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THE CORPORATE DEVICE AS A COVER FOR USURY—AMENDMENT TO NEW YORK GENERAL BUSINESS LAW, SECTION 374—CORPORATIONS PROHIBITED FROM INTERPOSING THE DEFENSE OF USURY.—The use of the corporate device as a cover for usury has recently been brought into the foreground of legal thought by the recent amendment to section 374 of the New York General Business Law and the events leading to its enactment. A brief history and commentary on this point of law now seems appropriate.

Usury, which originally simply meant any interest for the use of money but which now has come to mean excessive interest, has been looked upon since earliest times with abhorrence. Prohibitions or limitations which were found among the early laws of the Chinese, Hindus, in the Koran, Mosaic law, Athenian law and the Twelve Tables continued during the middle ages, when the taking of any interest was considered a vice and contrary to the laws of God.[1] When commercial necessity during the Tudor reign revived the previously limited practice of making loans at interest, it was restricted by statutes which continued to proclaim its detestable nature.[2] Excessive interest remained illegal in England until the increasing amount and complexity of commercial transactions resulted in such severe criticism of the usury statutes as restrictions on economic development that the laws were made less and less severe and were finally abolished in 1854.[3]

The evil which was recognized in earlier history, when the taking of any interest was forbidden, is the same evil which our laws today attempt to control while allowing a limited interest on the loan of money. This evil is not the fact that money is lent with interest but that an individual is placed in a position where, as a necessitous borrower, he may promise whatever interest or other monetary consideration or bonus is demanded by the lender in order to obtain a loan and will usually, because of the onerous interest requirements involved, be unable to free himself from debt. Our public policy has dictated the enactment of legislation to protect the borrower from extortion and oppression by unscrupulous persons who are ready to take undue advantage of the necessities of others. Experience has shown that a borrower's necessities may create such an inequality between lender and borrower as to deprive the latter of any freedom in contracting and place him at the mercy of unconscionable lenders. An individual burdened with an excessive debt frequently is compelled to seek a further series of larger loans in an ever increasing spiral until he reaches an impossible point where he can no longer hope to repay them and he loses all his assets. In theory then, the law places a borrower in the same legal category with persons under legal liability to contract such as infants and persons non compos mentis, although we will see that in practice not all borrowers qualify for this special protection.

The early colonial usury acts were modeled after the English acts, adopting the penalty of the mother statutes which rendered a usurious contract wholly void.[4] In their subsequent history the American statutes have also responded to the economic influence and have become less and less severe. However, due to the differing degree of such influence in various areas and the adoption of different methods to reach an equitable balance between the economic influence and the social need to protect the

1. See State ex rel. Embry v. Bynum, 243 Ala. 138, 9 So. 2d 134 (1942).

2. "And for as much as all usury, being forbidden by the law of God, is Sin and Detestable." 13 Eliz. c. 8 (1561).

3. Usury Laws Repeal Act, 17 & 18 Vict. c. 90 (1854).

4. See Plitt v. Kaufman, 188 Md. 606, 53 A. 2d 673 (1947).

individual, such statutes have reached a point of what appears to be great diversity. In most jurisdictions today the usurious contract is unlawful or void only as to the interest or as to so much of the interest as is in excess of the legal rate.[5] In Rhode Island we still find the entire usurious contract void but the interest rate allowed is thirty percent on loans above $50.[6] In many states the parties may agree in writing to pay interest above the legal rate frequently as high as ten or twelve percent[7] and Connecticut, where twelve percent may be orally agreed upon, has seen fit to exempt mortgages above $500 from the operation of its usury statutes.[8] A number of states such as Maine,[9] Massachusetts[10] and New Hampshire[11] have followed the English and Canadian[12] course and abolished their usury laws. Of course, most states, whether having liberal, severe, or no usury statutes, have realized the need of special legislation in certain types of loan transactions and consequently have enacted small loan and banking laws.[13] Statutewise, in the severe extreme we find several states, including New York where the legal rate is a maximum of six percent,[14] where a usurious contract remains void in its entirety[15] and where under certain circumstances a usurer may be subject to imprisonment.[16]

In 1850 the New York legislature, as a result of a case wherein a corporation availed itself of the usury statutes to avoid a large obligation,[17] passed the statute which denies the defense of usury to a corporation.[18] Although the purpose of the statute was said to be the prevention of avoidance by corporations of their contracts,[19] judicial interpretation in New York as well as elsewhere, has generally regarded such a statute as leaving the corporate borrower free to contract with lenders on whatever terms it wishes.[20] When we consider the basic evil which the statutes outlawing usury were designed to counteract, i.e., to protect the necessitous individual borrower from falling deeper and deeper into debt, it is obvious that, speaking generally, such evil cannot exist in the case of the corporate borrower, where unlimited individual liability

5. See 6 Williston, Contracts § 1683 (rev. ed. 1938).

6. R.I. Laws c. 485 §§ 2, 4 (1938).

7. Arkansas 10%, California 10%, Colorado 12%, Connecticut 12%, Florida 10%, Kansas 10%, Montana 10%, New Mexico 12%, Oklahoma 10%, Oregon 10%, Texas 10%, Utah 10%, Washington 12%, Wisconsin 10%, Wyoming 10%.

8. Conn. Gen. Stats. § 6784 (1949).

9. Me. Rev. Stats. c. 55, § 204 (1944). No usury law except as to loans not exceeding $300.

10. Mass. Gen. Laws c. 107, § 3 (1932).

11. N.H. Rev. Laws c. 367, § 1 (1942).

12. R.S.C. c. 156 (1952).

13. In New York see N.Y. Banking Law Art. IX (1932).

14. N.Y. General Business Law § 370 (1879). This rate is a reduction from the 7% allowed prior to 1879.

15. N.Y. General Business Law § 373 (1837). But the New York courts generally will apply the law of another state if the law of the other state is not as severe as that of New York. See Short v. Taylor Maide Co., 271 App. Div. 464, 66 N.Y.S. 2d 245 (1st Dep't 1946).

16. N.Y. Penal Law § 2400 (1904).

17. Dry Dock Bank v. American Life Ins. & Trust Co., 3 N.Y. 344 (1850).

18. N.Y. General Business Law § 374 (1955).

19. See Merchant's Exchange Nat'l Bank v. Commercial Warehouse Co., 49 N.Y. 635, 641 (1872).

20. See Hubbard v. Tod, 171 U.S. 474 (1898); MacQuoid v. Queens' Estate, 143 App. Div. 134, 127 N.Y. Supp. 867 (2d Dep't 1911).

is absent. The usual private business corporation, organized for profit, to succeed must take financial risks. If it fails, it (in reality, its members) may lose its assets, in which case it remains an empty shell and its members are free from individual liability. To permit the corporation, which usually seeks profits in excess of the legal rate of interest, to avoid an obligation on the ground of usury would indeed today be an anachronism.

The full extent to which the corporate form may be used in connection with the making of a loan, at a rate exceeding the rate of interest which may legally be charged an individual, was not completely apparent until the decision of the Court of Appeals in *Jenkins v. Moyse*.[21] In this case Jenkins was in need of a loan to apply to the mortgage debt upon his real estate. Upon consulting a broker, he was apparently told that the legal rate of six percent would not satisfy a prospective lender upon a second mortgage, but that by incorporating with title to the mortgaged property conveyed to the corporation, the corporation could obtain such a loan with the payment of a bonus. In behalf of the corporation to be formed, he authorized the broker to negotiate the loan and defendant agreed to make a loan of $27,000 receiving a second mortgage of $45,000 with interest at six percent. Jenkins formed the corporation, conveyed his real estate to it, and the corporation executed the second bond and mortgage. Jenkins in no way became personally bound. After a foreclosure action, in which he was denied a motion to vacate the sale and adjudicate that the loan transactions were personal transactions between the parties, Jenkins brought an action in equity to have the mortgage declared usurious and void. Findings had been made in the courts below that the corporate form was used merely for the purpose of concealing and covering up a corrupt, unlawful, and usurious loan made to the plaintiff.[22] The Court of Appeals, however, reversed, holding that it was not a usurious loan nor an evasion of the statute but rather a compliance with a law that left one way open for individuals to accomplish the result desired by both parties.

The unanimous decision of the court was, on the facts of the case, unquestionably sound. Usury, as the New York statutes now prescribe, is the exaction of interest in excess of the legal rate from *an individual*. Therefore, there can be no usury if the individual is not legally bound to repay the loan. He can only become bound to repay the loan if he personally executes the bond or note evidencing the loan. In *Jenkins v. Moyse* the individual never became personally obligated to repay the loan. Only the corporate borrower signed the bond or note. The evil which the usury statutes were designed to eradicate was not present. It is true that Mr. Jenkins might lose his real estate, as eventually he did, but at least he had the chance to "start fresh" free from a burdensome debt.

But suppose the transaction took a form whereby Mr. Jenkins remained personally obligated to pay the debt, i.e., a deficiency judgment which might result from the inadequacy of the security? In such a case it might be argued that the corporate form was merely used as a cover for usury. Judge Lehman probably had this in mind when he wrote: "The test of whether this loan is usurious is whether it was in fact made to the plaintiff. Doubtless at times loans are made in fact to an individual though in form they are made to a corporation to hide the fact that the lender has exacted an illegal rate of interest from the real borrower. We do not now deal with such a situation. Here the corporation was formed and the loan made to it, rather than to the individual who owned the corporate stock. . . . *He did not in his individual capacity borrow any money or agree to repay any money.* . . . We do not now decide whether

21. 254 N.Y. 319, 172 N.E. 521 (1930).

22. 229 App. Div. 743, 241 N.Y. Supp. 901 (2d Dep't 1930), rev'd, 254 N.Y. 319, 172 N.E. 521 (1930).

the plaintiff would be bound by the judgment if the contract had been tainted with usury."[23]

Although the above qualification must be considered dictum, it certainly calls out strongly for a limitation of the actual holding to the precise facts of the case. Some possible factors which the court might have considered as being outside the holding of the case, are: (1) negotiation and agreement by the money lender with the individual upon the loan prior to the formation of the corporation. But in *Kings Mercantile Co. v. Cooper*,[24] where the court, after saying that the defendant had been compelled by plaintiff to incorporate to avoid the effect of the usury statutes, said that "this is precisely what is permitted by *Jenkins v. Moyse*. . . .";[25] (2) payment of the proceeds of the loan to, or its repayment by, the individual rather than the corporation. But in *Werger v. Haines Corp.*,[26] the individual repayed the loans herself and in *In Matter of the Bank of New York and Fifth Ave. Bank*[27] a portion of the proceeds of the loan was paid directly to the individual, yet these loans were not held to be usurious; (3) personal use of the proceeds of the loan for purposes not beneficial to the corporation. But in *Kings Mercantile Co. v. Cooper* the court held that use of the proceeds of the loan to discharge a mortgage upon the individual defendant's property was immaterial and did not compel a finding that the loan was made to the individual. Also in the *Werger* case, the proceeds of the loan were turned over by the debtor corporation as a mere conduit to the individual to use in the operation of another business not connected with that of the debtor corporation and in *In Matter of the Bank of New York* there was also personal use of the proceeds of the loan by the individual; (4) where the individual becomes in some form also liable and thereby voids the limited liability purpose of corporate formation. Herein is the truly distinguishing factor; individual liability and the consequent evil which our usury statutes were enacted to overcome. The policy of our New York law which is intended to protect an individual from usury appears to be frustrated when an individual becomes personally obligated to repay a loan at a usurious rate of interest where the loan appears to be made to the individual as evidenced not only by his personal obligation to repay the loan but also by the fact that the proceeds thereof are for his personal benefit, even though the corporate device may be interposed to act as a conduit or nominal mortgagor.

Perhaps the nearest approximation to the situation seemingly indicated by Judge Lehman's dictum in *Jenkins v. Moyse* was disclosed in the case of *Werger v. Haines Corp.* Here plaintiff, in an action on promissory notes and to foreclose mortgage securities, moved for summary judgment on the pleadings. Defendant's answer alleged that the corporate defendant was organized in 1945 to import and sell foreign cars but that it had been divested of its authority to engage in that business prior to July, 1947 when the individual defendant, who operated another business of buying and selling domestic automobiles, and her agent applied to plaintiff for a loan. It was agreed that the defunct corporation would serve as the vehicle for the loan and the defendant transferred certain assets to the corporation to which the loan was made and paid a substantial bonus with the individual defendant signing as indorser. The

23. 254 N.Y. 319, 324, 172 N.E. 521, 522 (1930) (Emphasis added.).

24. 199 Misc. 381, 100 N.Y.S. 2d 754 (Sup. Ct. 1950). Discussed later in the text.

25. Id. at 383, 100 N.Y.S. 2d at 756.

26. 94 N.Y.S. 2d 691 (Sup. Ct. 1950), aff'd, 277 App. Div. 1108, 101 N.Y.S. 2d 361 (1st Dep't 1950), aff'd, 302 N.Y. 930, 100 N.E. 2d 189 (1951). Discussed later in the text.

27. 126 N.Y.L.J., No. 105, p. 1478, col. 1 (Surr. Ct. 1951), aff'd as modified, 280 App. Div. 947, 116 N.Y.S. 2d 57 (2d Dep't 1952), aff'd, 305 N.Y. 764, 113 N.E. 2d 154 (1953). Discussed later in the text.

loan was not beneficial to the defendant corporation as the proceeds thereof were turned over to the individual defendant who used it to conduct her domestic car business. The individual defendant repaid the loan and others were executed in the same manner. The trial court granted the motion, citing *Jenkins v. Moyse* as determinative of the issues. In the Appellate Division the judgment was affirmed by a three to two court. The dissenting opinion presents a plea for the narrower construction of the *Jenkins* decision: ". . . [T]he present answer does state in detail the evidentiary facts on which the defense of usury depends. It . . . sets forth . . . the matters which would appear to entitle her and the other defendants to defend at a trial. . . . That J. Valorie Haines and not Haines Corp. repaid the previous loans that had been made. That would appear to be a decisive fact . . ."[28] After stating the facts, the opinion continues: ". . . J. Valorie Haines assigned certain chattels to Haines Corp. . . . she never transferred the business to Haines corporation but continued to operate it herself and thus used the loans made by plaintiffs to further her individual purposes."[29] Stating that J. Valorie Haines indorsed the notes and chattel mortgage and the proceeds were immediately paid by the corporation to her, the minority opinion concluded thereby that she became the primary obligor. Then Justice Van Voorhis very ably distinguishes the *Jenkins* case: ". . . [B]ut the facts of that case are different. It involves a loan at more than legal interest to liquidate a mortgage and other liens upon real property which had been owned previously by an individual but had been transferred to the corporation to which the loan was made. Unlike the present case, the proceeds of the loan were expended to serve the purposes of the corporation by extinguishing liens upon what had then become its real estate."[30] He goes on to state that plaintiff knew the funds were not to be used by Haines Corporation; that the loan was made to it as a conduit to conceal the fact that the money was really being borrowed by an individual and therefore, "this case comes within the distinction drawn in *Jenkins v. Moyse*. . . . The distinction drawn by Justice Cuff in *Sherling v. Gallatin Improvement Co.* (145 Misc. 734, 735) is valid here: 'In the *Jenkins* case the corporation was formed expressly to make the loan. Here the corporation was formed to conceal the loan agreed to be made to the individual'. . . . It may be true as Justice Cuff adds, that 'only the uninitiated fail to escape' the requirements of the usury laws, and that plaintiffs here might have brought themselves within the *Jenkins* rule if they had required J. Valorie Haines to assign her auto business to the corporation, with the consequence that the proceeds of the loan would have been used for a corporate purpose. . . . The tendency to limit the application of the usury laws should not be indulged to the extent of altering and confusing customary rules governing commercial transactions and relationships."[31]

The evidence of an individual transaction could hardly be any stronger than in this case, but the Court of Appeals nevertheless affirmed the order granting the motion for summary judgment with no opinion, citing only *Jenkins v. Moyse* and *N.Y. Credit Men's Ass'n v. Manufacturers Discount Corp.*[32] In neither of the cited cases was the individual personally obligated as in the *Werger* case.

28. Werger v. Haines Corp., 277 App. Div. 1108, 1109, 101 N.Y.S. 2d 361, 363 (1st Dep't 1950), aff'd, 302 N.Y. 930, 100 N.E. 2d 189 (1951).

29. Ibid.

30. Ibid.

31. Id. at 1112, 101 N.Y.S. 2d at 366.

32. 298 N.Y. 512, 80 N.E. 2d 660 (1948). This was a suit wherein a trustee in bankruptcy applied to have loan transactions declared usurious and to direct an accounting upon merchandise pledged by the corporation of which the bankrupt was the sole stockholder and guarantor.

The lower courts for many years before the *Jenkins* case had declared loans such as there involved, usurious.[33] Since that decision the lower courts have occasionally referred to Judge Lehman's qualification,[34] yet in the case of *Kings Mercantile Co. v. Cooper*, a lower court said: "And where a borrower and a lender desire to effect a loan at a rate of interest in excess of the legal rate, it has been held entirely valid for the borrower to incorporate even though such act is solely for the purpose of taking the loan in the name of a corporation. Apparently in this situation form prevails over substance." (citing *Jenkins v. Moyse*).[35] Further, the court states: "The defendant seeks to differentiate the cited case factually [from *Jenkins v. Moyse*] because there the debtor conveyed the real property to a corporation and the corporation executed the bond and mortgage, whereas here the bond and mortgage were executed and delivered by the individual defendant as collateral security. *This is a distinction without a difference.* Security may be furnished by a guarantor as well as by a borrower."[36]

In *In Matter of the Bank of New York and Fifth Ave. Bank*, the bank was trustee under a will by which Mrs. W. was given a remainder, contingent upon her surviving her grandmother who was at this time eighty-one years old and dying of cancer. Mrs. W., in need of a personal loan, assigned a portion of her remainder in the trust valued at $105,000 to the Waterous Lumber Co., which was wholly owned by her husband, ostensibly to enable the corporation to obtain a loan by using the assignment as collateral. The assignment stated that the corporation was in need of financial assistance and might use the assignment as collateral *but that Mrs. W. shall not be liable for any deficiency.* The lumber company on the same day re-assigned this contingent interest to the lender to secure a $33,000 loan made by the lender to the corporation. Two weeks later the lender loaned the corporation an additional $32,000 which was also secured by Mrs. W's assigned interest in the trust. The lender was to be entitled to the entire $105,000 when and if the contingency occurred, but if Mrs. W. predeceased her grandmother the corporation was not to be liable for the loans. The grandmother died two months later and the lender demanded $105,000 from the corpus of the trust. In this accounting Mrs. W. filed objections to payment on the ground that these advances made by the respondent, constituted loans to Mrs. W. and consequently were usurious and void. The referee found as a fact that Mrs. W. had authorized the corporation to pledge her interest only for the actual amounts loaned plus the legal rate of interest but in a dictum he went on to say that in his opinion, the loan would be usurious and unconscionable if liability were not so limited. The referee stated in support of his dictum: "All agree that where the defense of usury is interposed, the substance of the transaction and not its form must govern. . . ."[37] and proceeded to distinguish *Jenkins v. Moyse* on the ground that here, despite the statement of corporate need in the assignment, the money was not used

33. See Jenkins v. Moyse, 229 App. Div. 743, 241 N.Y. Supp. 901 (2d Dep't 1930), rev'd, 254 N.Y. 319, 172 N.E. 521 (1930); Anam Realty Co. v. Delaney Garage, Inc., 190 App. Div. 745, 180 N.Y. Supp. 297 (1st Dep't 1920); Fort v. Central Park West Corp., 131 Misc. 774, 227 N.Y. Supp. 351 (Sup. Ct. 1928); First Nat'l Bank v. American Near East and Black Sea Lines, 119 Misc. 650, 197 N.Y. Supp. 856 (Sup. Ct. 1922).

34. Werger v. Haines Corp., 277 App. Div. 1108, 101 N.Y.S. 2d 361 (1st Dep't 1950) (dissenting opinion); In the Matter of the Bank of New York and Fifth Ave. Bank, 126 N.Y.L.J. 1478, col. 1 (Sup. Ct. 1951) (dictum); Sherling v. Gallatin Improvement Co., 145 Misc. 734, 260 N.Y. Supp. 229 (Sup. Ct. 1932).

35. 199 Misc. 381, 382, 100 N.Y.S. 2d 754, 755 (Sup. Ct. 1950).

36. Id. at 383, 100 N.Y.S. 2d at 756 (Emphasis added.)

37. 126 N.Y.L.J. No. 105, p. 1478, col. 3 (Surr. Ct. 1951).

for its benefit but rather by the individual. Further, a portion of the money was actually paid directly to Mrs. W. and the corporation was not even to be liable on the loans.

In the Appellate Division where the referee's judgment was amended to provide that the objections of Mrs. W. be dismissed and the assignee be paid out of the interest of the objectant in accordance with the terms of the assignments, the court said: "It was conceded that the assignments would be payable only by the estate, and then only in the event said remainderman survived the life tenant, and that neither the corporation nor said remainderman could be held liable in any event; and it was so understood by all the parties. Therefore said transactions were not loans to the remainderman and are not usurious on that account . . . and there was no duress by force of circumstances; it being established that objectant had a combined annual income of $37,000 from her grandfather's and her mother's estate."[38] The court appears to have recognized that there was no individual liability nor force of circumstances present and so the decision is in accord with the theory of our usury law. The Court of Appeals affirmed with no opinion.[39]

The amendment to section 374 of the New York General Business Law[40] during the 1955 session of the legislature was prompted by a situation particularly prevalent in Queens County where certain Long Island money-lenders were reported as having had a $12,000,000 business per year on second mortgage loans with at least 8000 small homeowners obtaining short term loans requiring interest reportedly as high as 65 percent.[41] The lenders secured themselves against the charge of usury merely by having the borrowers incorporate prior to making the loan and a grand jury called to investigate the situation found that under the judicial decisions, no crime had been committed. Section 374 of the General Business Law now allows the defense of usury to a corporation whose principal asset is the ownership of a one or two family dwelling where it appears that the corporation was organized within a period of six months prior to the corporation's execution of a mortgage on the one or two family dwelling. If the individual necessitous borrower is to be protected, as our public policy appears to demand, this amendment does not go far enough. This protection should not be limited only to the owners of one and two family dwellings and for only a six month period. Further, it appears that within a few months of its enactment, other loopholes were found and several operators have resumed the practices which the amendment was designed to stop.[42]

CONCLUSION

Judge Lehman's dictum in the case of *Jenkins v. Moyse,* which was apparently designed to limit the effect of the decision in that case to the important fact that

38. 280 App. Div. at 947, 116 N.Y.S. 2d at 59.

39. 305 N.Y. 764, 113 N.E. 2d 154 (1953).

40. N.Y. Sess. Laws 1955, c. 673. Section 374 of the General Business Law now reads: "Corporations prohibited from interposing defense of usury. No corporation shall hereafter interpose the defense of usury in any action. The term corporation, as used in this section, shall be construed to include all associations, and joint-stock companies having any of the powers and privileges of corporations not possessed by individuals or partnerships. The provisions of this section shall not apply to a corporation, the principal asset of which shall be the ownership of a one or two family dwelling, where it appears that the said corporation was organized and created within a period of six months prior to the execution, by said corporation of a bond or note evidencing indebtedness, and a mortgage creating a lien for said indebtedness on the said one or two family dwelling."

41. Long Island Star Journal, Feb. 14, 1955, p. 1, col. 4; April 27, 1955, p. 7, col. 5.

42. New York Times, Nov. 18, 1955, p. 23, col. 1.

there was there involved a really corporate transaction, appears to have been either ignored or disapproved of by our Court of Appeals. The result has been to permit the utilization of the corporate entity at times as a cover for loans to individual borrowers at a usurious rate of interest. Such a situation by itself would seem to call for a legislative clarification of the distinction between a truly corporate loan and one to an individual borrower. In addition the situation of the necessitous small homeowner borrower, who may be willing to mortgage his principal possession at any rate of interest or bonus, whether or not he becomes personally obligated, to secure a loan, demands truly effective legislation rather than the limited improvisation which the legislature enacted in 1955.

A new and enlightened approach to the use of the corporate device in loan transactions is in order.