous states was modeled on the Uniform Small Loan Law.[20]

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15. Address by Benjamin J. Danielle to Joint Committee of the Senate and House of Representatives on the District of Columbia, *reprinted in* Shanks, *supra* note 11, at 331.

16. F. RYAN, *supra* note 14.

17. *Id.* at XVI-XVII. Ryan states: "The business world's problem of getting rid of the old usury laws will still persist. The impossible, unreasonable general statutory maximums which can never have any power over the market rate of pure interest, still remain, like dead timber in a forest, to obstruct the progress of business." *Id.* at XVII.

18. B. CURRAN, TRENDS IN CONSUMER CREDIT LEGISLATION 1-4 (1965). Curran provides a detailed analysis of the growth and form of consumer credit legislation.

19. *Id.* at 1-4, 131. Benfield, *Interest Ceilings and the Uniform Consumer Credit Code*, 56 A.B.A.J. 946, 946 (1970). As an example, Benfield cites Illinois, which at that time had an installment loan act, an installment loan law, a consumer finance act, a revolving loan and credit law, an insurance premium financing law, a motor vehicle installment sales act and an "other goods" installment sales act. He noted that each act had different maximum rate provisions and other arbitrary differences. *Id.* Illinois also has a general usury ceiling setting maximum interest at eight percent. ILL. ANN. STAT. ch. 74, § 4(1) (Smith-Hurd Supp. 1979).

20. *See generally* B. CURRAN, *supra* note 18, at 15-45; L. ROBINSON & R. NUGENT, REGULATION OF THE SMALL LOAN BUSINESS (1935); Hubachek, *The Development of Regulatory Small Loan Laws*, 8 LAW & CONTEMP. PROB. 108 (1941).

Originally promulgated in 1916 by the Russell Sage Foundation, a charitable institution, the model law was seen as a social cure for the growing problem of the loan shark business. Under the usury laws, legitimate lenders could not feasibly make small loans to the growing class of wage earners who could only offer income from their jobs as security. Loan sharks acting outside the law filled this need but utilized abusive techniques and charged exorbitant rates.[21] The model statute attempted to address the problem by permitting certain approved and licensed lenders to charge higher than the legally permitted rate. In return for this privilege the participating lenders, usually personal finance companies, agreed to abide by state regulations. The statute covered loans of up to $300, permitted an interest rate of up to three and one half percent per month on unpaid principle,[22] and contained numerous provisions designed to protect the small borrower.[23] The model act was received very favorably. By 1941, thirty-five states had adopted it or a variation based on it. Today Arkansas is the only state without such legislation.[24] Later, many states adopted other legislation providing special regulation for certain types of loans and borrowers. These special statutes established new rate ceilings for particular loan types and exempted the transactions from the coverage of the general usury statute. The most common examples are statutes regulating the practices of pawnbrokers, credit unions, and installment sales finance companies. Many states also adopted special statutes providing for bank installment loan regulation.[25] Because of the narrow purpose and limited scope of each statute, the control imposed frequently gives rise to inequitable results.[26]

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21. Nugent, *The Loan-Shark Problem*, 8 L. & CONTEMP. PROB. 3, 5-6 (1941). *See generally* Birkhead, *Collection Tactics of Illegal Lenders*, 8 L. & CONTEMP. PROB. 78 (1941).

22. Neifield, *Institutional Organization of Consumer Credit*, 8 L. & CONTEMP. PROB. 23, 26 (1941). Later drafts of the uniform act lowered the permissible monthly rate to three percent for the first $100 and two percent for the excess up to $300. B. CURRAN, *supra* note 18, at 22.

23. Hubachek, *supra* note 20, at 117-18. These provisions included: prohibitions against deceptive advertising, against liens on real estate, against confessions of judgment or powers of attorney, disclosure requirements for interest charges and all essential terms of the loan, and limitations of ten percent on assignment of future wages. *Id.*

24. B. CURRAN, *supra* note 18, at 16. In Arkansas, the ten percent usury rate is in the State constitution and the legislature is powerless to promulgate a small loan law that allows rates higher than this ceiling. The state formerly had such a law, but the Arkansas Supreme Court found several of its provisions unconstitutional in 1952, and the law was repealed in 1953. *Id.* at 26.

25. *See generally* B. CURRAN, *supra* note 18; Johnson, *Regulation of Finance Charges on Consumer Installment Credit*, 66 MICH. L. REV. 81 (1967).

26. The problem is determining in each state whether a specific statute covers a particular transaction or whether it is controlled by the general usury law. Because the statutes were promulgated to regulate particular types of transactions and lenders, there is often very

In the late 1960's, criticism of the inconsistencies and complexity of the web of state consumer credit legislation resulted in a drive to formulate a uniform consumer credit law, analogous to the Uniform Commercial Code, to address the problem of consumer credit on a comprehensive basis. The proposed Uniform Consumer Credit Code[27] emphasized regulation of credit practices while allowing competition and a reasonable rate of return to lenders.[28] The basic interest rate ceilings proposed were thirty-six percent for loans of $300 or less, twenty-one percent for loans of $300-1,000, fifteen percent for loans greater than $1,000 or an alternative comprehensive eighteen percent overall usury ceiling.[29] The Code contained extensive measures regulating credit practices for borrowers' protection as well as administrative measures to enforce the provisions.[30] Legislative reception of the Code, however, has not been overwhelming. Only nine states have adopted it since its proposal in 1969.[31]

In 1974, Congress considered the problems caused by overly restrictive regulation of interest rates in some states and preempted state usury laws with regard to certain loans made by certain lenders. Based on studies outlining the detrimental effects of general maximum ceilings on interest rates for business credit in three states that had no exceptions to their usury ceilings for business loans,[32] Congress passed legislation freeing certain lenders of large business loans from low local usury ceilings.[33] The law permitted national banks and federally insured state chartered banks and savings and loan associations to charge interest on business and agri-

different and sometimes unjust treatment of different loans based on whether they fall within a particular law. Thus, an individual who borrows $5,000 to purchase an automobile might be subject to one interest rate regulation whereas if he borrowed the money solely as a personal loan he might be subject to another, possibly lower rate.

27. Jordon & Warren, *The Uniform Consumer Credit Code*, 68 COLUM. L. REV. 387 (1968).

28. *Id.* at 394-95. The UCCC adopts the traditional pattern of existing legislation by incorporating interest rate ceilings. It emphasizes, however, that they play a secondary role in its operation. Its primary method of consumer protection is regulation of credit procedures to prevent oppressive lending practices. At the same time, it emphasizes the protective benefits to the consumer of competition and as a result eliminates entry barriers to potential lenders and provides measures for disclosure to borrowers. *Id.*

29. *Id.* at 401.

30. Benfield, *supra* note 19, at 947. These provisions include: prohibition of confession of judgment and waiver of defense clauses, restrictions on wage assignments and garnishments, prohibitions of deficiency judgments in small credit sales, and a general authorization to obtain injunctions against unconscionable selling, lending or collection practices. *Id.*

31. NATIONAL CONSUMER FINANCE ASSOCIATION, *supra* note 2. These states are Colorado, Idaho, Kansas, Oklahoma, Indiana, Maine, South Carolina, Utah and Wyoming.

32. These states were Arkansas, Tennessee and Montana. S. REP. No. 93-1120, 93d Cong., 2d Sess., *reprinted in* [1974] U.S. CODE CONG. & AD. NEWS 6249, 6259-60.

33. Act of Oct. 29, 1974, Pub. L. No. 93-501, 88 Stat. 1557 (1974).

cultural loans in the amount of $25,000 or more, regardless of any state constitutional or statutory provision, at a rate of up to five percent in excess of the discount rate in effect at the Federal Reserve Bank for the district in which the institution is located.[34] The law expired in July, 1977, but similar legislation, although limited in its application to Arkansas, was enacted in November, 1979 providing temporary relief for that state from its constitutional interest rate restrictions.[35] In December, 1979, Congress enacted legislation temporarily preempting all states' interest rate restrictions on business and agricultural loans greater than $25,000. In their place, Congress substituted a federal standard permitting interest charges up to a maximum of five percent in excess of the federal discount rate.[35.1] The law applies only for a six month period ending July 1, 1980, after which the state restrictions come back into effect. In addition, the legislation includes provisions preempting state restrictions on interest rates for residential loans and mortgages for a three month period ending March 31, 1980.[35.2] The legislation was passed in response to fears about the impact on the credit market of the intersection of many states' usury ceilings and the high interest rates resulting from Federal Reserve policy. It is important to note, however, that the federal legislation is only a temporary remedy for the problems caused by present state usury statutes. On its expiration, the state ceilings will again be in effect.

General statutory usury ceilings are still in existence in the majority of states and there is no indication that they will soon be abandoned. Despite the many exceptions to their coverage, these ceilings still constitute a significant control on the cost and availability of credit to prospective borrowers. In the 1970's the state of the United States economy caused interest rates to approach and surpass the rate permitted by the usury statutes of many states. During the period that the usury ceilings were actually in force, it became possible to judge their effectiveness in carrying out the legislative purposes and to gauge their impact on the economy.

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34. *Id.* The Act, in effect, substitutes a sliding scale standard for loans by lenders that meet the statutory criteria in states where these loans would not be permissible under existing usury legislation.

35. Act of Nov. 5, 1979, Pub. L. No. 96-104, [1979] FED. BANKING L. REP. (CCH) ¶ 58,900. The legislation applies only in those states with constitutional provisions limiting interest to ten percent and has an expiration date of July 1, 1981.

35.1. Act of Dec. 28, 1979, Pub. L. No. 96-161, [1979] FED. BANKING L. REP. (CCH) ¶ 98,080.

35.2. *Id.* The legislation only applies to loans secured by a first lien on residential real property or by a first lien on stock in a residential cooperative housing corporation.

III. Statutory Forms and Exemptions

At present, the great majority of the states have some form of usury ceiling in effect. These statutes vary greatly among states in their terms, scope of application, degree of regulation, provisions for enforcement, and penalties for violation. Because of the historical precedent discussed above,[36] however, the statutes share a fundamental approach and methodology; all consist of a general statutory provision limiting return to a fixed percentage of principal. Each law addresses the usury problem by regulating loan rates rather than the lenders' methods of making loans. Many of the statutes do not differentiate among the many variables that determine the cost of credit, such as loan amounts, loan purposes—business or personal, consumption or production, or administrative costs. More importantly, the majority of statutes do not consider two key elements of every loan: first, the degree of the borrower's sophistication or bargaining power and second, the degree of risk assumed by the lender in making the loan. Consequently, in many cases the statutes provide the same degree of protection for an experienced businessman as for an uneducated welfare mother. They contemplate that the lender will charge the same rate of interest to a borrower of a fully collateralized loan as to a borrower who puts up no security.

Because of the large number of variations among the states on the basic statutory ceiling, this Note will discuss only a representative sample of the statutes and the most common exceptions to their coverage. Banking and other business interests continually have requested the states to repeal the general statutory ceilings. Although all but a few have refused to repeal the legislation, the majority of the states have created exceptions to the coverage of the statutes and, as a result of the recent rise in interest rates, adjusted the ceiling upward.[37] In many states a general statutory ceiling applicable to all loans remains in effect, but the maximum rate differs tremendously from state to state.[38] Establishing the maximum rate is merely a question of line drawing that requires a legislative deter-

36. *See* note 9 *supra* and accompanying text.

37. Massachusetts repealed its usury law in 1868. *See* note 14 *supra* and accompanying text. New Hampshire repealed its law in 1921. *See* F. Ryan, *supra* note 14, at 91. Several states have recently abandoned the fixed statutory ceiling in favor of the sliding scale approach and the Uniform Consumer Credit Code. *See, e.g.*, Alaska Stat. § 45.45010(b) (Supp. 1979) (five percentage points over the discount rate charged by Twelfth Federal Reserve district). *See* notes 104-106 *infra* and accompanying text. New York recently raised its usury ceiling from 8.5% to 9.5%. *New York's Usury Ceiling Raised After 5 Years of Inaction*, 100 Sav. & Loan News 16 (1979).

38. Compare the statutory ceiling in Pennsylvania, six percent, with the ceiling in Rhode Island, twenty-one percent.

mination of the point at which interest rate charges become impermissibly high and thus usurious. Several states set the ceiling rate relatively high, permitting a greater margin in which freedom of contract and the unregulated credit market can function. In other states, the ceiling rate is set at or below the market rate. The broadest and most restrictive type of usury statute recognizes no exceptions to the regulation. The following discussion[39] will demonstrate that these laws, when effective, have the most detrimental impact on the economy.

An interesting variation in many statutes is a special exception for residential mortgage loans. These exceptions include provisions excluding VA-FHA loans,[40] exempting Savings and Loan Associations,[41] providing special higher rates for realty mortgages,[42] and eliminating limitations on conventional home loans.[43] Because home mortgage loans are generally fully secured by real estate, the lender assumes less risk than when making general consumer loans. Consequently, there is a more constant market rate and less opportunity for taking advantage of a naive borrower. In addition, legislatures probably view the fact that the borrower is in a financial position to purchase a residence as a sign that the borrower possesses a sufficient level of sophistication and bargaining ability so that he does not require state protection. From a practical viewpoint, because of the propensity of Americans for single family home ownership, the great demand for mortgage money by consumers and the political pressure created thereby probably had some effect on legislatures' decisions to promulgate these exceptions.

A second common exception, the most important in terms of volume of loans made, provides for less restriction on business credit. Four methods are utilized and often combined in a single statute: first, corporations are denied the defense of usury;[44] second,

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39. *See* notes 84-91 *infra* and accompanying text.

40. *E.g.*, ALA. CODE § 8-8-6 (1975); IOWA CODE ANN. § 682.46 (West 1946). Some state statutes contain two or more of these exemptions.

41. *E.g.*, FLA. STAT. ANN. § 665.395 (West Supp. 1979); ME. REV. STAT. ANN. tit. 9-B, § 432.2 (1978). *See generally* B. CURRAN, *supra* note 18, at 60-64.

42. OHIO REV. CODE ANN. § 1343.01(4) (Page Supp. 1978); OR. REV. STAT. § 82.010(6) (1977).

43. *E.g.*, CONN. GEN. STAT. ANN. § 37-9 (West Supp. 1979); MICH. COMP. LAWS § 438.31(c)(2) (Supp. 1979-80); VA. CODE § 6.1-330.37 (1979).

44. The first corporate exception statute was enacted in New York in 1850. 1850 N.Y. Laws, Ch. 172, § 1 (now N.Y. GEN. OBLIG. LAW § 5-521 (McKinney 1978)). The amendment to the usury ceiling was promulgated in response to a New York Court of Appeals decision, *Dry Dock Bank v. American Life Ins. & Trust Co.*, 3 N.Y. 344 (1850), in which a company that had been saved from bankruptcy by a loan made at a crucial time, avoided the repayment of $250,000 principal plus interest on the basis that the contract was usurious.

different rates are applied for loans to individuals and to businesses;[45] third, if the loan exceeds a certain amount there are no restrictions on interest rates;[46] and, last, in some states corporations receive a complete exemption from interest rate limitations.[47] The basis for these exceptions is both theoretical and practical. The exceptions reflect a recognition that the usury laws are aimed at protecting poor individual consumers rather than large corporations that routinely rely on highly sophisticated leveraging techniques to maximize their rate of return. These exceptions thus are an admission that the lines of protection of the all inclusive statutory ceiling were drawn too broadly for the relevant public purpose of controlling usurious loan transactions. Inherent in this recognition is the determination that large businesses, at least those that opt for the corporate form,[48] possess sufficient bargaining competence to fend for themselves in the credit marketplace. Many legislatures chose to draw the line of exclusion at incorporation. Presumably these legislatures have concluded that an entity possessing adequate business acumen or access to legal advice to opt for statutory incorporation does not need protection from its mistakes in the credit marketplace. Another consideration, the most important for purposes of usury law reform, revealed by these exceptions is the perhaps unconscious acceptance by legislatures that establishing an interest rate ceiling does not control the actual market price of credit.[49]

45. Mississippi's usury law provides generally for a ten percent ceiling for loans, but for loans over $250,000 to partnerships and over $2,500 to corporations there is a fifteen percent ceiling. MISS. CODE ANN. § 75-17-1(5)(3) (Supp. 1978). Similarly, Illinois' usury law applies a general eight percent ceiling on loans to individuals but places no limits on business loans. ILL. ANN. STAT. ch. 74, § 4 (1)(a), (c) (Smith-Hurd Supp. 1979). *See also* ARIZ. REV. STAT. ANN. §§ 44-1201, 1209 (Supp. 1979-80); MO. REV. STAT. §§ 408.030, 408.035(1), (2) (Supp. 1979).

46. Pennsylvania's usury law, for example, provides a six percent ceiling on loans to individuals and to unincorporated businesses and no limits on loans to corporations. For loans greater than $10,000 to unincorporated businesses and greater than $50,000 to individuals, there is no rate limit. 41 PA. CONS. STAT. ANN. §§ 201, 301(f) (Purdon Supp. 1979-80). Nebraska exempts from its usury law loans to corporations and loans greater than $100,000 to individuals and unincorporated businesses. NEB. REV. STAT. §§ 45-101.03, 101.04(2), (4) (1978).

47. *E.g.*, LA. REV. STAT. ANN. § 12:703 (West Supp. 1979); N.D. CENT. CODE § 47-14-09 (Supp. 1979); OHIO REV. CODE § 1701.68 (Page 1978).

48. The exemption of corporations from usury laws generally meets with approval but is often criticized as being too narrow in its scope. *See* notes 101-03 *infra* and accompanying text. For a consideration of the abuses of the corporation exception, see Note, *Stemming Abuses of Corporate Exceptions From the Usury Laws: A Legislative and Judicial Analysis*, 59 IOWA L. REV. 91 (1973). This Note considers whether the purpose of usury laws to protect the individual borrower is being circumvented in many states because of the ease of incorporation.

49. *See* notes 61-66 *infra* and accompanying text.

IV. Purposes of Usury Legislation and Success of the Present Statutory Form

Before turning to the impact on the economy of an effective usury ceiling, it is advantageous to examine more closely the purposes and asserted social and economic support for the statutes. The ancient ethical and religious views outlined above served as the original basis for regulation of interest rates. It was believed that public protection through regulation was necessary for the poor oppressed borrower who was forced by circumstances to go into debt and to place himself at the mercy of unscrupulous lenders. Although public attitudes toward consumer debt have changed dramatically, many of the ancient prejudices toward lenders have survived.[50] These views, coupled with an increasing distrust of all "big business," have made legislatures hesitant to repeal the restrictions. In recent years, supporters of interest rate legislation have aligned their cause with the popular trend toward consumerism. As a consequence, the legislation has assumed renewed relevance and support among consumer advocate groups. Instead of relying solely on moral and ethical grounds, today's arguments are couched in terms of inequalities of bargaining position between the parties resulting in unconscionable interest rates and profits.[51] These arguments state that in today's highly complex credit market borrowers are often unsophisticated about credit and its costs. In their desire and need for the loan proceeds, these borrowers will enter contracts unaware

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50. National Commission on Consumer Finance, *supra* note 3, at 5-6. Despite this tremendous growth and acceptance of consumer credit—or perhaps because of it—public opinion of lenders, in contrast to other businessmen, is often not favorable. Milton Friedman, in a 1970 magazine article entitled "Defense of Usury," quoted the following statements on the prejudices against lenders made by Jeremy Bentham in 1787 and reaffirmed their present validity:

> The business of a moneylender . . . has no where, nor at any time, been a popular one. Those who have the resolution to sacrifice the present to future, are natural objects of envy to those who have sacrificed the future to the present. The children who have eat their cake are the natural enemies of the children who have theirs. While the money is hoped for, and for a short time after it has been received, he who lends it is a friend and benefactor: by the time the money is spent, and the evil hour of reckoning is come, the benefactor is found to have changed his nature, and to have put on the tyrant and the oppressor. It is an oppression for a man to reclaim his own money; it is none to keep it from him.

Newsweek, Apr. 6, 1970, at 79.

The folklore of the rapacious lender who is eager to repossess or foreclose at the first indication of default and to obtain huge profits without concern for the debtor is considered in Kripke, *supra* note 10, at 448-51. The author notes that the "self-interest of business alone makes the writer disbelieve that credit grantors of substantial size, with reputations to protect in the financial world, walk into specific credit-granting situations knowing that where will be a collection problem to sweat out." *Id.* at 449.

51. Oeltjen, *Usury: Utilitarian or Useless?*, 3 Fla. St. L. Rev. 167, 206-07 (1975).

of the extent of their contractual obligations and the actual or "effective" interest costs of the bargain. In some sectors of the population, studies indicate a high degree of insensitivity to changes in interest rates.[52] Often, a more important consideration than total interest costs for consumers with short term goals is the amount of the monthly payment.[53] In contrast, lenders are highly knowledgeable and skilled in the operation of the credit market. The proponents of usury legislation assert that lenders are adept at designing bargains that appear acceptable to the inexperienced consumer, but whose effective cost is an unreasonable rate of return. As a result, the parties occupy highly unequal bargaining positions. Based on this inequality, advocates of usury legislation argue that the state should step in and exercise its police power to protect the consumer.

Another theoretical basis in support of the present form of usury legislation is the view that the credit market, unlike the great majority of markets for other goods and services in this country, does not function efficiently if regulated solely by competition.[54] Supporters of this view assert that because the operation of the credit market is imperfect, borrowers do not pay a fair price. This imperfection stems from the inability of consumers to choose rationally among credit options because of their inherent complexity.[55] Consequently, the demand for credit is highly inelastic; variations in price do not affect the level of demand.[56] A second asserted imperfection is the tendency for local credit sources to obtain and exert monopolistic power in their particular market area.[57] In light of these market flaws, supporters contend that only government regu-

52. *E.g.*, Due, *Consumer Knowledge of Installment Credit Charges,* 20 J. MARKETING 162 (1955). *See also* Juster, *Consumer Sensitivity to the Price of Credit,* 19 J. FIN. 222 (1964). Juster finds it necessary to qualify the traditional view represented by Due that consumers are unresponsive to changes in the finance rates. He states: "[C]onsumers appear to be unresponsive to finance rates because they do not have access to anything like a perfectly competitive capital market. The closer capital markets come to this analytical ideal, the more sensitive will consumers be to the costs of funds." *Id.* at 233. For the methods in the Uniform Consumer Credit Code to bring about a more competitive capital market, see note 28 *supra* and accompanying text. *See also,* F. Juster & R. Shay, Consumer Sensitivity to Finance Rates: An Empirical and Analytical Investigation (National Bureau of Economic Research, Occasional Paper 88, 1964); Mandell, *Consumer Perception of Incurred Interest Rates: An Empirical Test of the Efficacy of the Truth-in-Lending Law,* 26 J. FIN. 1143 (1971) (a study of the effects on consumer sensitivity of disclosure under the Truth-in-Lending Law); Parker & Shay, *Some Factors Affecting Awareness of Annual Percentage Rates in Consumer Installment Credit Transactions,* 29 J. FIN. 217 (1974).

53. *See, e.g.*, Due, *supra* note 52, at 165; Shay, *The Price of New Automobile Financing,* 19 J. FIN. 205, 219-20 (1964).

54. *E.g.*, Johnson, *supra* note 25, at 89-97; Jordan & Warren, *supra* note 27, at 388-92.

55. *See* notes 52-53 *supra* and accompanying text.

56. Jordan & Warren, *supra* note 27, at 391.

57. Johnson, *supra* note 25, at 95-97.

lation will insure fair prices of credit for consumers.

One method to accomplish this regulation and the method adopted almost universally by the states is enactment of maximum interest rates. Supposedly this measure protects the borrower from exploitation while insuring the availability of credit at a reasonable rate. Implicit in the view of supporters of the present form of usury legislation is the idea that lenders have a social duty to provide credit at a reasonable rate to consumers. Government is charged with enforcing this social duty through its regulation of the interest rate.[58]

It is not disputed that the legislative objectives for usury laws, protecting the consumer and providing credit for public consumption at a fixed reasonable rate, are valid and commendable public purposes and proper subjects for government regulation.[59] The issue, however, is whether these public purposes are achieved by the present legislation and whether the benefits produced are worth the societal costs. It is necessary to evaluate the present system both from an economic viewpoint to determine its efficiency in achieving its objectives, and from a social viewpoint to determine the value of the achievement realized.[60]

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58. This view was recently espoused in an editorial in a Tennessee newspaper during the legislative hearings in that state on raising the interest rate from the constitutional ten percent maximum:

> It may not have fully dawned yet on some legislative members that they now are the regulators of the state's lending institutions, or that they have a heavy duty to protect the public by making sure those institutions serve the needs of those who borrow money.
>
> . . . .
>
> Traditionally the interest rate limit was locked into the state Constitution, saving legislators the burden of becoming bank regulators. The 10% rate was fixed in the Constitution on the theory that it was immoral to deprive a borrower of more than 10% of the principal in repaying a loan. Usury—the practice of charging an unconscionable rate of interest—is a crime. Interest rates, then, are a moral as well as legal question.
>
> . . . .
>
> [T]he real issue the legislature is dealing with is how much interest the industry should be allowed to charge by law.
>
> The Senate . . . should look first at the plight of the borrowing public and weigh just how much a borrower can afford to pay in interest rates during a period of punishing inflation. Then senators should evaluate the profit and earning records lending institutions have enjoyed.
>
> . . . .
>
> [T]here is no reason why Tennessee's lending institutions are entitled to a special profit mandated by state law.

The Tennessean, Apr. 3, 1979, at 12, col. 1.

59. Munn v. Illinois, 94 U.S. 113 (1876), affirmed the constitutional power of the states to regulate property that the owner devotes to a use in which the public has an interest.

60. *See* notes 120-24 *infra* and accompanying test. Ryan, in his consideration of the problems of usury laws, emphasizes the importance of this two-tiered evaluation:

A. *The Effect of Usury Ceilings on the Economic Function of Interest Rates*

To gauge the effectiveness of the present system of usury legislation, it is necessary to examine the economic function of interest rates in the credit market. Interest is the cost imposed on a borrower for the present use of capital over a specified period of time. This cost, like the cost of other goods and services, is a function of the intersection of the demand for credit with the supply in the credit marketplace. Unlike other goods and services, the price of which is paid in full at the time of the exchange, the cost of credit includes the element of uncertainty of non-repayment of both principal and interest. This element of uncertainty is a cost that lenders must consider in establishing the rate for a particular loan. Consequently, the calculation of market rate includes a base charge of the cost of "riskless" credit and additional charges sufficient to cover the risk expense.[61] When the market rate for credit for a particular transaction is below the usury ceiling, the statute has no effect because market forces determine the cost of the credit.[62] When the market rate exceeds the ceiling and the transaction is not exempted, however, lenders are unable to earn the market determined return on loans made. Consequently, these lenders have no incentive to lend because a market analysis reveals that there is either no profit or less than market return to be earned from the transaction. The

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> There exists within the bounds of the science of jurisprudence, an inarticulate evolving body of economic thought, apart from but parallel to the systems as developed by the economists. It is to be found in legislative acts and in court dicta and decisions. This field of thought might be called "juristic economics." Whether society ought to establish statutory maximums for loan charges is much more than a question in the theory of interest. It is a problem touching not only the domain of economic theory, but also the fields of jurisprudence and governmental science. Usury laws exist today because the juristic theory of a usury law is sound. If this were not so, the laws would not he on the statute books of forty-three sovereign states. The economist who says that the typical American usury law is merely an evidence of the American legislator's ignorance of economic principles, might well consider whether he has fully grasped the juristic theory upon which a usury law is based.

F. RYAN, *supra* note 14, at XI.

61. NATIONAL COMMISSION ON CONSUMER FINANCE, *supra* note 3, at 139-47. Generally, the administrative costs of lenders are relatively fixed and unrelated to the amount of credit extended. The risk assumed by the lender and the related charge that he imposes, depend on the terms of the loan and the characteristics of the borrower. *See* notes 69-71 *infra* and accompanying text. *See generally* G. KAUFMAN, MONEY, THE FINANCIAL SYSTEM, AND THE ECONOMY 127-28, 151 (1973); C. PRATHER, MONEY AND BANKING 76-80 (1969).

62. J. VAN HORNE, FINANCIAL MARKET RATES AND FLOWS 220 (1978). Proponents of an unregulated market point to the fact that competition in the free market, not usury statutes, has historically kept interest rates well below the statutory maximum. They also assert that states that have exempted corporations from the usury regulations have not experienced unreasonable interest rates for business credit.

practical result is that less credit is available on the controlled market.[63] Lenders with flexible portfolios will choose to invest in uncontrolled investments or loan in states without effective usury restrictions.[64] When earnings fall below the market return other lenders whose investment opportunities are less flexible may be forced to cut back or even cease lending.[65] To the extent that lenders invest out of state, this credit leaves the state economy while other funds become tied up in uncontrolled investments and are thus unavailable to borrowers. At the same time, because of the lower than market rate, demand for credit will be artificially high and will increase competition for the available funds. Some of these additional borrowers will be consumers who would not have borrowed had the interest rate been at market rate.[66] Consequently, the impact of effective usury ceilings on the supply of regulated credit available to consumers is significant.

In addition, usury ceilings affect the distribution of the remaining available credit. Interest rates, the cost of credit, perform a rationing function similar to the cost of other goods. The rate determines the allocation of a scarce resource, credit, by establishing the level of demand for the credit among competing consumers.[67] The cost of credit established by these market forces presents consumers with a choice that is exercised by bidding with dollars. Depending on their resources and preferences, consumers may determine that the prospective use of the principal for the loan period is not sufficiently desirable to justify the costs. Similar is the decision not to purchase or to postpone the purchase of clothes, gasoline, luxury items or other goods and services because of their cost.[68] Consequently, credit is rationed to those who exercise their choice and are most willing to pay for it.

When the usury ceiling is in effect, however, the law interferes with the allocation role of interest rates; the ceiling restricts the freedom of borrowers to express their choice with dollars. As the

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63. Keleher & King, *Usury: The Recent Tennessee Experience,* 6 ECON. REV. 69, 71-72 (1978); Ostas, *Effects of Usury Ceilings in the Mortgage Market,* 31 J. FIN. 821, 831 (1976); Wheatley & Gordon, *Regulating the Price of Consumer Credit,* 35 J. MARKETING 21, 27-28 (1971).

64. Keleher & King, *supra* note 63, at 71-72. For an article describing the contraction and outflow of credit in Missouri in the early 1970's because of that state's eight percent usury ceiling, see *When Usury Laws Backfire Against Borrowers,* BUS. WEEK, Aug. 17, 1974, at 93.

65. Keleher & King, *supra* note 63, at 71-72. *See generally* Greer, *Rate Ceilings and Loan Turndowns,* 30 J. FIN. 1376 (1975).

66. Keleher & King, *supra* note 63, at 71-72. *See* note 73 *infra.*

67. Bowsher, *Usury Laws: Harmful When Effective,* FED. RES. BANK ST. LOUIS 16, 18 (Aug. 1974).

68. *Id.*

return on loans drops below market rates, lenders will attempt to maximize profits by adopting methods to allocate credit that will minimize their risk and costs. Termed non-price rationing devices[69] because the credit is allocated according to factors other than cost, lenders will ration credit based on the contract terms or on borrower characteristics.[70] An example of nonprice rationing criteria based on contract terms is the shift to requirements of larger loans, higher loan fees, higher down payments, and shorter maturities because of the lower costs involved in proportion to the rate of return.[71] A lender must derive all of his profit from the price he charges for the loan. If the price is fixed, he will attempt to minimize his costs within this profit margin. The most extensively used nonprice rationing criteria are those relating to the borrower's wealth and the risk of nonpayment he presents. Factors such as wealth, income, available collateral, and the relationship between the parties will determine the risk. As a consequence of the use of these criteria, the prospective borrowers who are first excluded from the legal credit market and denied the ability to borrow at any price are those borrowers who are in the market for small loans and are not competitive in the nonprice rationing system. Generally this is the segment of the population with poor credit ratings, low incomes, and high rates of unemployment.[72] Ironically, this class includes those unsophisticated borrowers that the usury laws were designed to protect. The borrowers most assisted by the ceiling are the wealthy, low risk borrowers who are most competitive in the nonprice rationing system.[73] Depending on the scope of the usury statute and the exceptions to its application, the supply of credit available to consumers will contract as the discrepancy between the market rate for credit and the legal rate increases. As this gap widens, a greater percentage of the population will be excluded from the loan market.[74]

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69. Keleher & King, *supra* note 63, at 72-73.

70. *Id. See also* Robins, *The Effects of State Usury Ceilings on Single Family Homebuilding*, 29 J. FIN. 227, 229 (1974).

71. Ostas, *supra* note 63, at 831.

72. *Usury Laws Force Young Lower Income Buyers Out of the Housing Market*, 100 SAV. & LOAN NEWS 28 (1979); Bowsher, *supra* note 67, at 18; Wheatley & Gordon, *supra* note 63, at 23-24.

73. Bowsher, *supra* note 67, at 18. Ironically, these consumers are those most capable of paying the market rate of interest. In addition, the artificially low cost attracts "elective" borrowers, those with excess investment capital that elect to borrow because of the benefits of the low rate. Their increased demand and presence in the market displaces additional numbers of high risk, less competitive borrowers.

74. Ostas, *supra* note 63, at 830.

B. *Results of Studies on the Economic Impact of Usury Laws*

Empirical studies of the effect of usury ceilings reinforce the conclusions discussed above. A study of the effect of usury laws during the tight money period of the 1960's on housing construction revealed that the drastic slowdown in construction was concentrated in nine states where buyers were prohibited by usury statutes from paying more than seven and one half percent interest.[75] There was no decline in states where there was no restriction on loan charges. In a study of the effects of usury laws on the economies of states in the Eighth Federal Reserve District,[76] the author found significant evidence of a contraction of available financing. In the first four months of 1974, the average interest rate on FHA 30-year mortgages was 8.78% nationally; in states in the district with an eight percent usury ceiling there was a thirty-four percent decrease in residential construction, which contrasts with a sixteen percent decline in the other states in the district.[77]

An in-depth study of the recent Tennessee experience with market rates exceeding the ten percent constitutional ceiling provides further evidence of the detrimental effect of the general statutory ceiling.[78] The study found a high degree of contraction of the supply of funds covered by the usury ceiling as these funds were shifted to nonrestricted investments. A significant amount of capital left the state economy and created a net decrease in credit available to state borrowers.[79] The study found that finance companies in the state had ceased making loans because they were unable to make a profit under the ten percent ceiling after purchasing capital at market rates and assuming risks and administrative costs. The finance companies estimated the decline in loans outstanding at twenty to thirty-five percent, a value of about 150 million dollars.[80] Many threatened to leave the state if the legislature did not lift the usury ceiling.[81] The commercial banks included in the study were less dependent on consumer borrowing and had a significantly

75. Cooper, *A Study of Usury Laws in the United States to Consider Their Effect on Mortgage Credit and Home Construction Starts: A Proposal for Change*, 8 AM. BUS. L.J. 165, 182 (1970). For an empirical analysis of the effects of usury laws on the housing industry, see Ostas, *supra* note 63. Ostas found that loan to price ratios, loan maturities, and mortgage loan volume decrease in proportion to the amount by which free market rates exceed usury limits. *Id.* at 830.

76. Bowsher, *supra* note 67.

77. *Id.* at 19.

78. Keleher & King, *supra* note 63.

79. *Id.* at 72-78.

80. *Id.* at 75.

81. *Id.* at 77.

higher proportion of low risk, large scale borrowers. For the most part, these banks did not discontinue consumer loans as finance companies did but utilized nonprice methods to reduce risk and increase effective yield.[82] All banks reported a tightening of credit standards and required a deposit relationship before considering a prospective borrower's application.[83] Lending institutions in bordering states reported sizable increases in loans to Tennessee residents, but access to these lines of credit was generally limited to residents of border areas and to borrowers of large sums.

Similar studies have been conducted on the economic impact of the Arkansas usury ceiling when market rates rose above the ten percent constitutional limit for a sustained period.[84] In Arkansas the usury law voids "[a]ll contracts for a greater rate of interest than ten percent per annum."[85] The provision recognizes no significant exceptions. Because it is a constitutional rather than a statutory ceiling, the state legislature cannot create exceptions to its coverage without an amendment to the constitution. The studies describe the devastating effect the usury ceiling had on the Arkansas credit market and the state's economy as a whole when the market rate reached the usury ceiling. The installment loan market was effectively closed down by the regulation. In 1970 Universal C.I.T., a national consumer finance company chain, closed at least thirteen offices in the state and discontinued making loans.[86] Associates Discount and American Finance Company closed all their offices and left the state. By March 1974 there were only four companies outside of commercial banks offering installment loans in Arkansas;[87] the commercial banks were forced to raise their credit standards significantly to reduce risk. Consequently the high risk borrowers—the poor, the elderly, and the unemployed—were denied credit. In addition, the study emphasized the oppressive effect of the usury law on

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82. *Id.* at 75-77.

83. *Id.* at 77.

84. Lynch, *Consumer Credit at Ten Per Cent Simple: The Arkansas Case,* 1968 U. ILL. L.F. 592; Mitchell, *Usury in Arkansas,* 26 ARK. L. REV. 263 (1972); Study, *An Empirical Study of the Arkansas Usury Law: "With Friends Like That. . .,"* 1968 U. ILL. L.F. 544; B. Lambert, The Arkansas Usury Law—A Hindrance to Progress When Interest Rates Are High (March 1974) (unpublished study) (copy on file with *Vanderbilt Law Review).*

85. ARK. CONST. art. 19, § 13. Because of the all-inclusiveness of the Arkansas law, it provides an opportunity to analyze the effects of a "pure" usury ceiling, one whose control of interest rates is not diminished by special credit legislation. *See* note 24 *supra.* If the statute and the economic and social philosophy behind it is not successful in Arkansas, it provides strong evidence that similar, if less restrictive, statutes in other states are not fulfilling their intended function.

86. B. Lambert, *supra* note 84, at 43-47.

87. *Id.* at 47.

the state's border cities, which were forced to compete with relatively unregulated jurisdictions.[88] The most damaging result of the ten percent ceiling was the contraction of business credit and the virtual elimination of risk and venture capital from the state. The large national insurance and mortgage companies that normally provide much of the risk capital throughout the nation systematically removed Arkansas from consideration as an investing market.[89] The U.S. Congress recognized these detrimental effects on business and agricultural credit in this state and others in 1974 and again in 1979 and remedied them to some extent with legislation that preempted the restrictions on large business and agricultural loans made by most banks in the state.[90] James Mitchell, in a 1972 article,[91] summarized the effect of the ten percent interest ceiling during periods of high interest rates:

> 1. It drives risk capital from the market and risk takers—particularly ambitious young native sons—from the state.
> 2. It drives the price of legitimate money up since many borrowers must travel out of state to get money or must bring test cases to see if they have successfully evaded the law.
> 3. It raises the cost of many retail credit items since retailers must make up out of cash profits what they would otherwise get out of interest paid by credit buyers.
> 4. It eliminates jobs from the economy since many consumer loan companies and more retailers have simply refused to locate in the state . . . .
> 5. It helps depress development of Arkansas border cities—Texarkana being the prime example . . . .
> 6. It raises credit standards, thereby denying to the poor the ability to buy and enjoy household appliances and other such common items which form the core of the credit market in most states.[92]

Investigations in other states have resulted in similar findings.[93] As the studies reveal, the protection afforded the consumer by usury statutes is of questionable value. For potential middle income and

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88. *Id.* at 15-19. Lambert found that the usury ceiling had slowed significantly the development of Texarkana, Arkansas, and Fort Smith because of this competition. His study revealed that in 1970 Texarkana, Arkansas, which consisted of one-third of the Texarkana metropolitan area, had only four new and used car dealerships while Texarkana, Texas had forty. A similar disparity was found in the numher of furniture and appliance dealers present in different sectors of the city. *Id.* at 17.

89. *Id.* at 48-53.

90. *See* notes 32-35 *supra* and accompanying text. *See also* Stephens Security Bank v. Eppivic Corp., 411 F. Supp. 61 (W.D. Ark. 1976).

91. Mitchell, *supra* note 84.

92. *Id.* at 316-17.

93. *See* Bowsher, *supra* note 67; Giles, *supra* note 1; King, *Usury Ceilings: Shield or Scourge?*, 64 ECON. REV. 111 (1979) (analysis of nine recent studies of the effects of usury ceilings on mortgage credit in the United States); Wheatley & Gordon, *supra* note 63, at 23-28; Touche, Ross & Co., A Study of the Mortgage Loan Interest Rate Ceiling in Texas (Nov. 1978) (unpublished study for Texas Savings and Loan League).

wealthy borrowers, the laws may make it significantly more difficult to obtain credit. For poor and high risk borrowers, the laws may effectively foreclose the opportunity to obtain funds from a legal source at any price.

C. *The Loan Shark Problem*

Another important social impact of effective usury ceilings is their support of the illegal loan market. Studies have found the problem of loan sharking and its concomitant consumer abuses to be directly related to the degree of restraint of interest rate controls in a particular jurisdiction.[94] The loan shark problem prompted legislatures across the country in the early twentieth century to adopt uniform small loan legislation that permitted legitimate lenders to charge higher than ceiling rates on small loans.[95] The practical result of the exclusion of poor and high risk borrowers from the legal market by effective usury ceilings is to force some of these borrowers to seek credit in the illegal market. Recent studies reveal that, at least in many areas, this illegal loan market is operated by the syndicate on a highly organized and sophisticated scale. These studies also reveal an alarming growth in size of the problem in the past several decades and cite estimates from the late 1960's of loan volumes ranging from $350 million to over $1 billion.[96] In this market, there is a significant lack of competition and no government regulation of loan practices. The result is often outrageous interest charges and abusive lending practices.[97] Other harmful effects of the presence of organized crime in a traditionally legitimate industry include financial support of the syndicate's other activities and the general expansion of its power and control.[98] Unfortunately, usury ceilings when in effect foster the growth of loan sharking by contributing to the pool of potential borrowers from this market. Again ironically, the class most likely to resort to the illegal market includes the poor and uneducated borrowers that present usury legislation attempts to protect.[99]

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94. Jordan & Warren, *supra* note 27, at 389-90; Neifield, *supra* note 22, at 24-25; Oeltjen, *supra* note 51, at 214-15.

95. B. CURRAN, *supra* note 18, at 16; Jordan & Warren, *supra* note 27, at 389-90.

96. Note, *Loan-Sharking: The Untouched Domain of Organized Crime,* 5 COLUM. J.L. & SOC. PROB. 91, 92 (1969).

97. *Id.* at 95-96. One survey reported interest rates ranging up to 2,000 percent and averaging 250 percent annually. Comment, *Syndicate Loan-Shark Activities and New York's Usury Statute,* 66 COLUM. L. REV. 167, 167 (1966).

98. Note, *supra* note 96, at 98-101.

99. *Id.* at 96-97, 100.

V. Proposals for Reform

A. *The Corporate Exception*

As interest rates rose during the 1970's to the maximum legal level in many states and as the unfavorable effects described above became evident, many states began to consider methods to reform the general usury ceiling. The simplest reform to implement would be expansion of the corporate exception within the framework of the present usury laws.[100] Enactment of these exceptions across the country would free business credit from the restrictions of usury ceilings and would remove some of the legislation's purposeless control and restraint of businesses. This reform, however, would be a partial reform at best. Although the corporate legal form is some indicia of business sophistication, it is not an accurate definition of those who are adequately sophisticated as not to require government protection. Other business entities such as single proprietorships and partnerships are often equally sophisticated in business affairs.[101] Individuals also are discriminated against by this classification. The exception does not attempt to differentiate between those individuals that are sufficiently knowledgeable to fend for themselves in the credit marketplace and those that are not. The protection of all consumers as a class is too broad, with the result that too many individuals are prevented from entering contracts, the risks and costs of which they are fully aware. Another problem is the lack of uniformity among the states as to the treatment of corporations formed ostensibly for the purpose of avoiding the usury restrictions.[102] Finally, the corporate exception sometimes may encourage

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100. *See* notes 44-49 *supra* and accompanying text.

101. Many states have recognized this failure to distinguish accurately the entities that are competent to bargain in the credit market without state protection. Thus, the usury law in Illinois provides no limits for both corporations and unincorporated businesses with loans greater than $5,000. Ill. Ann. Stat. ch. 74, § 4(1)(c) (Smith-Hurd Supp. 1979). *See also* Neb. Rev. Stat. § 45.101.04 (1978) (no interest rate limits for corporations and no limits for loans to partnerships); N.D. Cent. Code § 47-14-09 (Supp. 1979) (no interest rate limits for corporations or for businesses with loans greater than $35,000); Va. Code §§ 6.1-330.43-.44 (1979) (no interest rate limits for corporations and for unincorporated businesses with loans greater than $5,000). The U.S. Congress, in recent legislation preempting state usury restrictions on large business loans made by national and federally insured state banks, recognized the distinction and opted to exempt all business loans and not merely those made to corporate entities. S. Rep. No. 93-1120, 93d Cong., 2d Sess. (1974) *reprinted in* [1974] U.S. Code Cong. & Ad. News 6249, 6261.

102. *See* Shanks, *supra* note 11, at 344-500. The problem is the judicial treatment of corporations formed for the sole purpose of falling within the exception to the usury laws. The courts have taken two different approaches. One approach is to determine only if the entity is a valid corporation under the laws of the state; if so, the corporation is exempt from the usury laws regardless of the purposes for incorporation. *See, e.g.,* Werger v. Haines Corp., 302 N.Y. 930, 100 N.E.2d 189 (1951). The second approach considers the purpose for incorpo-

an inefficient and unwise preference among potential borrowers for the corporate form over other legal frameworks.[103]

B. *The Sliding Scale*

Another proposal that several states have enacted[104] is termed the "sliding scale."[105] Under this system, the fixed statutory ceiling is replaced with a flexible "sliding" maximum that is keyed to a federal index of interest rates. Usually the index is the Federal Reserve Discount Rate; the statutory rate is set at some margin, such as five percentage points,[106] above this rate. As the index rate changes, the usury ceiling rises or falls correspondingly. Allowing the permissible interest rate to fluctuate based on changes in the economy and in cost of credit to lenders has several distinct advantages. Because the index to which the usury rate is keyed reflects the market price of credit, the ceiling is a realistic reflection of the market determined rate. The sliding scale provides considerably less restriction on both business and individual credit availability and allows competition to set the rate within the confines of the statutory margin. Lenders are able to obtain a suitable profit margin. Greater numbers of borrowers are able to obtain credit and still be protected from unreasonable interest rates. Under this system, a greater percentage of borrowers—those who present the normal risk of nonpayment—are accommodated because in most proposals the margin above the index is set to provide a reasonable return on loans to these types of borrowers. In addition, the flexible scale avoids the problem of credit interruption caused by legislative delays that occur when the market rate rises to the level of the fixed ceiling rate. This proposal seems to be the one most acceptable to both the credit

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ration and whether the loan is actually for the corporation or for an individual who owns it. If the latter, the court may pierce the corporate veil and consider the transaction within the scope of the usury law. *See, e.g.,* Gelber v. Kugel's Tavern, Inc., 10 N.J. 191, 89 A.2d 654 (1952). *See generally* Note, *Stemming Abuses of Corporate Exemptions From the Usury Laws: A Legislative and Judicial Analysis,* 59 IOWA L. REV. 91 (1973).

103. This problem arises when the decision whether to incorporate is influenced by the availability of credit to corporations in jurisdictions with restrictive usury laws. Incorporation is not the most efficient legal framework for many types of businesses. *See* R. HAMILTON, CORPORATIONS—INCLUDING PARTNERSHIPS AND LIMITED PARTHERSHIPS 7-11 (1976). In addition, from a public policy standpoint incorporation limits the liability of ownership for torts and other acts that subject the business to potential liability. It may not be advantageous for state laws to create an additional factor weighing in favor of this form.

104. *See, e.g.,* ALASKA STAT. § 45.45.010(b) (Supp. 1979); DEL. CODE ANN. tit. 6, § 2301 (Supp. 1978); TENN. CODE ANN. §§ 47-14-102-103 (Supp. 1979).

105. *See* Cooper, *supra* note 75, at 185-89; Merriman & Hanks, *Revising State Usury Statutes in Light of a Tight Money Market,* 27 MD. L. REV. 13, 15 (1967).

106. There is some disagreement as to what is the appropriate index for the sliding system. *See* Giles, *supra* note 1, at 544-47.

industry and consumer advocate groups.

Unfortunately, the sliding scale also represents only a partial solution. Despite its tremendous improvement over the fixed rate, it still shares many of the problems inherent in a fixed maximum ceiling. This proposal provides access to credit for a greater percentage of borrowers who present the normal risk, but depending on the size of the margin above the index, it still eliminates certain classes of borrowers from the credit market. It excludes high risk borrowers when the costs of administration and risk exceed the legal return.[107] For the same reason, the sliding scale could also restrict the availability of high risk venture and development capital in the state.[108] Thus, despite the advantage of flexibility, the sliding scale has the same fundamental flaw as the fixed rate; it fails to consider risk as a factor in the cost of credit.

C. *The Unconscionability Standard*

Another proposal[109] advocates the wholesale repeal of the present fixed rate usury laws and the substitution of a flexible unconscionability standard. This standard would permit judicial review of loan agreements to determine if overreaching or unjust bargaining methods forced the borrower into an unconscionable bargain. Under the proposal, the parties would have complete freedom of contract to agree to any interest rate, but the "courts may declare any loan transaction usurious where the interest rate is excessive and the loan, taken as a whole, is harsh and unconscionable."[110] The result is an unregulated market subject only to the requirement of good faith and fair dealing, similar to the standard for sales contracts under the Uniform Commercial Code.[111] The proposal also suggests that there be a presumption of fair dealing, especially in commercial loans, when equal bargaining power is likely. In the absence of evidence of bargaining inequality or overreaching, the court would not interfere with the contract. In the event of evidence of overreaching or substantial bargaining inequality, the courts would examine the loan even if the interest rate is not extraordinarily high.[112]

This proposal has significant merit and provides an appealing

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107. *See* note 51 *supra* and accompanying text.

108. *See* notes 62-74 *supra* and accompanying text.

109. Note, *An Ounce of Discretion for a Pound of Flesh: A Suggested Reform for Usury Laws*, 65 YALE L.J. 105 (1955).

110. *Id.* at 108.

111. U.C.C. § 2-302. For a criticism of the origin and value of this provision, see Leff, *Unconscionability and the Code—The Emperor's New Clause*, 115 U. PA. L. REV. 485 (1967).

112. Note, *supra* note 109, at 109.

compromise between freedom of contract, an unrestricted credit marketplace, and provisions for consumer protection. It would eliminate the detrimental effects on the economy and the exclusion of borrowers from the credit market that occurs under present legislation.

Several potential problems, however, are present in the scheme. One is the costs of administration that might arise under the standard. Each review of an agreement would require evidence, opinions as to reasonableness and market rate, and a hearing. This would be a significant addition to the caseload of already burdened judicial and administrative systems. A second problem is the uncertainty inherent in the unconscionability standard.[113] The standard provides no clear gnidelines for predicting when a loan will be deemed unconscionable. Although this problem will not arise in the majority of loans, those made to credit-worthy borrowers at normal market rates, it might arise in cases of high risk loans in which the lender is forced to charge a high rate of interest in order to cover his costs and the risks assumed. Consequently, the standard promulgated by the legislature should include the determination of when an interest rate is unconscionable: whether an unconscionable interest rate exists only in instances in which overreaching is present and the borrower is forced to pay higher than the market rate, or if the market

113. The problems raised by judicial determination of the unconscionability standard are evident in the court's construction of the standard for sales contracts under U.C.C. § 2-302. This section states in part: "If the court as a matter of law finds the contract . . . to have been unconscionable at the time it was made, the court may refuse to enforce the contract . . . ." *Id.* The official comment defines the test for unconscionability as "whether, in the light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of the making of the contract." The comment further states that it is a question of the "prevention of oppression and unfair surprise . . . and not of disturbance of allocation of risks because of superior bargaining power." U.C.C. § 2-302, Official Comment 1. In several cases, however, courts have emphasized the inequality of the bargaining power rather than oppression and unfair surprise. In Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965), the Court of Appeals for the District of Columbia considered contracts for the sale of household goods and appliances and held that the trial court should reconsider the terms of the contracts to determine if they were unconscionable. The dissenting judge, however, recognized the delicate social issues involved, and stated that the role of the state in consumer protection was one for the legislature to define. As background to this case, it is advantageous to consider a study made of installment sales and credit practices for the sale of household furnishings and appliances in the District of Columbia. FEDERAL TRADE COMMISSION, ECONOMIC REPORT ON INSTALLMENT CREDIT AND RETAIL SALES PRACTICES OF DISTRICT OF COLUMBIA RETAILERS (1968). The study revealed that low income market retailers received an average percentage gross margin on most appliances that was twice that of general market retailers. The net profits after expenses such as insurance and shoplifting and bad debt losses, however, were about the same for ghetto furniture retailers as for the retailers operating in the general market. *See also* Leff, *supra* note 111, at 551-58.

rate itself is at some point unconscionable.[114] The proposal indicates that the former is appropriate, but under the present ceilings it appears that the legislature, by deeming the market rate for loans illegal, has concluded that those rates are unconscionable. This determination is more appropriate for legislative than judicial consideration because of the fundamental social policy questions presented.

VI. AN ALTERNATIVE PROPOSAL

A. *Advantages of a Free Market*

In depth consideration of the problems created by usury laws leads to the conclusion that an unregulated credit market is substantially more beneficial to the public than the present system. The only purpose of usury ceilings that finds support in public policy is the protection of unsophisticated borrowers. There is no logical basis in economic theory for the regulations as a method to provide plentiful, inexpensive credit for the public.[115] In addition, as the evidence reveals, the argument that present laws protect unsophisticated consumers presupposes that it is better for them to get no loan than a loan at the interest rates set in a free market. One author has described the benefits of the unregulated system in this manner:

> (1) the very costly process of regulation, which surely feeds the fires of inflation and fuels bureaucratic waste, could be eliminated; (2) the whole area could rapidly become less complex as the need to devise schemes to increase revenues by skirting usury laws evaporates; (3) through competition, debtors would be charged only what their risk class dictates; (4) merchants of debt would be limited to a marginal rate of return; and (5) credit would be made available to a wide spectrum of potential borrowers.[116]

Admittedly, there would be some abuse by unscrupulous lenders in an unregulated market, but there are methods to regulate the practices of lenders themselves without regulating the market rate and without unduly interfering with the affairs of honest businessmen and the operation of the credit market.[117] The states could implement a streamlined unconscionability standard, with "unconscionable" defined as a rate of interest above the market rate procured through overreaching. The effect of this standard would be to give

114. *See* notes 126-31 *infra* and accompanying text.

115. *See* notes 62-66 *supra* and accompanying text; Avio, *On the Effects of Statutory Interest Rate Ceilings*, 29 J. FIN. 1383 (1974); Greer, *Rate Ceilings, Market Structure, and the Supply of Finance Company Personal Loans*, 29 J. FIN. 1363 (1974).

116. Oeltjen, *supra* note 51, at 223.

117. The Uniform Consumer Credit Code adopts this view. *See* notes 28 & 30 *supra* and accompanying text.

borrowers protection from those lenders that do not act in good faith. The borrower would have the opportunity to prove overreaching and the lender would have the opportunity to show that the rate was in fact reasonable. The standard would operate to raise automatically the bargaining position of naive borrowers. Lenders making loans to these borrowers would consider at the time of making the loans whether a court would find the rate of return reasonable in light of the costs and risks present. The standard would exert constant pressure on lenders to maintain defensible bargaining practices, but at the same time would cause little hindrance or interruption for the majority of lenders who routinely employ ethical bargaining methods. States could also issue guidelines for proper lending practices that would help lenders determine what constitutes overreaching. In addition, states could attempt to improve competition among lenders so that consumers would have the maximum number of sources of credit at the least expensive rates available.[118] Finally, uniform disclosure legislation, similar to the Federal Truth-in-Lending Act, could be enacted to increase the information available to the consumer. Other means of counseling and educating borrowers could be implemented to increase their ability to comprehend available information.[119]

In light of the illegal and totally unregulated market that provides the only option for many borrowers who are excluded from access to legal credit under present legislation,[120] an unrestricted legal market might constitute the most efficient method of social protection for the majority of borrowers. In an unregulated market, the great majority of borrowers would have access to credit from lenders whose practices are subject to public review.[121] The result might be that a smaller percentage of borrowers would fall prey to unscrupulous lenders whose unethical practices were not detected by public scrutiny. In addition, all prospective borrowers under this system would have freedom of choice, which although not easily valued in dollars, is of tremendous siguificance in terms of maximiz-

118. Despite the traditional assumption that the credit market requires regulation because competition does not work adequately, see Jordan & Warren, *supra* note 27, at 389, 391, and Oeltjen, *supra* note 51, at 209-12, the great majority of studies that bave considered the problem in detail suggest that the credit market can operate relatively efficiently with competition. The Uniform Consumer Credit Code adopts this view and provides for minimal entry barriers for potential lenders in order to maximize competition. Jordan & Warren, *supra* note 27, at 394-95. *See also* NATIONAL COMMISSION ON CONSUMER FINANCE, *supra* note 3, at 136-39.

119. NATIONAL COMMISSION ON CONSUMER FINANCE, *supra* note 3, at 193-200.

120. *See* notes 94-99 *supra* and accompanying text.

121. Many authorities view competition by legal lenders as the determinative factor in controlling the loan shark problem. Oeltjen, *supra* note 51, at 220-21.

ing human satisfaction.[122] In choosing this system, the legislature would be opting for the lesser of two social costs: the cost of allowing unscrupulous lenders to take advantage of a percentage of borrowers in exchange for the benefit of permitting the vast majority of borrowers the benefit of freedom of choice and freedom from the restrictions of over-protective legislation. In weighing the social costs and benefits of the unregulated system, there is strong support for this choice because of the doubts about the societal benefits of the present system. In the United States, as a rule, government resorts to price fixing only in emergency situations or under other special circumstances; prices in the great majority of markets for goods and services in the nation are not regulated.[123] As a result, many economists question government's election to protect the naive consumer in the credit market when he is free to enter unreasonable contracts for the purchase of commodities in other, unregulated markets.[124] Under this analysis, there is no basis for imposing the considerable restriction of present legislation on the credit market and on competent, sophisticated borrowers that do not need state protection and are injured by it.

In addition, there is a fundamental theoretical problem at issue that should be considered by the legislature before it decides to reject the unconscionability standard for a more restrictive usury law. Any regulation of credit costs other than the protection of borrowers from unfair dealing by lenders will exclude some high risk borrowers from the credit market.[125] The legislature cannot expect lenders to lend to consumers at the ceiling rate if an investment with greater return or a less risky investment with equal return is available. The provision of goods or services at or below market rates amounts to a subsidy. It is unlikely that lenders voluntarily will assume the social welfare role of providing credit for these borrowers at below market rates. Present legislation intends for lenders to assume this role, but the economic results reveal that it has not been successful and will not be until additional incentives to lend are

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122. As James Cooper pointed out in his review of the effect of usury laws on the availability of mortgage credit, "We should not underestimate the immeasurable effects on family life of the postponed fulfillment of a life goal such as a home of one's own." Cooper, *supra* note 75, at 169. Because residential mortgages are among those types of loans that usury laws most restrict, this problem is highly significant. Statistics reveal that the impact of rationed mortgage credit under effective usury ceilings falls most heavily on middle and lower income young families attempting to purchase their first homes. *Usury Laws Force Young, Lower Income Buyers Out of Housing Market, supra* note 72, at 28.

123. Jordan & Warren, *supra* note 27, at 388-89.

124. Bowsher, *supra* note 67, at 17. *See* note 118 *supra*. *But see* notes 52-57 *supra* and accompanying text.

125. *See* notes 69-73, *supra* and accompanying text.

provided.[126] Under present legislation, consumers are protected from all interest rates above the statutory ceiling that are deemed usurious per se, although in many cases the rate may be a reasonable market rate. The legislature should carefully consider the impact on high risk borrowers of a social policy decision to "protect" these consumers from "unfair" interest rates.

Consequently, a key issue for legislative consideration is whether the market rate for a loan should ever be deemed usurious. Franklin Ryan, in his analysis of usury laws,[127] addresses this dilemma and delineates two instructive definitions of usury. "Legal usury" he defines as taking more than the law permits as a charge for the use of money.[128] Under this definition, it is irrelevant whether the lender deserves the additional return because of his costs, whether the borrower is in a financial position to and is desirous of paying the charge to obtain the principal and whether the additional return is reasonable in light of the costs and risks of the loan.[129] Ryan defines the second type of usury, "moral usury," as the "taking advantage of the ignorance or necessitous condition of the needy borrower so as to get him into a hard bargain and to extract from him unduly high charges."[130] Ryan claims that it is this second type of practice that legislatures attempted to eradicate through regulation. The method they chose to prevent moral usury was legal usury, by establishing a rate that they deemed the maximum reasonable return for granting credit. Inherent in Ryan's analysis is the view that the market rate is never really morally usurious,[131] that the lender is not "taking advantage of . . . the needy borrower" when the borrower has the option of transacting in an open market with other lenders who would charge virtually the same rate.

The opposing view is that at some point society deems the rate of interest, even if justified as reasonable from a market analysis, to be too great. The legislature should devise price fixing structures to prevent the exaction of these rates. The lender, however, will not lend at the fixed rate—that rate deemed "fair" by the legislature—if it is below market. Consequently, the legislature must recognize that such a price fixing scheme represents a conscious decision to exclude a class of borrowers from the legal market in order to protect them from their own mistakes.

126. For a discussion of the alternative methods and costs of providing this subsidy to high risk borrowers, see note 140 *infra*.

127. F. RYAN, *supra* note 14.

128. *Id.* at XII.

129. *Id.* at 77.

130. *Id.* at XII.

131. *Id.* at 77.

B. *Proposal . . . A Modified Free Market*

As a practical matter, the determinative factor in the proposal outlined above is the likelihood of persuading state legislatures that the proper role of the state would be to regulate only moral usury—unfair bargaining practices—and not the cost of credit itself. In light of the historical bias in favor of interest rate legislation,[132] the intense emotional, moral, and social disagreement over it,[133] and the traditional hesitancy of government to retrench in regulation of an area that it has previously occupied, such deregulation appears highly unlikely. Consequently, it is advantageous to consider an alternative proposal. The objective of this proposal is two-fold: to protect the unsophisticated borrower from unscrupulous lenders, unfair credit practices, and from an "unfair" rate and to minimize the burdensome effect of the regulation on the economy.

In order to replace the general statutory ceiling with a more efficient scheme, it is necessary to devise a system that, first, considers and makes allowances for the different levels of bargaining competence of borrowers, and, second, considers the importance of risk in determining the price of credit. To minimize the burdensome restraint on the ability of the public to borrow, the legislature must establish a standard that differentiates among levels of bargaining competence and indicates the point at which the prospective borrower has reached a bargaining position of sufficient sophistication to compete in an unregulated market. If the borrower meets this minimum level of bargaining competence, the state should not control the rate of interest that he can agree to pay. Any control over such a borrower, even a "margin of safety" system such as the sliding scale approach, runs the risk of restricting venture capital and other loans that present higher than normal risk.[134] For the legislation to be most efficient and cause the least interruption of the credit market, it should affect only the class of borrowers that does not meet this minimum level. The standard should be simple to apply so that lenders will have clear guidance in differentiating among borrowers. The corporate exception, although deficient because of its limited application, is an example of a standard that distinguishes among borrowers' levels of bargaining power and is simple to apply.[135] A more suitable standard is one that accurately and specifically defines the class of borrowers that is most often subject to the abuses because of needy circumstances and lack of

132. *See* notes 5-15 *supra* and accompanying text.
133. *See* note 58 *supra*.
134. Bowsher, *supra* note 67, at 18-19.
135. *See* notes 44-49 *supra* and accompanying text.

sophistication and bargaining ability. This class consists of individuals that are in the market for loans for personal consumption and for small amounts. Consequently, the legislation should only apply to borrowers taking out consumer loans, in contrast to commercial or investment loans,[136] for a small amount such as less than $10,000.[137] Borrowers who meet these minimum requirements—those that seek non-consumer loans or loans larger than $10,000—would be presumed to have some basic degree of bargaining competence and business knowledge and would not be subject to the law's protection.

The next problem is to assure that a significant supply of consumer credit will be made available to high risk borrowers in the class protected by the legislation, while retaining reasonable limits on the rates charged those borrowers. A sliding scale system with a substantial margin, such as ten interest points,[138] above the Federal

136. Business and investment loans should not be covered by usury legislation even if they meet the second classification of small amount. To subject loans for these purposes to rate ceilings would give rise to interference with business and investment credit. As in the case of borrowers who fall within the corporate exception, there is no need to protect borrowers of these types of loans because they possess the requisite degree of business sophistication and the knowledge to choose among credit options. A disclosure of purpose requirement could be implemented in loan transactions with the burden of proof on lenders to show reasonable inquiry and good faith belief that the purpose was as represented in cases of non-consumer loans exempted from the legislation.

137. This legislative classification based on loan amount causes the regulation to apply to the vast majority of needy and unsophisticated borrowers who are most likely to be victimized by unscrupulous lenders without creating the tremendous burden on the rest of the borrowing public imposed by present legislation. The standard insures that few borrowers that fall within the class requiring protection would not be covered by the law. Few borrowers in this class are in the market for loans of an amount greater than $10,000; even if they make application for a loan of this size, it is doubtful that they could obtain the loan because of the high risk of nonpayment. Consequently, these poor, high risk borrowers are in effect protected by the market. Many states, in their present usury legislation, recognize the correlation between loan amount and borrower sophistication. Thus, in states such as Ohio, Kentucky, Alaska, Hawaii, and Delaware, present legislation provides an exemption from the rate ceilings when loan amounts reach a certain size. Again, however, in most states the lines of the classification are drawn too broadly for the purpose to be achieved. Thus, in Alaska and Ohio, the exemption only applies to loans greater than $100,000. ALASKA STAT. § 45.45.010(b) (Supp. 1979); OHIO REV. CODE ANN. § 1343.01(B)(1) (Page Supp. 1978). In Hawaii the loan must be greater than $750,000. HAWAII REV. STAT. § 478-8 (1976). Kentucky law provides a much lower exemption point of $15,000. KY. REV. STAT. § 360.010 (Supp. 1978).

Determining the loan amount that is to make the legislation operative is essentially a question that should be addressed after careful consideration by the legislature of credit circumstances in a particular state. Empirical studies, considering education, income, and borrowing habits, could be done to determine the minimum loan amount for which state protection would not be necessary. A higher or lower minimum amount might be a more appropriate dividing line for a particular jurisdiction. The amount chosen should be keyed to a flexible federal index to prevent the figure from becoming unrealistic through inflation of the currency.

138. Again, establishing this margin in which the parties can agree to an interest rate

Reserve Discount Rate would best achieve this objective. The legislature would deem any interest rate above this maximum too great to allow a borrower of this "consumer" class to pay regardless of the risks he presents. This system would provide all of the advantages of the sliding scale described above,[139] but in addition, the ten point margin would allow a more substantial range above the federal index in which lenders could tailor interest charges to the administrative costs and risks of each loan. As a result, legitimate sources of credit would be available not only for borrowers who present normal risk but for those in the high risk category. The higher market rate of return permitted would provide the necessary incentive for lenders to offer credit to a greater percentage of high risk borrowers. At the same time, the system would place reasonable limits on rates for the protection of these borrowers.[140] Finally, the system as

is a question of legislative line drawing. The legislature should resist the temptation to set the maximum at what it deems a "reasonable rate of interest" for the majority of borrowers. By providing an extra margin over the interest rate that borrowers of average risk will be required to pay, tbe legislature provides the incentive for lenders to accommodate a greater number of high risk borrowers.

139. *See* notes 101-05 *supra* and accompanying text.

140. As a consequence of placing these limits of reasonableness on loan rates, however, some borrowers that would have access to sources of credit in an unregulated market will be excluded from legal credit sources by their failure to meet the requirements of the credit industry even within these expanded interest rate limits. The legislatures might consider the possibility of social welfare programs structured to enable these borrowers to obtain credit within the reasonable rate limitations. Such social welfare programs must either compel lenders to lend to these borrowers by law or create additional incentives to compensate for the lower than market return. One method would be to create a pool of high risk borrowers that cannot obtain credit independently at the usury ceiling rate. The state could devise a method similar to high risk automobile insurance pools often found in states with no fault insurance programs to assign a pro rata number of these borrowers to each lender, perhaps based on the volume of business that lender did in the state. The state could require by law that lenders make credit available to these borrowers at the maximum legal rate. The legislature could promulgate standards to differentiate borrowers of mere high risk from those that present little or no likelihood of repayment in order to control the bad debt costs imposed on the lender. This method of providing credit to these borrowers may be highly appealing to some sectors of society, because initially it appears that lenders would absorb the costs of this subsidy. *See* note 58 *supra*. Closer consideration, however, reveals that the proposal would operate in a highly inequitable manner (without deciding whether imposing this welfare cost on lenders would be equitable). Lenders would not absorb the costs of providing credit to high risk borrowers at below market rates, but would pass them through to other borrowers by raising the cost of credit for them. The result would be that the subsidy would be borne not by tbe enterprise or by society as a whole but by other consumers who utilized the state's credit institutions. Certainly this is not a highly equitable allocation of the welfare cost.

A more just apportionment of this welfare cost would be for all members of society to bear a proportionate share. This is usually done by funding a subsidy from general tax revenues. One method would be for states to guarantee high risk loans in order to bring the interest rate within legal levels. A similar program of guaranteeing student loans has been implemented on the federal level. The advantages of such a program would be access for all a whole would provide clear-cut guidelines for lenders to follow in determining whether the legislation applied to particular loan transactions.

VII. Conclusion

The general statutory ceiling form of usury legislation found in the majority of states should be repealed or reformed. The application of a single numerical ceiling to all loan charges for all types of loans and borrowers is an archaic and unrealistic approach to regulation of today's complex credit industry. The legislation, in its present form, injures the class of borrowers it was desigued to protect by excluding them from the credit market and in some cases forcing them to resort to illegal sources of credit. Even if the legislature deems this exclusion proper—in effect decides that a class of borrowers should be prohibited from borrowing when rates reach a certain point—the present legislation with its low fixed ceiling and all-inclusive application is too broad. It indiscriminately relegates borrowers to this excluded class, without any basis for the legislative classification in lack of bargaining power or inability to pay higher interest. The legislation provides no other advantages to the borrowing public with the possible exception of allowing wealthy borrowers to obtain credit at lower than market rates. In addition, when effec-

borrowers to legitimate credit sources, reasonable rates for all borrowers, and increased competition between legal and illegal credit suppliers. The disadvantages, of course, would include significant cost to the state, but it is unavoidable if this subsidy is to be provided. *See* J. Van Horne, *supra* note 62, at 223-26.

A third alternative would be the formation of a credit union, underwritten by the government, to serve as a lender of last resort for this class of high risk borrowers. A similar program has been implemented by the Small Business Administration to provide credit at reasonable rates for high risk businesses. This proposal would provide all the advantages of the guarantee system. Disadvantages would include the costs of formation and operation of an ongoing government bureaucracy.

A fourtb and appealing method to allocate this subsidy cost would be to provide tax incentives, either at the federal or state level, to lenders to provide high risk credit. The characteristics of the class of bigh risk borrowers to be subsidized could be specified in tax legislation. For lenders providing credit to these borrowers, a decrease in tax liability would be permitted in proportion to the amount of high risk credit loaned. This system would impose the costs of the welfare subsidy on all taxpayers as a class. In addition, if desired, the system could be structured to furnish an additional incentive to lenders to work with borrowers that have problems meeting their obligations and to avoid foreclosure.

The need for the alternative methods of subsidy discussed above and the size of the pool of potential participants are questions of social policy that should properly be addressed by the legislatures. These bodies should be fully aware that in considering whether to set a maximum rate on interest and in determining the point at which the rate is set, the key underlying issue is whether to subsidize borrowers tbat cannot obtain credit at normal market rates. For a general discussion of the social allocation of capital, see J. Van Horne, *supra* note 62, at 217-41.

tive, the ceiling causes considerable interruption of the credit market, resulting in a widespread impact on the overall economy of the state.

This Note suggests that the proposal outlined above would solve the majority of the problems created by the present statutory form. The proposal recognizes that in order to prevent contraction of credit supply, the market must be allowed to set the market cost of credit to provide lenders with an incentive to lend. Within this framework, the best protection for the high risk borrower is for the system to insure legitimate lenders who are competing for his business. This competition would provide lawful sources of credit to these borrowers while minimizing the costs to them. At the same time, the proposal recognizes the social objective of establishing boundaries of reasonableness to the rates of return set by the market. The proposal emphasizes the importance of drawing the legislative classification narrowly because of the restraint imposed on freedom of choice. It is suggested that the proposal is equally appropriate for states with extensive special credit regulation as for those with little control. For those with extensive legislation, it would provide an umbrella framework to insure consumer protection in transactions not included in the special laws while preventing the inflexibility and the unfair results that occur when transactions do not fall within the special statutes.[141] The proposal, as outlined above, provides consumer protection while eliminating the widespread detrimental burden on the flow of credit. The legislature should combine this standard with laws providing consumer protection from and redress for abusive lending practices. This combination would protect the unwary borrower while assuring access to credit for most borrowers, reasonable market returns for lenders, and freedom of choice in the credit market.

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141. *See* note 26 *supra* and accompanying text.