LEGAL NEWS ALERT

Lending Money: Avoiding The Pitfalls Of Usury

By Gregory J. Kowalsky

The doctrine of usury has been with us since time immemorial. Even the Bible has restrictions on interest rates: "You may charge a foreigner interest, but you may not charge your brother interest…" – Deuteronomy 23:20. Even though this doctrine has been with us for millennia, lenders are still tripped up by usury laws.

Lending money today is generally guided by more than religious teachings. Understanding the rules our society has chosen to adopt can ensure maximum returns, while avoiding situations resulting in the total loss of principal. Indeed, focus on more than just the size of the numeral denoting interest is required. Lenders must pay close attention to the total amount lent, cumulative annual obligations (including fees other than interest), and the type of borrower. Consequences for violating usury laws are dire, and at times, have criminal implications.

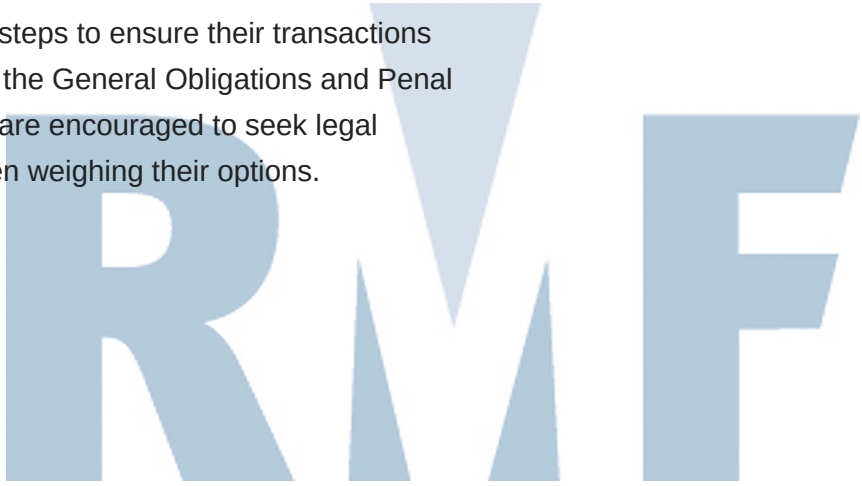
Clever borrowers often capitalize on the mistakes of their lenders by asserting usury defenses after-the-fact. Transaction fees and compounded interest, although common, can tip a loan into usurious waters if not carefully structured. New York General Obligations Law §5-501 limits the rate of interest chargeable for money, goods, or things to 16%, and New York Penal Law §190.40 makes it a criminal offense to charge interest at a rate exceeding 25%. In determining whether these statues have been violated, courts will consider all fees, costs, interest, and any other monetary obligation involved in the transaction. Thus, an otherwise compliant loan, charging interest at a non-usurious rate, can still violate the statute if the agreement provides for compounding interest (GOL §5-527[3]), administrative charges, or other costs, which, when taken together, makes the rate of return usurious.

However, there are exceptions. For instance, a loan that exceeds $250,000.00 need not comply with the civil usury limitations. Thus, lenders dealing in loans exceeding a quarter of one million dollars may charge a rate of interest up to 25%. Additionally, creditors need not concern themselves with penalties, late fees, or other obligations incurred after default because they are not considerations when determining if a loan is usurious. Even transaction fees like closing costs may be excluded from usury calculations if deemed reasonable, and not a pretext for higher interest.

Loans to corporations are governed by different rules. In these transactions, creditors can charge above 16% because corporations may not assert the defense of civil usury. The policy behind society's protection of individual debtors does not apply to corporations, which tend to be viewed as sophisticated parties. Criminal usury prohibitions still apply to business entities, precluding rates of 25% and higher, but unlike civil usury, the Penal Law does not void a debtor's obligation to repay principal. "Corporations" are defined by the statute as all associations, and joint-stock companies having any of the powers and privileges of corporations not possessed by individuals or partnerships.

This includes limited liability companies, but does not include partnerships, which are more akin to individuals.

Creditors must ensure their transactions comply with usury laws before a deal is closed. Since litigation can be expensive and take years to resolve, a lender must evaluate, before a lawsuit is brought, the possibility that a borrower has a valid usury defense. If so, the lender may waste valuable resources prosecuting a claim that cannot be won, adding insult to injury by losing not only principal, but attorneys' fees pursuing the principal. All lenders should take the necessary steps to ensure their transactions conform to the General Obligations and Penal Laws, and are encouraged to seek legal advice when weighing their options.



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