Winter 2015

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Recommended Citation
49 Real Prop. Tr. & Est. L.J. 549 (2015).

USURY AND LOAN TRANSFERS

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Authors' Synopsis: This Article is primarily concerned with the effect of transferring a mortgage loan from its originating loan broker to a group of small investors when that loan was—at its inception—usurious. However, because the rules applicable to that situation are not confined to mortgage law, we begin with a general explanation of usury rules before dealing with the particular real estate loan transaction mentioned.

I. SOME PRELIMINARY FEATURES OF USURY

Usury occurs when a lender has charged its borrower greater interest than the applicable legal rules allow.[1] Regulation of maximum interest rates is more or less a nationwide policy, although individual states set

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1 *See, e.g.*, Moncure v. Dermott, 38 U.S. 345, 356 (1839) (citing Barclay v. Walmsley, (1803) 102 Eng. Rep. 750 (K.B.); 4 East 54) ("There must be a loan, and the taking of more than legal interest, or the forbearance of payment of a pre-existing debt, upon a contract for illegal interest, to constitute usury.").

different upper limits and often do so in different ways.[2] Some impose a cap on all loan transactions,[3] whereas, at the other extreme, a few appear to impose no limit whatsoever.[4] In many jurisdictions, no comprehensive and accurate description of their usury rules is possible because their statutes or decisions are filled with too many distinctions—imposing rate limits on some transactions while at the same time, letting other transactions go unrestrained.[5] States commonly make these distinctions by way of exemptions rather than definitions.[6]

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[2] *See, e.g.*, N.C. GEN. STAT. § 24-1 (2013); NEV. REV. STAT. ANN. § 99.050 (LexisNexis 2013).

[3] *See, e.g.*, N.C. GEN. STAT. § 24-1 (imposing an 8% cap on all North Carolina loans).

[4] *See, e.g.*, NEV. REV. STAT. ANN. § 99.050; *see also* Income Tax Buyers, Inc. v. Hamm, No. 91-CP-40-3193, 9004, 1992 WL 12092431, at *4 (S.C. C.P. Jan. 14, 1992) ("This Court is aware of [plaintiff]'s argument that South Carolina has no usury law. It has no industrial loan law either."). Internationally, the United Kingdom has no usury law, as is also true for the Philippines and most states in Australia. *See* Paul Hayeck, *An Economic Analysis of the Justifications of Usury Laws*, 15 ANN. REV. BANKING L. 253, 256 (1996) (stating there are no anti-usury laws in the United Kingdom); Ponciano S. Intal, Jr. & Gilberto M. Llanto, *Financial Reform and Development in the Philippines, 1980-1997: Imperatives, Performance and Challenges*, XXV J. PHILIPPINE DEV. 1, 15 (1998) (stating that in 1976 the Philippines Usury Act was abolished); Pierre Van Der Eng, *Consumer Credit in Australia During the Twentieth Century*, 18 ACCT., BUS., & FIN. HIST. 243, 248 (2008) (stating there are no anti-usury laws in Australia).

[5] *See, e.g.*, ALA. CODE § 8-8-5 (LexisNexis 2002) (distinguishing between transactions over or under $2,000); Carozza v. Fed. Fin. & Credit Co., 131 A. 332, 342 (Md. 1925) (distinguishing corporate borrowing from individual borrowing).

[6] Transactions often declared exempt in many jurisdictions include:

- loans above a certain amount, see ALASKA STAT. § 45.45.010(b) (LexisNexis 2012) (exempting loans under $25,000); GA. CODE ANN. § 7-4-2(a)(B) (2004) (exempting loans over $250,000); IOWA CODE ANN. § 535.2(2)(a) (Supp. 2014); KY. REV. STAT. ANN. § 360.010(1)(b) (2008); N.C. GEN. STAT. § 24-1.1 (2013); N.D. CENT. CODE § 47-14-09(2)(d) (Supp. 2013) (exempting loans over $35,000); OHIO REV. CODE ANN. § 1343.01(B)(1) (LexisNexis 2012) (exempting loans over $100,000); OR. REV. STAT. § 82.010 (2013);
- loans for agricultural purposes over $25,000, see IOWA CODE ANN. § 535.2(2)(a)(5);
- loans for business purposes, see D.C. CODE § 28-3301(d)(1)(B) (2001);
- loans to non-profit or religious entities, see D.C. CODE § 28-3301(d)(1)(A), (D);
- loans to particular types of entities, see IOWA CODE ANN. § 535.2; N.D. CENT. CODE § 47-14-09(2) (1999 & Supp. 2013);
- secured loans, see CONN. GEN. STAT. § 37-9(3) (2011) (exempting secured loans above $5,000); D.C. CODE § 28-3301(d)(2) (exempting loans above

A. The Logic of Exemptions

The discrepancy between the principle of imposing usury restrictions on the one hand and then, on the other, of making exemptions to those restrictions is probably the result of a natural tension that exists between the often contrary positions that legislators and judges frequently hold as to what is in the best interests of the borrowers. From one perspective, imposing legal limits on interest rates is effective only under the assumption that lenders will still continue to make loans and will obediently lower their charges to bring them into compliance with what the law permits. Whereas, contrarily, others fear that lenders will be deterred from making loans at rates they perceive to be uneconomical, which means that borrowers will be left without access to funds they may desperately need.[7] Rather than choosing one approach as appropriate in all cases, many jurisdictions attempt to accommodate both sides of the argument—imposing usury restrictions that may appear general but have been eviscerated with numerous exemptions.

1. Federal Lenders

Some of these exemptions from usury restrictions are quite broad. Federal lending institutions, for instance, are not subject to most state restrictions.[8] Because that exemption occurs by federal override, the Supremacy Clause assures that no states have rules to the contrary.[9] And

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$1,000); IOWA CODE ANN. § 535.2(2)(a)(1), (3), (4); N.C. GEN. STAT. § 24-1.1A; OR. REV. STAT. § 82.025(3), (4);

- second mortgages, see VA. CODE ANN. § 6.2-327 (2010); VT. STAT. ANN. tit. 9, § 41a(b)(7) (2006).

[7] For instance, an interest rate cap of 10% would be decidedly unattractive to a lender in an economy that was experiencing 20% inflation.

[8] The National Bank Act, "12 USC § 85 prohibits one state . . . from overriding interest rates that are lawful in the state where a national bank is based." Swanson v. Bank of Am., N.A., 563 F.3d 634, 636 (7th Cir. 2009). In general, state attempts to avoid the federal protective envelope are unsuccessful: "'In any view that can be taken of [§ 86], the power to supplement it by State legislation is conferred neither expressly nor by implication.'" Beneficial Nat'l Bank v. Anderson, 539 U.S. 1, 10 (2003) (quoting Farmers' & Mechanics' Nat'l Bank, 91 U.S. 29, 35 (1875)). "'Federal law . . . completely defines what constitutes the taking of usury by a national bank.'" *Id.* (quoting Evans Nat'l Bank of Savannah, 251 U.S. 108, 114 (1919)).

[9] *See* U.S. CONST. art. VI, cl. 2 ("This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, anything in the Constitution or Laws of any state to the Contrary notwithstanding.").

because such exempted national lenders are in actual competition with local lenders, state legislatures feel a natural pressure to level the playing fields and give their own locally regulated lending institutions similar latitude, lest they go elsewhere or elect to become federally rather than locally regulated.[10] Equal protection concerns similarly restrict states' abilities to regulate one class of lenders at the expense of another.[11]

2. Time-price

Another common exception to usury restrictions is the rate that a seller imposes on a buyer as a charge for her being permitted to pay the purchase price in installments over time rather than immediately—the "time-price differential." A few states do regulate those charges,[12] but generally, a seller is deemed free to impose whatever charge she wants for accepting delayed payment of an item, just as she was free to set the original selling price for the item itself.

3. Type of Lender

Other jurisdictions make further distinctions according to the type of loan or type of borrower, some of which we have described in the footnote below.[13] However, the most common forms of exemptions

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[10] For example, when the California Supreme court, in *Wellenkamp v. Bank of America*, 582 P.2d 970 (1978), held that a due-on-sale clause in a deed of trust would constitute an impermissible restraint on alienation if enforced automatically (that is, without showing justification in each particular case), numerous institutional lenders in California converted their state charters to federal charters in order to escape from that doctrine. *See* Fidelity Fed. Sav. & Loan Ass'n v. de la Cuesta, 458 U.S. 141, 148–49 (1982). The issue took on sufficient importance as to lead Congress to enact the Garn Act, permitting all lenders, whether state or federal, to enforce due on sale clauses. *See* Garn-St. Germain Depository Institutions Act of 1982 § 341, 12 U.S.C. § 1701j–3 (2012); Brush v. Wells Fargo Bank, N.A., 911 F. Supp. 2d 445, 460 (S.D. Tex. 2012).

[11] *See, e.g.*, Glenn v. State, 644 S.E.2d 826, 828 (Ga. 2007) (upholding a statute criminalizing payday loans of under $3,000, when made by residents of the state, *but* not when made by out-of-state banks).

[12] *See, e.g.*, Clark v. Aaron's, Inc., 914 F. Supp. 2d 1301, 1313–15 (N.D. Ga. 2012); Bell v. Muller, 118 P.3d 405, 408 (Wash. Ct. App. 2005).

[13] For instance, Alabama exempts loans that are over $2,000. *See* ALA. CODE § 8-8-5 (LexisNexis 2002). Connecticut exempts real property mortgage loans that are over $5,000. *See* CONN. GEN. STAT. § 37-9(3) (2013). North Dakota exempts loans "made to a foreign or domestic corporation, foreign or domestic limited liability company, cooperative corporation or association, or trust; . . . [or] made to a partnership, limited partnership, or association that files a state or federal partnership income tax return." N.D. CENT. CODE § 47-14-09(2)(b) & (c) (1993). Oregon exempts loans "from a tax qualified retirement plan to a person then a participant under the plan." OR. REV. STAT.

appear to be those based upon the type of lender making the loan. The federal lender exemption has been already covered.[14] At the state level, many specialized lenders, such as pawnbrokers, are exempted from the State's general usury rules, because they often are subjected to more particularized regulations[15] appearing elsewhere in the state's laws, or because they have been freed from all regulation.

II. CAN AN EXISTING LOAN BECOME USURIOUS?

In *LFG National Capital v. Gary, Williams, Finney, Lewis, Watson, & Sperando P.L.*,[16] the original lender was LawFinance, a California corporation, which loaned $10 million to a Florida law firm to finance the firm's litigation, on a contingent fee basis, of major personal injury and civil rights cases around the country.[17] The original interest rate for the loans was the London Interbank Offered Rate (LIBOR) plus 3% (for a total of 16%), increasing the rate in cases of default by another 5% (to a

§ 82.025(6) (2013). Delaware exempts all loans made to corporate entities. *See* DEL. CODE ANN. tit. 6, § 2306 (2013).

[14] *See supra* note 8 and accompanying text.

[15] For example, North Dakota exempts loans by "bona fide pawnbrok[ers]," on loans under $10,000. *See* N.D. CENT. CODE § 47-14-09(2)(a). Oregon excludes pawnbrokers, OR. REV. STAT. § 82.025(1), and broker-dealers carrying debit balances for their customers, OR. REV. STAT. § 82.025(8). The State of Washington has a reverse "most favored lender" exemption for state-licensed depository institutions, allowing them to have the same power and status as national banking associations. *See* WASH. REV. CODE § 30.04.025 (2005). According to Miller and Starr, California provides 26 usury exemptions for different types of lenders, including banks charted by the State of California, another state, another nation, or by the United States; savings associations chartered by the State of California, another state, or the Federal government; holding companies or subsidiaries of an exempt institution; California insurance companies; pension funds; licensed broker-dealers; business and industrial development corporations; trust companies and trust departments of exempt banks; credit unions; industrial Loan companies; pawnbrokers; personal property brokers, consumer finance lenders, and commercial finance lenders; Veterans' Administration and Federal Housing Administration; nonprofit cooperative associations; common interest development associations; medical malpractice insurance cooperatives; college-level educational institutions; and California state retirement systems. *See* HARRY D. MILLER & MARVIN B. STARR, CALIFORNIA REAL ESTATE 3D, ¶ 21:35. Miller and Starr's list of exempt transactions (besides exempt lenders) includes time price-differentials, shared appreciation loans, federally-related home loans, business loans to sophisticated borrowers, retail installment contracts, and corporate reorganizations. *See id.*

[16] 874 F. Supp. 2d 108 (N.D.N.Y. 2012).

[17] *See id.* at 112 (This loan was clearly not a real estate loan, but its terms would be familiar to real estate borrowers and lenders, and its holding well fits real estate lending transactions.).

total of 21%).[18] Under California's general constitutional cap of 10% (or 5% over an index),[19] such rates would be usurious,[20] but LawFinance as a "Finance Lender," was specially regulated,[21] and thus exempt from that general limit.

Notwithstanding the lender's exempt status, the law firm borrower still sought to defend on usury grounds, arguing that, three days after having made the loan, LawFinance had assigned the loan to its affiliate LFG National, a Delaware entity with its principal place of business in Nevada.[22] As either a Delaware entity or a Florida resident, the assignee, LFG National Capital, was unlikely to qualify on its own for an exemption in California.[23] However, because the California constitution provides that its usury laws do not apply "to persons authorized by statute, *or to any successor in interest* to any loan or forbearance exempted under this article,"[24] the defense failed.[25] If the loan was not usurious when made—because the original lender was exempt—then it did not later become usurious when turned over to a nonexempt transferee.[26] To hold otherwise, opined the court, "would in effect

[18] *See id.* at 113.

[19] *See* CAL. CONST. art. XV, § 1(2).

[20] The loan documents included a California choice of law clause. *See LFG Nat'l Capital*, 874 F. Supp. 2d at 113. In light of the fact that the lender was a California entity, that provision was probably safe from attack, notwithstanding that the debtor was a Florida entity and the UCC security filing was made in Florida. *See id.*

[21] *See* CAL. FIN. CODE § 22002 (West 1999).

[22] *See LFG Nat'l Capital*, 874 F. Supp. 2d at 112. Had this loan been subject to the laws of Florida, Delaware, or Nevada, it probably would have still survived. In Florida, the interest rate limit is 25% for loans over $500,000. *See* FLA. STAT. ANN. §§ 687.02, 687.071 (West 2003). In Delaware, there is no interest rate limit on loans of $100,000, so long as they are not secured by the borrower's principal residence. *See* DEL. CODE ANN. tit. 6, § 2301(c) (2013). And Nevada imposes no limit on rates. *See* NEV. REV. STAT. ANN. § 99.050 (2013). Conversely, had the loan been deemed usurious, in either California or Florida, the borrower would not owe any interest at all to the lender. *See also* DEBTOR-CREDITOR LAW § 43.19 (Theodore Eisenberg ed., 2014).

[23] *See LFG Nat'l Capital*, 874 F. Supp. 2d at 112. Another entity involved in the transaction was "LFG Servicing," but its status with respect to usury was not discussed. *See id.* at 124–25.

[24] CAL. CONST. art. XV, § 1 (emphasis added).

[25] *See LFG Nat'l Capital*, 874 F. Supp. 2d at 125.

[26] *See id.*

prohibit—make uneconomic—the assignment or sale by banks of their commercial property to a secondary market."[27]

The principle that a successful defense against a usury charge is not jeopardized because the loan was transferred by an exempt lender to a nonexempt one appears widely accepted. And the circumstances of the transfer are not likely to affect the status of the loan as far as usury is concerned. The fact that the transferee purchased the loan at a large enough discount to make its effective return exceed a usury cap (if it had been originated as a new loan between payor and transferee) generally does not work as a defense.[28] Indeed, bond markets would undergo serious shock if discount and premium prices could not be altered constantly as market conditions change. Similarly, buyers who purchase time-price obligations from sellers clearly lack the exempt status of their transferors, but not the exempt status of the paper they have purchased.[29] (While there is some momentum towards restricting the recovery of purchasers of defaulted residential mortgages,[30] that is in the nature of anti-deficiency rather than usury protection).

On the other hand, when the original reason for holding a loan not usurious was the exempt status of the lender, as opposed to its low interest rate, the doctrine of successor protection does not always apply with the same force. The nominal first lender may have been merely a front for the real, second lender—who used its "nominee" solely to avoid having to comply with the requirements the jurisdiction imposed as a condition for obtaining such exemption.[31] In California, a loan secured

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[27] *Id.*; *see also* FLA. STAT. § 687.04(1) (West 2003) (providing that "the penalties provided for by this section shall not apply: (1) To a bona fide endorsee or transferee of negotiable paper purchased before maturity, unless the usurious character should appear upon its face, or unless the said endorsee or transferee shall have had actual notice of the same before the purchase of such paper"). In California, Miller and Starr say: "If the loan is exempt but is acquired after origination by a person who was not a party to a pre-arranged credit and assignment transaction, the loan should remain exempt." MILLER & STARR, *supra* note 15, ¶ 21:35 n.1.

[28] *See, e.g.*, Milana v. Credit Disc. Co., 163 P.2d 869, 873 (Cal. 1944); Moe v. Transamerica Title Ins. Co., 98 Cal. Rptr. 547, 554 (Cal. Ct. App. 1971).

[29] *See, e.g.*, Ghirardo v. Antonioli, 883 P.2d 960, 968 (Cal. 1994); *see also* DCM Partners v. Smith, 228 Cal. App. 3d 729, 739 (Cal. Ct. App. 1991) (changing terms of exempt transaction does not affect the exemption).

[30] *See* NEV. REV. STAT. ANN. §§ 40.430, 40.455, 645F.430, 645F.440 (2014); *see also* Lavi v. Eighth Judicial Dist. Court, 325 P.3d 1265, 1276 (Nev. 2014); Schleining v. Cap One, Inc., 326 P.3d 4, 6 (Nev. 2014).

[31] Indeed, the loan sale by Law Finance occurred only three days after the loan was made, and the sale was to a related entity. *See LFG Nat'l Capital*, 874 F. Supp. 2d at 112.

by real estate that was "made or arranged" by a real estate broker is statutorily exempt from the state's usury laws,[32] a situation that has inevitably tempted lenders to use brokers as fronts in their real estate lending activities.[33]

III. GOING FROM USURY TO NONUSURY

The converse side of the question—whether a loan that was initially usurious may end up not being subject to attack—can sometimes be easy to dispose of. Two common situations illustrate this situation.

A. Transfer of the Loan Collateral

Where a loan is secured by real estate (or personal property), it is not uncommon to see the mortgaged land transferred to a new owner before the loan is paid off. If the loan was initially usurious, the new owner of the property may be tempted to assert that defect as a defense against the lender. Unfortunately for the new owner, that defense is almost never successful.[34]

The general statement of the courts in rejecting a usury contention made by a subsequent owner of the property encumbered by the tainted loan is that usury is a "personal" defense, which can be asserted only by the original borrower.[35] A more intelligent and useful explanation is that if the purchaser of the property has deducted the balance of the mortgage debt from the acquisition price she had to pay, then she cannot "have [her] cake and eat it too."[36] To the grantee, the mortgage was not a

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[32] CAL. CIVIL CODE § 1916.1 (West 2010).

[33] The rule also forces California judges to decide just how much effort and involvement a real estate broker must have invested in a transaction to justify the lender's claim that the loan was made or arranged by the broker rather than the lender. *See, e.g.*, Bock v. Cal. Capital Loans, Inc., 156 Cal. Rptr. 3d 874, 876 (Cal. Ct. App. 2013); Gibbo v. Barger, 19 Cal. Rptr. 3d 829, 833–34 (Cal. Ct. App. 2004).

[34] *See, e.g.*, De Wolf v. Johnson, 23 U.S. 367, 382–83 (1825).

[35] *Id.* at 393; *see also* Call v. Palmer, 116 U.S. 98, 103 (1885); *In re* Worth, 130 F. 927, 930 (N.D. Iowa 1904); Boyett v. Rutland Sav. Bank, 116 S.W.2d 857, 860 (Tex. Civ. App. 1938); Cont'l Assurance Co. v. Gibner, 119 S.W.2d 588, 592 (Tex. Civ. App. 1938); Volunteer State Life Ins. Co. v. Robinson, 74 S.W.2d 188, 192 (Tex. Civ. App. 1934).

[36] Norton v. Commerce Trust Co., 71 F.2d 136, 136 (5th Cir. 1934); *see also* Ames v. Occidental Life Ins. Co., 291 P.182, 183 (Cal. 1930). Although courts often state the rule as applicable to a grantee who has "assumed" the mortgage, the explanation equally well suits the purchaser who took "subject" to the mortgage, so long as the mortgage debt was subtracted from the price that had to be paid. The rule may not fit the situation in which the grantee agreed only to assume the amount "legally due."

promise to pay interest to the lender, but rather a required flat sum payment to the grantor's lender as part of the purchase price,[37] making it look more like a time-price differential than a loan.[38] For rather similar reasons, a borrower who has already lost his property on foreclosure cannot make a usury claim against the foreclosure purchaser.[39]

B. Transfer of Negotiable Paper

If the loan was embodied in a negotiable instrument that had thereafter been negotiated to a holder in due course, Article 3 of the Uniform Commercial Code (UCC) generally gives the transferee a defense against claims of usury.[40] When a note is negotiable, UCC section 3-305(b) provides that the only valid defenses against a holder in due course are the "real" ones enumerated in section 3-305(a)(1); other defenses are cut off against a holder in due course by virtue of section 3-305(a)(2).[41] Usury is usually an "other" defense.[42] While there are some exceptions to section 3-305 in section 3-306, they do not relate to usury.[43]

C. Transfers to Nonholders in Due Course

This leaves hanging the more difficult question of what to do when the transferee of the loan does not qualify as a holder in due course, either because the original note was not a negotiable instrument, or because its transfer was not a proper negotiation.

That predicament—a "bad" note transferred to a "good" person—was recently illustrated in *Creative Ventures, LLC v. Jim Ward & Associates*,[44] a California appellate decision. In that case, the plaintiffs borrowed $2 million to finance their real estate ventures.[45] Their loans were at only 10% interest, the California maximum, but the loan broker added his commission to the interest rate, bringing the effective rate up to 16%.[46]

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[37] *See Norton*, 71 F.2d at 136.

[38] *See* W. Coast Builders, Inc. v. Pac. States Auxiliary Corp., 18 P.2d 71, 72 (Cal. Dist. Ct. App. 1933).

[39] *See* Edgell v. Ham, 93 F. 759, 764 (5th Cir. 1899).

[40] *See* U.C.C. § 3-305 (amended 2002), 2 U.L.A. 155 (2004).

[41] *See id.*

[42] *See* Robinson v. Rudy, 666 S.W.2d 507, 509 (Tex. App. 1983).

[43] *See, e.g.*, Thompkins v. Mortg. Lenders Network USA, Inc., 61 A.3d 829, 836 (Md. Ct. Spec. App. 2013).

[44] 126 Cal. Rptr. 3d 569 (Cal. Ct. App. 2011).

[45] *See id.* at 569.

[46] *See id.*

This 16% charge was not originally thought to be usurious because of the California exemption for loans "made or arranged by any person licensed as a real estate broker,"[47] described earlier. Everyone simply assumed that this transaction came under the broker arranged loan exemption.[48]

The problem was that the broker had allowed his corporate license to lapse.[49] Although his individual license was still in good standing, he handled these loans through his corporation—the unlicensed entity.[50] This blunder meant that the broker arranged loan exemption did not apply and, therefore, the total charge of 16% was usurious.[51]

This fact was not discovered by the borrowers until after they had fully repaid the loans, but upon discovery they sued to recover all the interest they paid, as California usury law permits.[52]

What makes the appellate opinion affirming the borrowers' recovery notable is that the 54 individuals who advanced small sums ($25,000 to $50,000) to the loan broker to generate a large enough amount to handle the borrower's financing needs were joined as defendants in the action.[53] These individuals had been paid returns on their advances, but not at

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[47] CAL. CIV. CODE § 1916.1 (West 2010).

[48] *See Creative Ventures, LLC*, 126 Cal. Rptr. 3d at 570. More technically, the loans should probably have been characterized as broker "made," rather than "arranged," because the funds came from numerous small private investors who had advanced them to the broker, who then loaned them (himself) to the borrowers. *See id.* at 569.

[49] *See id.* at 570.

[50] *See id.* at 573.

[51] *See id.*

[52] California allows borrowers in usurious transactions to recover all unlawful interest paid. *See* White v. Seitzman, 41 Cal. Rptr. 359, 362 (Cal. Dist. Ct. App. 1964). It also permits them sometimes to recover treble interest. *See* Heald v. Friis-Hansen, 345 P.2d 457, 462 (Cal. 1959). Treble interest was denied by the trial court in *Creative Ventures*, on the ground that the overcharge was not malicious. *See* 126 Cal. Rptr. 3d at 579–80. The United States Supreme Court said, in 1836:

> [H]e who seeks the aid of equity to be delivered from usury, must do equity by paying the principal and legal interest upon the money borrowed. . . . This is essential to every such application in a court of equity: first, to give the court jurisdiction; and to enable the chancellor, if he thinks proper to do so, to require the payment of principal and interest before the hearing of the cause. The relief sought in such cases is an exemption from the illegal usury.

Stanley v. Gadsby, 35 U.S. 521, 522 (1836). But probably nothing stops a legislature from changing that rule and converting a usurious loan into an interest free one.

[53] *See Creative Ventures, LLC*, 126 Cal. Rptr. 3d at 568.

usurious rates.[54] In fact, they knew nothing about the transaction or about its usurious features.[55] Should they have to forfeit the "legitimate" interest that they had received?

The trial court reasoned that the investors should not have to refund the interest payments they received, because the investors were holders in due course, protected under UCC section 3-305.[56] But the court of appeals concluded that such characterization of the investors was impossible because the notes had not been endorsed to them and they did not hold the notes.[57]

The notes were originally made payable "'to the order of JIM WARD & ASSOCIATES (the 'Holder,' which term shall include all assignees of this Note.)'"[58] In the lawsuit, the parties agreed that the notes were negotiable instruments—a characterization that might be challenged in light of the many other cluttering provisions included in the notes.[59]

In finding the trial court's ruling to be incorrect, the court of appeals reasoned:

> Investors might have become holders had JWA negotiated the notes by indorsing and transferring possession to Investors. (Com. Code, § 3201.) But negotiation does not take place, and the transferee does acquire the rights of a holder, unless the instrument is indorsed. (*Id.* § 3203, subd. (c).) It follows that, since there is no evidence that JWA negotiated the promissory notes by endorsement and delivery, Investors cannot be holders in due course.[60]

Instead of negotiating and transferring the notes to the investors, JWA, pursuant to the loan servicing agreements with the investors, retained possession of the notes, collected the payments, and remitted appropriate shares of the proceeds to the investors.[61] Under such circumstances, they could not be treated as endorsees or holders of the notes.[62]

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[54] *See id.* at 578.
[55] *See id.* at 579.
[56] *See id.* at 575.
[57] *See id.* at 577–78.
[58] *Id.* at 569 (quoting the promissory note contained within the court record).
[59] *See id.* at 575.
[60] *Id.* at 576.
[61] *See id.* at 569.
[62] *See id.* at 575.

Even if the possession (holder) issue could be dodged, by saying that JWA held the notes as agent of the investors (thus, the notes were constructively held by the investors themselves), the notes could not have been endorsed to the investors, which is a necessary step to allow the investors to claim holder in due course status.[63]

Holder in due course status makes an enormous difference. Had the investors been holders in due course, they would have held the notes free of any defense of usury, as noted earlier. But given the loan servicing arrangement, the investors were not holders in due course, they were merely common law assignees of the notes.[64] As assignees, they were entitled to enforce the obligations assigned to them, but those collection rights were subject to whatever defenses the obligors had against their assignor.[65] The investors may have made no usurious profit on their investments, but that did not mean that the rights assigned to them were free of the original taint of usury generated by the unlicensed status of the transferor.[66] So the investors lost all the interest they had received.[67]

It seems easier to feel sorry for the innocent investors[68]—who lost all interest—than for the sophisticated borrowers, who ended up receiving interest-free money as the result of a licensing fumble by the intermediary loan broker (who had been retained by the borrowers to get the funds). But if usury is to be treated as a legitimate defense for borrowers, and if appropriate sanctions are to include recovery of all interest paid, then the result was "correct," and will likely be followed in similar situations. This conclusion means that attorneys whose clients invest their savings in fractional shares of larger mortgage loans must warn clients of the risk that they may lack any holder in due course defenses if the loans turn out to be legally problematic. And attorneys whose clients make, sell, or service such loans for investors should devise arrangements that will allow their clients to guaranty their investors that all such risks have been eliminated.

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[63] *See id.* at 576.

[64] *See id.* at 577.

[65] *See id.*

[66] Two of the investors testified that they received, respectively, eight and ten percent interest on their loans. *See id.* at 570.

[67] *See id.* at 568.

[68] Who were probably mainly retirees.

IV. SOLVING THE PROBLEM

Solutions should not be impossible to find. To have the protection that they needed, the investors in *Creative Ventures*[69] needed to be sheltered by the holder in due course doctrine; indeed, that is what the law of negotiable instruments is all about. The loans they invested in needed to be represented by negotiable notes that had been properly negotiated—to them or to someone fronting for them. This was a lesson Wall Street taught a few decades ago when it began to securitize individual mortgage notes into pools held by special purpose entities, which were then redivided into tranches and sold to investors by way of certificates that were defense free.[70] Consequently, many of those teachings of how loans were securitized should be useful for the *Creative Ventures*[71] financer.[72] First, the note must be negotiable when it is initially executed and it must be order or bearer paper. While an original payee may be able to qualify as a holder in due course,[73] transferee status is a safer alternative, meaning that the ultimate investors should not be named in the original note itself. Investors should also proceed with caution to ensure that other provisions of the note do not impair its negotiability.[74] Second, the note should be endorsed, rather than assigned, to the investors.[75] The final step—the one that the *Creative Ventures*[76]

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[69] *See Creative Ventures, LLC*, 126 Cal. Rptr. 3d at 568.

[70] *See generally* Timothy J. Riddiough, *Can Securitization Work? Economic, Structural, and Policy Considerations* (June 2010), *available at* http://www.fdic.gov/bank/analytical/CFR/mortgage_future_house_finance/papers/riddiough.pdf (outlining the modifications necessary to securitize underlying loan-securities).

[71] 126 Cal. Rptr. 3d 564 (Cal. Ct. App. 2011).

[72] While the securitization episode may have ultimately come to a disastrous conclusion, that was because too many of the mortgages in the pools were trash, or because the sponsors of those pools had been too rushed to comply with the formalities mandated by their pooling agreements, not because the investors failed to qualify for holder in due course protection.

[73] *See* U.C.C. § 3-302, note 4 (amended 2002), 2 U.L.A. 155 (2004).

[74] *See* Dale A. Whitman, *How Negotiability Has Fouled Up the Secondary Mortgage Market, and What to Do About It*, 37 PEPP. L. REV. 737, 739–40 (2010).

[75] *See* U.C.C. § 3-201 (amended 2002), 2 U.L.A. 102. This step is unnecessary if the notes are bearer paper. *See id.* "If an instrument is payable to bearer, it may be negotiated by transfer of possession alone." *Id.* § 3-201(b), 2 U.L.A. 102. If the bank issues a cashier's check to the Buyer, the Buyer must endorse the check to the Seller during the sale. However, if the check is made payable to the Seller the Buyer is simply a "remitter" of the check and his endorsement is not required to facilitate the sale. *See id.* § 3-201, cmt. 2, 2 U.L.A. 102.

financer failed to take—is to have the notes delivered to a proper "holder." It may have made sense for the financer to physically retain the notes, given that there were numerous investors for each note and that to be able to service the loans it was technically required to exhibit the appropriate note to the payors to collect the payments due on it. As there was only one note, it could not give each investor a genuine copy of the original note, nor could it tear up those single pieces of paper into fifty-three little pieces. But a comprehensive agency and servicing agreement could solve this issue.

What the financer should have learned from Wall Street was that the notes could be delivered to a third person—probably an entity of some kind, preferably bankruptcy remote, who would qualify for holder in due course status, and thus be able to hold the notes free of the risk that they would later be subject to any usury defense.

The investors should also not have been given fractional interests in the notes—another feature that made it impossible for them to assert holder in due course status for themselves[77]—instead, they should have been given fractional interests in the entity that did hold the notes and had holder in due course status. Such a strategy should not be difficult to follow. We have long enabled individuals to form a group and then empowered the group to collectively exercise the rights previously held individually.[78] If the *Creative Ventures*[79] financer wanted to fully insulate its investors, it should have done what the secondary market has learned to do in the last few decades for its investors.

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[76] 126 Cal. Rptr. 3d 564 (Cal. Ct. App. 2011).

[77] Under U.C.C. section 3-203(d), a note is negotiated only if the *entire* instrument is transferred to the transferee. *See* U.C.C. § 3-203(d) (amended 2002), 2 U.L.A. 106 (2004). So fractional transfers of the notes to the investors, even if there had been proper endorsements, would not have worked. The Official Comment to U.C.C. section 3-203 states:

> The cause of action on an instrument cannot be split. Any endorsement which purports to convey to any party less than the entire amount of the instrument is not effective for negotiation. This is true of either "Pay A one-half," or "Pay A two-thirds and B one-third." Neither A nor B becomes a holder. On the other hand an endorsement reading merely "Pay A and B" is effective, since it transfers the entire cause of action to A and B as tenants in common.

U.C.C. § 3-203, cmt. 5, 2 U.L.A. 108. The last sentence of this comment does suggest that the investors might be protected if they held their shares of the notes as tenants in common, but that appears as an awkward and clumsy alternative. *See id.*

[78] Thus we have trusts, corporations, partnerships, LLCs.

[79] 126 Cal. Rptr. 3d 564 (Cal. Ct. App. 2011).

V. CONCLUSION

There are serious risks for persons who purchase participating interests in larger loans, because the structure of those arrangements likely fails to give them holder in due course protection against usury claims. Counsel for both the original lender and the later loan participants must watch closely to assure that those risks have been minimized.