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ADDING INSULT TO INJURY: HOW *IN RE VENTURE MORTGAGE FUND* EXPOSES THE INEQUITABLE RESULTS OF NEW YORK'S USURY REMEDIES

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INTRODUCTION

For centuries, usury laws protected needy and desperate debtors from lenders' outrageous demands.[1] The protection of the needy and desperate, of the uninformed and unsuspecting, has been the upstanding principle behind these laws.[2] Usury laws are one of the earliest forms of consumer protection law,[3] having been in place over a millennia and within a wide variety of cultures in order to protect "the needy from the greedy."[4] This ideal was seemingly not in dispute in 1787 when Jeremy Bentham posed the classic freedom of contract objection to usury regulation.[5] While he postulated that, "no person of 'sound mind' who is 'acting freely' should be hindered from striking a loan bargain on terms she finds accept-

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1. Ronald Goldstock & Dan T. Coenen, *Controlling the Contemporary Loanshark: The Law of Illicit Lending and the Problem of Witness Fear*, 65 CORNELL L. REV. 127, 180-84 (1980) (describing the societal problems caused by loan sharking).

2. Robin A. Morris, *Consumer Debt and Usury: A New Rationale for Usury*, 15 PEPP. L. REV. 151, 160 (1988) ("Protection of the vulnerable is one of the oldest motivations for consumer protection.").

3. Lynn Drysdale & Kathleen E. Keest, *The Two-Tiered Consumer Financial Services Marketplace: The Fringe Banking System and its Challenge to Current Thinking About the Role of Usury Laws in Today's Society*, 51 S.C. L. REV. 589, 657 (2000) (describing the increase of fringe banking and predatory lending practices).

4. *Id.*

5. Steven W. Bender, *Rate Regulation at the Crossroads of Usury and Unconscionability: The Case for Regulating Abusive Commercial and Consumer Interest Rates Under the Unconscionability Standard*, 31 HOUS. L. REV. 721, 728 (1994) (calling for the adoption of an unconscionability standard of usury regulation rather than the traditional usury regime).

able,"[6] usury proponents disagreed, claiming that Bentham's ideal contradicts the moral policies that require usury regulation.[7] They have decried Bentham's depiction of loan bargaining as "rosy-eyed and idealistic."[8] To add to the debate, outrageous episodes of lender abuse in the 1990s have bolstered a strong consumer protection movement.[9] Some initiatives have focused on the inadequacies of current systems in regulating certain lending activities,[10] such as the new loan sharks who operate "auto-title pawns" (or "title loans"),[11] and "payday lenders."[12] Others have focused on modern predatory lending practices, which threaten desperate and needy borrowers.[13]

6. *Id.* (quoting JEREMY BENTHAM, DEFENCE OF USURY (1787), *reprinted in* 3 THE WORKS OF JEREMY BENTHAM 3 (Russell & Russell 1962) (John Bowring ed., William Tait 1843)).

7. *Id.*

8. *Id.* (citing Morris, *supra* note 2, at 156) (challenging Bentham's free market argument).

9. *Id.* at 811; *see infra* notes 11-13 and accompanying text (describing modern episodes of lender abuse).

10. Bender, *supra* note 5, at 807; Drysdale & Keest, *supra* note 3, *passim.*

11. In an "auto-title pawn," sometimes referred to as a "title loan," the lender offers a small loan secured by a nonpurchase money interest in the borrower's car. Drysdale & Keest, *supra* note 3, at 598. In some instances, the loan is structured as a "buy-leaseback" transaction, where the borrower pledges the title to the vehicle over to the lender, with the lender leasing the vehicle back to the borrower. *Id.* Other lenders will actually require the customer to turn over a key to the car, in order to simplify repossession if the borrower defaults. *Id.* Abuses in this area include the following examples: a woman who lost her car to repossession after paying $400 in interest on a $250 loan; a borrower living on income from social security disability who borrowed $500 to pay medical bills, but ended up losing his truck when, after paying more than $2000 in interest payments over the course of a year and a half, he still owed $ 612; a borrower who paid $370 per month over twenty months ($7400) on a $1700 loan to cover for mortgage payments, but still owed $2070 in order to protect the family car from repossession by the title lender. *Id.* at 607.

12. Payday lending involves very short-term cash loans, commonly under $1000 for a term of two weeks. *Id.* at 601. The borrower generally advances a postdated check for the principal amount plus a "fee," and the lender advances cash in the sum of the principal. *Id.* At the end of the loan term, the borrower pays the principal plus the fee to redeem the check, or allows the lender to deposit the check to pay off the loan. *Id.* If the borrower cannot repay the loan, he may extend the loan for another "fee," or he can borrow the cash to pay off the first loan from another lender, with another added "fee," which can lead to a pyramid effect. *Id.*

13. Predatory lending practices normally involve factors such as the following: the borrower does not have full knowledge and understanding of the terms of the loan; there is no affirmative disclosure to the borrower of all material information regarding the terms of the loan and the borrower's rights; the lender obscures material information about the loan terms; there is pressure to induce the borrower to enter into the loan agreement; the lender has knowledge that the borrower's income is insufficient to meet the terms of the loan; there is a pattern of targeting vulnerable populations for the purpose of making high-cost loans. Deborah Goldstein, Note, *Protecting*

What has since emerged from the usury debate amounts to a distinction between borrowing by unsophisticated or desperate parties, and borrowing in a commercial context, which presumes a level of sophistication and equal footing.[14] Usury regulations in most states "treat corporate or business borrowers differently than consumer borrowers."[15] This manifests itself in allowing higher interest rate ceilings for corporate borrowers, exempting corporate loans from usury limits altogether, and even extending the "corporate exemption" to business loans generally.[16] Yet, even in a commercial context, small businesses may have less familiarity with commercial transactions and might suffer as much as unsophisticated consumer borrowers.[17] On the other hand, usury opponents, realizing the consumer justifications for strong usury regimes, argue that legislators should resist reaching for the blunt instrument of usury to restore contractual order in the marketplace,[18] arguing for a cost justification standard of unconscionability.[19]

However, most of the usury debate today focuses on the usury laws themselves. Should interest limits be adopted, or should states turn to the unconscionability standard as their model to combat predatory lending?[20] There are also advocates and consumer protection groups that promote new legislation addressing loop-

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Consumers from Predatory Lenders: Defining the Problem and Moving Toward Workable Solutions, 35 HARV. C.R.-C.L. L. REV. 225, 233 (2000) (describing the elements and problems of predatory banking).

14. Bender, *supra* note 5, at 791.

15. *Id.*

16. *Id.* Many states exempt loans to corporations from their usury statutes on the theory that unlike consumer loans, corporate loans were negotiated at arm's length. *Infra* notes 128-132 and accompanying text. Thus, some have argued that the exemption should apply to all business loans, whether made to a corporation or other business entity, such as a partnership, LLC, or sole proprietorship.

17. Bender, *supra* note 5, at 792.

18. *Id.* at 811.

19. *Id.* The unconscionability standard operates within the general law of contracts, where unconscionability is invoked to deny specific performance of a contract for grossly inadequate consideration or to generally police unfairness in contracts. *Id.* at 735. A traditional usury regime relies on certain discrete elements in order to trigger a violation, such as specific types of loans over specified interest rates. *Id.* However, the unconscionability standard favors a flexible case-by-case fairness standard, which includes proof of procedural unfairness and interest rates that are grossly exorbitant in the context of a case-by-case factual analysis. *Id.*

20. *Compare* Morris, *supra* note 2, at 178-79 (advocating usury regulation as the most effective way of controlling debt), *with* Bender, *supra* note 5, at 811 (advocating the standard of unconscionability to regulate predatory lending and "to restore contractual order in the marketplace").

holes that allow "fringe banking predatory lending"[21] to flourish.[22] The current debate, however, has not adequately focused on the various usury remedies and their impact on equitable policy concerns. Usury remedies are notoriously nonuniform,[23] but usury penalties have historically been more severe than they are now.[24] The most common remedy for usury violations is the disallowance of the entire interest charged.[25] A few states void only the interest that exceeds the usury limit,[26] but most usury regimes levy some additional sanction, such as the forfeiture of all the interest, as a deterrent.[27] However, some states still impose severe punitive civil

21. Drysdale & Keest, *supra* note 3, at 589; *supra* notes 11-13 and accompanying text (describing some elements of predatory lending, such as the "auto-pawn title" loans and "payday lenders").

22. Drysdale & Keest, *supra* note 3, *passim.*

23. Bender, *supra* note 5, at 789.

24. *Id.*

25. *Id.* at 790 n.346 (citing DEE PRIDGEN, CONSUMER CREDIT AND THE LAW § 10.07 (1991)).

26. *Id.* at 790; *e.g.*, DEL. CODE ANN. tit. 6, § 2304(b) (2001) (Delaware: borrower not required to pay the creditor the excess over the lawful rate); MO. REV. STAT. § 408.050 (2001) (Missouri: borrower may sue usurer for any and all sums paid in excess of the principal and legal rate of interest); TENN. CODE ANN. § 47-14-117(a) (2001) (Tennessee: usurious contract shall not be enforceable; but the lender may sue to recover the principal actually advanced, plus lawful interest); VT. STAT. ANN. tit. 9, § 50 (2001) (Vermont: borrower may recover the amount paid above the legal interest).

27. Bender, *supra* note 5, at 790; *e.g.*, ALA. CODE § 8-8-12(a) (2001) (Alabama: usurious contracts cannot be enforced except as to the principal); ARIZ. REV. STAT. § 44-1202 (2001) (Arizona: usurer forfeits all interest); GA. CODE ANN. § 7-4-10(a) (2001) (Georgia: usurer shall forfeit the entire interest; no further penalty or forfeiture shall be allowed); 815 ILL. COMP. STAT. § 205/6 (2001) (Illinois: borrower may recover twice the total of all interest); LA. REV. STAT. ANN. § 9:3501 (West 2001) (Louisiana: usurious contract results in the forfeiture of the entire interest); MD. CODE ANN., COM. LAW I § 12-114(a) (2001) (Maryland: usurer forfeits the greater of three times the amount of excess illegal interest, or $500); MICH. COMP. LAWS § 438.32(2) (2001) (Michigan: usurer barred from the recovery of any interest); MINN. STAT. § 334.02 (2001) (Minnesota: borrower may recover the full amount of interest paid); MONT. CODE ANN. § 31-1-108(1) (2001) (Montana: usurious contract shall be deemed a forfeiture of a sum double the amount of interest); NEB. REV. STAT. § 45-105 (2001) (Nebraska: usurious contract shall not be void, but usurer shall recover only the principal, without any interest); N.J. STAT. ANN. § 31:1-3 (West 2001) (New Jersey: in usurious contract, no more than the amount actually lent, without interest, may be recovered); N.C. GEN. STAT. § 24-2 (2001) (North Carolina: penalty for usury shall be the forfeiture of the entire interest); N.D. CENT. CODE § 47-14-10 (2001) (North Dakota: usury shall be deemed a forfeiture of the entire interest and a forfeiture of twenty-five percent of the principal); OKLA. CONST. art. XIV, § 3 (Oklahoma: usurious loans shall be deemed a forfeiture of the entire interest); 41 PA. CONS. STAT. § 502 (2001) (Pennsylvania: borrower may recover triple the amount of excess illegal interest); TEX. FIN. CODE ANN. § 305.001(a) (2001) (Texas: usurer is liable for the greater amount of: (1) three times the amount of illegal interest less the legal interest allowed; or (2) $2,000 or twenty percent of the principal, whichever is less); WASH.

sanctions, denying the recovery of not only the interest but the loan principal as well.[28] Additionally, only a few states provide for criminal penalties for usury violations.[29] How these various ap-

REV. CODE § 19.52.030(1) (2001) (Washington: usurious contract shall not be void, but the creditor shall only be entitled to the principal); W. VA. CODE § 47-6-6 (2001) (West Virginia: usurious contracts shall be void as to all interest, and the borrower may recover four times all interest agreed to be paid, and in any event, a minimum of $100); WIS. STAT. § 138.06(1) (2001) (Wisconsin: usurious contracts shall be valid to recover the principal amount loaned in excess of $2,000, but no interest may be recovered).

28. Bender, *supra* note 5, at 790; *e.g.*, ARK. CONST. art. XIX, § 13 (Arkansas Constitution: usurer forfeits the principal and interest of usurious consumer loans); ARK. CODE ANN. § 4-57-106 (2002) (Arkansas Code: usurious contracts shall be void); ME. REV. STAT. ANN. tit. 9-A, § 5-107(1) (2001) (Maine: if usurer threatens borrower with violence to cause harm to the person, reputation, or property as a means to enforce repayment, the loan is unenforceable); MINN. STAT. § 334.03 (2001) (Minnesota: usurious loans shall be void); N.Y. GEN. OBLIG. LAW § 5-511(1) (McKinney 2000) (New York: usurious loans shall be void); R.I. GEN. LAWS § 6-26-4(a) (2001) (Rhode Island: usurious loans shall be void); TEX. FIN. CODE ANN. § 305.002(a) (2001) (Texas: lender who charges interest that is greater than twice the interest rate authorized forfeits the principal amount and any interest charged); VA. CODE ANN. § 6.1-330.47 (2001) (Virginia: usurious contract shall be null, void, and unenforceable by the lender).

29. Bender, *supra* note 5, at 790; *e.g.*, CAL. CIV. CODE § 1916-3(b) (2001) (California: usurer is guilty of a felony, and is punishable by state imprisonment for not more than five years or jailing by the county jail for not more than one year); COLO. REV. STAT. § 18-15-104(1) (2002) (Colorado: creditor of loan contract that charges an interest rate exceeding forty-five percent commits the crime of criminal usury, which is a class 6 felony); CONN. GEN. STAT. § 21-47(a) (2001) (Connecticut: usurer shall be guilty of a class D felony); FLA. STAT. ch. 687.071(2)-(4) (2002) (Florida: provider of loan with interest rate exceeding twenty-five percent but not in excess of forty-five percent, shall be guilty of a misdemeanor in the second degree; provider of loan with interest rate exceeding forty-five percent, shall be guilty of a felony of the third degree; an extortionate extension of credit or where, "the creditor . . . had a reputation . . . for the use or threat of use of violence . . . to cause harm to the person, reputation, or property of any person to collect extensions of credit or to punish the nonrepayment thereof," shall be guilty of a felony of the second degree); GA. CODE ANN. § 7-4-18 (2001) (Georgia: loans bearing interest rate of more than five percent per month, shall be guilty of a misdemeanor); HAW. REV. STAT. § 478-6 (2001) (Hawaii: usurer shall be fined not more than $250, or imprisoned not more than one year, or both); MASS. GEN. LAWS ch. 271, § 49(a) (2001) (Massachusetts: provider of loan with an interest rate greater than twenty percent shall be guilty of criminal usury, punishable by imprisonment for not more than ten years or by a fine of not more than $10,000, or both); MICH. COMP. LAWS § 438.41(1) (2001) (Michigan: lender charging interest on a loan at a rate exceeding twenty-five percent is guilty of criminal usury, punishable by imprisonment not to exceed five years or fined not more than $10,000, or both); N.Y. PENAL LAW § 190.40 (McKinney 2000) (New York: lender charging interest on a loan at a rate exceeding twenty-five percent is guilty of criminal usury in the second degree, a class E felony); N.D. CENT. CODE § 47-14-11 (2001) (North Dakota: usurer shall be guilty of a class B misdemeanor); WIS. STAT. § 138.06(2) (2001) (Wisconsin: usurer may be fined not less than $25 nor more than $500, or imprisoned not more than six months, or both).

proaches to usury remedies impact the general usury debate has not been adequately explored.

This Note evaluates New York's usury remedy regime, which is among the most severe in the country. This Note focuses exclusively on the ramifications of New York's severe usury remedy regime, and how it leads to inequitable results which are contrary to the underlying purpose of the usury laws. These inequitable results are illustrated by the Southern District of New York Bankruptcy Court's decision in *In re Venture Mortgage Fund, L.P.*[30] and subsequent decisions which reflect a basic flaw in New York's usury laws. Part I of this Note discusses the history of New York's usury laws, focusing on their origins and public policy concerns that have been applied throughout the ages. Part II analyzes *In re Venture Mortgage Fund* and subsequent decisions, including a discussion of the background of the failed ponzi scheme that led to the ongoing bankruptcy proceedings in the case. Part III analyzes New York's usury remedies as compared to other remedy regimes, and argues that the New York legislature should adopt remedies that more adequately reflect the equitable purpose of the usury laws. This Note concludes that although the forfeiture of principal is a useful deterrent, the adoption of a discretionary standard will provide equitable results and at the same time keep the deterrent factor in place.

I. History of New York's Usury Laws

A. Origins of American Usury Law – Usury in Medieval Europe and England

The history of credit, and thus usury, dates back to ancient times. According to some historians, credit long predates industry, banking, coinage, and probably even money.[31] Along with the discovery of credit came the concept of charging some form of compensation for the extension of the credit.[32] Ever since man discovered credit and later, the monetary system, societies have been developing ways to regulate credit and the amount of compensation charged for credit.[33] The first recorded usury laws date back

30. *In re* Venture Mortgage Fund, L.P., 245 B.R. 460 (Bankr. S.D.N.Y. 2000), *aff'd* 282 F.3d 185 (2d Cir. 2002).

31. Todd J. Zywicki, *The Economics of Credit Cards*, 3 Chap. L. Rev. 79, 148 (2000) (citing Sidney Homer & Richard Sylla, A History of Interest Rates 3 (3d ed. 1991)) (discussing the origins of usury regulation).

32. *Id.* "Loans at interest may be said to have begun when the Neolithic farmer made a loan of seed to a cousin and expected more back at harvestime." *Id.* (quoting Homer & Sylla, *supra* note 31, at 3).

33. *Id.*

to around 1800 B.C.E. in the Code of *Hammurabi*, which contained statutory limitations on interest rates.[34] The Romans placed an interest cap limit at eight and one-third percent.[35] However, these limitations on interest rates usually had little practical effect; when market rates were higher than the legal rate, the legal rate was usually simply ignored.[36]

The Bible and English statutory and common law were the strongest influences on the regulation of usury and abusive interest rates in the United States.[37] In medieval Europe, usury laws were under the influence of the Catholic Church ("the Church"), which prohibited lending for any profit. Thus, no amount or rate of interest on a loan was allowed, and the Church repeatedly condemned the assessment of usury.[38] The Church based its condemnation on the Bible, which specifically prohibited interest taking in three separate verses.[39] The Church shared the belief of many other societies throughout history that the taking of interest was unjust, which stemmed from a desire to prevent the exploitation of the needy.[40] The Church used this rationale to target the medieval equivalent of the "loan shark," because a loan often represented an unequal bargaining position by the lender, leading to possible exploitation of the borrower.[41] Moreover, the Church felt that interest would enable the rich to get richer and the poor to get poorer.[42] As in the rest of medieval Europe, the Church was also the chief authority

34. *Id.*

35. *Id.*

36. James M. Ackerman, *Interest Rates and the Law: A History of Usury*, 1981 ARIZ. ST. L.J. 61, 75 (cited in Zywicki, *supra* 31, at 148).

37. Bender, *supra* note 5, at 725.

38. KEVIN W. BROWN & KATHLEEN E. KEEST, USURY AND CONSUMER CREDIT REGULATION § 2.2.1, at 20 (1987); MARK H. LEYMASTER, CONSUMER USURY AND CREDIT OVERCHARGES § 3.3, at 23 (1982); *see generally* ROGER FENTON, A TREATISE OF USURIE 1-66 (Theatrum Orbis Terrarum, Ltd., Walter J. Johnson, Inc. 1975) (1611) (discussing the biblical definition of usury and the biblical authority to prohibit usury).

39. *Exodus* 22:25 ("If thou lend money to any of my people that is poor by thee, thou shalt not be to him as an usurer, neither shalt thou lay upon him usury."); *Leviticus* 25:36-37 ("Take thou no usury of him, or increase: but fear thy God; that thy brother may live with thee. Thou shalt not give him thy money upon usury, nor lend him thy victuals for increase."); *Deuteronomy* 23:19-20 ("Thou shalt not lend upon usury to thy brother; usury of money, usury of victuals, usury of any thing that is lent upon usury. Unto a stranger thou mayest lend upon usury; but unto thy brother thou shalt not lend upon usury.").

40. Alastair McIntosh & Wayne Visser, *Short Review of the Historical Critique of Usury*, *in* ACCOUNTING, BUSINESS & FINANCIAL HISTORY § 8:2, at 180 (1998).

41. *Id.*

42. FENTON, *supra* note 38, at 98-107; McIntosh & Visser, *supra* note 40, at 180.

on the regulation of usury in medieval England, in both its prohibition and its enforcement.[43] The penalties for practicing usury, as administered by the Catholic authorities, usually included the forfeiture of the entire loan principal and the return of any loan principal or interest payments already collected.[44] The religious penalties typically included a censure from the Church and excommunication.[45] Furthermore, the lender was denied a Christian burial until his estate paid back any usury or principal.[46]

Early English secular usury statutes also prohibited the taking of any interest. The earliest usury statutes in England date back to the laws of Alfred the Great and later the laws of Edward the Confessor and William the Conqueror.[47] These early statutes served mainly to strengthen the Church's usury prohibition by setting an absolute ban on usury, prohibiting the charging of any interest, and exacting civil penalties in addition to those already administered by the Church.[48] The usury statute of Edward III in 1341[49] gave the Church the authority to administer penalties during the life of the usurer, while the crown was given control over usury enforcement after the usurer's death. This included having the usurer's goods forfeited to the king,[50] and his lands returned to the lord of the fee.[51] England further enacted usury statutes in 1487[52] and 1494,[53] during the reign of Henry VII, which greatly enhanced the crown's control over usury regulation and enforcement. These statutes called for usury cases to be brought in the courts of the crown,

43. J.B.C. MURRAY, THE HISTORY OF USURY 41 (1866).

44. JAMES A. WEBB, A TREATISE ON THE LAWS OF USURY § 5, at 4 (1899).

45. *Id.*

46. FENTON, *supra* note 38, at 70-72; WEBB, *supra* note 44, § 5, at 4.

47. MURRAY, *supra* note 43, at 33.

48. FENTON, *supra* note 38, at 71; MURRAY, *supra* note 43, at 33; WEBB, *supra* note 44, § 5, at 4.

49. 15 Edw. 3 c. 5 (1341) (Eng.).

50. FENTON, *supra* note 38, at 70-72; MURRAY, *supra* note 43, at 33; WEBB, *supra* note 44, at § 5, at 4.

51. A medieval lord's estate consisted of the lord's personal house and grounds, personal cultivable land, and land held by tenants, who were known as serfs. David A. Thomas, *Anglo-American Land Law: Diverging Developments from a Shared History*, 34 REAL PROP. PROB. & TR. J. 143, 190 (1999). The serfs' interest in the land was known as a "fee," which gave them a right to occupy the land in consideration for services or produce paid to the lord, or lord of the fee. *Id.* at 202. A "fee simple" interest was inheritable without restrictions and potentially endless in duration. After the *Statute Quia Emptores* in 1290, it also became transferable without the consent of the lord. *Id.* at 175. Thus, the usurer in Medieval England risked having his fee simple interest forfeited to the lord. WEBB, *supra* note 44, § 5, at 4.

52. 3 Hen. 7, c. 5 (1487) (Eng.).

53. 11 Hen. 7, c. 8 (1494) (Eng.).

common law courts, and local tribunals, instead of solely in the ecclesiastical courts.[54] Thus, for much of the early period of English legal history, usury laws adhered to Canon Law[55] and Church doctrine, totally outlawing the charging of interest.

In early sixteenth century Europe, it was realized that the complete prohibition of lending for profit impeded economic development,[56] and as a result, the religious opposition shifted from an absolute usury prohibition to a less stringent standard of a "moral opposition to abusive interest."[57] With growing trade and commerce, the tension between the need for economic development and the desire to insulate society from excessive, and sometimes oppressive, debt became more difficult to balance.[58] This was especially true for the merchants, traders, and industrialists who needed extra capital to expand their commercial enterprises.[59] The continuing power of the Church made it difficult to simply ignore the usury restrictions when they became inconvenient,[60] and so lenders and borrowers began to devise creative ways of evading usury restrictions.[61] These included formulating various exceptions to the absolute prohibition of usury, which were accepted, or at least tolerated, by the Church.[62] These exceptions were "mainly twisted logical explanations, convenient doctrines, and clever legal fictions that the Church leaders were either unable or disinclined to reject."[63] Thus, despite the Church's "absolute" ban on lending money for interest, usury was present throughout the Middle Ages.[64]

The exceptions to avoid the usury restrictions of the late Middle Ages demonstrated the power of the merchant and industrialist

54. MURRAY, *supra* note 43, at 45. In England, the ecclesiastical courts had jurisdiction over matters concerning the established church and religious matters. BLACK'S LAW DICTIONARY 530 (7th ed. 1999).

55. Canon Law is the body of Roman Catholic jurisprudence that was complied between the twelfth and fourteenth centuries. BLACK'S LAW DICTIONARY 198 (7th ed. 1999).

56. Morris, *supra* note 2, at 153.

57. Bender, *supra* note 5, at 725.

58. Morris, *supra* note 2, at 153.

59. BROWN & KEEST, *supra* note 38, § 2.2.1, at 19.

60. Zywicki, *supra* note 31, at 149.

61. *Id.*

62. BROWN & KEEST, *supra* note 38, § 2.2.1, at 20-21; LEYMASTER, *supra* note 38, § 3.3, at 23.

63. BROWN & KEEST, *supra* note 38, § 2.2.1, at 21; LEYMASTER, *supra* note 38, § 3.3, at 23.

64. Zywicki, *supra* note 31, at 149.

market and the difficulties of credit regulation.[65] These imaginative exceptions also hindered the ability of regulators to prevent commercial credit deals from occurring.[66] For example, among the exceptions was a credit sale or "time-price" exception,[67] the hazard of principal or investment exception,[68] the "contract of redemption" or "bills of exchange" exception[69] (used especially in mining enterprises), and the infamous *contractum trinius* or "triple contract."[70] Besides these various exceptions to evade the usury laws, underground lending at interest was also a widespread practice, de-

65. *Id.*

66. *Id.*

67. Essentially, a merchant was allowed to quote two prices on an item: one, if cash was to be paid today, and another, usually higher, if the payment was to be made at some later time. LEYMASTER, *supra* note 38, § 3.3. This exception was devised by Medieval European merchants who were transferring funds from one city to another and wanted to take advantage of and profit from exchange rate differentials. *Id.* at § 3.3 n.67.

68. If the lender gave over the money to a tradesman or merchant for a business purpose, and stipulated that he would be subject to any losses, he had put his "principal in hazard." BROWN & KEEST, *supra* note 38, § 2.2.1, at 20. He had in fact invested the money, not lent it, and retained ownership in the money (up to his share). *Id.* Thus, the lender was entitled to any profits as well. *Id.* The charge above the amount of principal was not usury, but the lender's share in the profits; the arrangement was viewed as a partnership. *Id.* This practice led to many abuses, as intricate contracts were set up under the guise of investments and hazards to principal, when the hazards themselves were based on contrived contingencies only. *Id.*; FENTON, *supra* note 38, at 19, 25.

69. These involved highly sophisticated sale and bargain agreements that were really usurious contracts under the guise of sales. FENTON, *supra* note 38, at 58, 142-43. They normally involved a loan attached with the sale of an item with a repurchase option at some later day, usually at a lower price. *Id.* at 142. The overall effect amounted to an artificial gain for the lender (original seller), who ended up with his original item back and more cash. *Id.* Because the gain arose under the guise of a sale and not from the loan, it was not considered usurious. *Id.* at 143.

70. This was a legal trick used by European merchants in the Middle Ages to allow borrowing at usury. Ackerman, *supra* note 36, at 77.

> It was a combination of three separate contracts, each of which was deemed permissible by the Church, but which together yielded a fixed rate of return from the outset. For example, [the first contract would call for] Person A [to lend] £100 [to] Person B for one year. [In the second contract], A would then sell back to B the right to any profit over and above say £30, for a fee of £15 to be paid by B. Finally, [in the third contract], A would insure himself against any loss of wealth . . . at a cost to A of £5 paid to B. The [net] result of these three simultaneously agreed contracts was an interest payment of £10 [£15 fee to A less the £5 fee to B] on a loan of £100 made by A to B.

Tarek El Diwany, *Islamic Banking Isn't Islamic*, *at* http://www.islamic-finance.com/indexnew.htm; *see also* JOHN T. NOONAN, THE SCHOLASTIC ANALYSIS OF USURY 202-48 (1957) (discussing the "triple contract" and other usury evading devices).

spite the absolute ban on usury.[71] Peasants, nobles, and merchants all had access to an underground credit market for profit.[72]

While the Church's ban on usury may not have been absolute, it was often at least moderately effective.[73] The Church's sweeping prohibition of interest was neither casually enforced nor lightly regarded by social political leaders and the common man of the time.[74] Indeed, the usury prohibition altered significantly the nature of banking and seemed to impose real limits on certain types of lending.[75]

B. The First Modern Usury Statutes

With the beginning of the Protestant Reformation in early sixteenth century Europe, some Christian theologians began to reinterpret the biblical restriction on usury to accommodate the needs of trade and development.[76] While still attempting to control lenders on moral grounds, the new interpretations allowed lending for profit so long as the interest charged did not "shock the conscience."[77] Some Protestants, especially those of the "French School,"[78] agreed that interest taken from the desperate or needy was indeed forbidden and quite despicable.[79] However, loans given for business or commercial purposes, where both parties could bargain at arm's length, was not considered exploitative.[80] Additionally, only high or excessive interest rates were considered abusive, while low rates were reasonable.[81] John Calvin's writings on usury enumerated seven rules in which interest taking was pro-

71. 2 C.G.A. CLAY, ECONOMIC EXPANSION AND SOCIAL CHANGE: ENGLAND 1500-1700, at 233 (1984).

72. *Id.*

73. Edward L. Glaeser & Jose Scheinkman, *Neither a Borrower Nor a Lender Be: An Economic Analysis of Interest Restrictions and Usury Laws*, 41 J.L. & ECON. 1, 2 (1998) (discussing the origins and historical policy concerns of usury regulation).

74. *Id.*

75. *Id.*

76. Morris, *supra* note 2, at 153.

77. *Id.* This standard was the precursor to the standard of unconscionability.

78. The "French School" was a very procapitalist group of early Protestants originating in France. NOONAN, *supra* note 70, at 365-72. They believed that civil governments should act independently from the Church in creating policies affecting their citizens. *Id.* Furthermore, they believed that civil governments should be concerned with efficient markets, not enforcing Catholic doctrine. *Id.* One of the great proponents of the "French School" of thought was John Calvin of Geneva. *Id.* at 366.

79. NORMAN JONES, GOD AND THE MONEYLENDERS: USURY AND LAW IN EARLY MODERN ENGLAND 16 (1989); NOONAN, *supra* note 70, at 366.

80. NOONAN, *supra* note 70, at 368.

81. RICHARD H. TAWNEY, RELIGION AND THE RISE OF CAPITALISM 109 (1926). Tawney used an analogy to profits. Just as excessive profit was unjust and immoral,

hibited.[82] First, it is forbidden to make a living of usury by generating a custom or trade of it (charging interest once or twice was not usury). Second, usury must not be taken from the poor or needy.[83] Third, a lender must not be addicted to gain, but rather must always be ready and willing to furnish a free loan to a poor neighbor who is in need.[84] Fourth, the golden rule[85] must always be kept.[86] Fifth, the interest rate should be reasonable.[87] Sixth, the borrower must be treated with respect.[88] Seventh, the rate should not exceed the limit placed upon it by the respective government.[89] Calvin's followers generally ignored these rules, interpreting his writings as "a wholesale sanctioning of interest."[90] The rules were interpreted to mean that usury and interest were not per se forbidden, as long as the usurer was careful not to oppress the debtor and followed his heart to do what was right.[91]

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while reasonable profit was valid, so was excessive interest prohibited, while reasonable interest was permitted. *Id.*

82. FENTON, *supra* note 38, at 62.

83. *Id.*

84. *Id.*

85. The golden rule in the Judeo-Christian ethic traces its origin to the Biblical commandment: "You shall love your neighbor as yourself." *Leviticus* 19:18. Jesus reiterated the rule by stating:

> You shall love the Lord your God with all your heart, and with all your soul, and with all your mind. This is the great and first commandment. And a second is like it: You shall love your neighbor as yourself. All the Law and the Prophets hang on these two commandments.

Matthew 22:38-40. This evolved into the golden rule: "So in everything, do to others what you would have them do to you, for this sums up the Law and the Prophets." *Matthew* 7:12; *Luke* 6:31 ("Do to others as you would have them do to you."). The golden rule is prominent in the ethics of Judaism and many other religious and moral teachings. *E.g.*, TALMUD BAVLI, *Shabbos* 31a:

> A certain gentile came [to Hillel] and said to him, make me a proselyte, on condition that you teach me the whole Torah while I stand on one foot . . . . [Hillel] said to him, what is hateful to you, do not do to your neighbor: that is the whole Torah; all the rest of it is commentary; go and learn.

86. FENTON, *supra* note 38, at 62.

87. *Id.*

88. *Id.*

89. *Id.*

90. McIntosh & Visser, *supra* note 40, at 177.

91. JONES, *supra* note 79, at 45-46. It should be noted that, while the Calvinists and the Protestants of the "French School" were generally in favor of permitting usury, other reformation groups were not. Martin Luther initially took a strong stance against usury and, like some leading Catholics, strictly condemned the practice. ROGER LOCKYER, TUDOR AND STUART BRITAIN 153 (1964); TAWNEY, *supra* note 81, at 95. He preached against the practice of taking any interest and thoroughly condemned the Pope for the many "devices" that the Church permitted to evade the usury prohibition. FENTON, *supra* note 38, at 142-43. One such exception, the "contract of redemption" exception, so enraged Luther that he called the Pope the an-

This new idea influenced the "modern" English usury statutes of the mid-sixteenth century. These were the first European usury statutes that rejected the Church's absolute prohibition on interest taking. Instead, they placed a statutory limit on the permissible rate of interest.[92] The first of these statutes was passed by the English Parliament in 1545 during the reign of King Henry VIII, entitled "An Act Against Usury."[93] This statute provided for an interest rate ceiling of up to "ten in the hundredth" (ten percent).[94] The adoption of an interest rate ceiling became the foundation of English usury law.[95]

While this statute was repealed in 1552,[96] the English Parliament reenacted the statute in 1570.[97] The 1570 statute permanently legalized an interest rate ceiling, and became the foundation of English usury law.[98] In 1624, the interest rate ceiling was lowered to eight percent,[99] and in 1660 lowered further to six percent.[100] Finally, in 1713, the Statute of Anne[101] set the rate at five percent.[102]

The early usury statutes in the United States were directly derived from the English statutes.[103] During the eighteenth century, the American colonies enacted usury statutes modeled after the English Statute of Anne of 1713.[104] The states retained their body of English Law, including their usury statutes.[105] Newly admitted states, in turn, generally copied their usury laws from existing

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tichrist for allowing it. *Id.* at 143. However, he later moderated his strong views, claiming that "paying interest was no sin" and that "interest which does not exceed 4 or 5 percent is not immoral." Ackerman, *supra* note 36, at 78. Though he still had reservations about the practice of usury, he assured his followers that it was lawful within a reasonable interest rate ceiling. *Id.*

92. Bender, *supra* note 5, at 725.

93. 37 Hen. 8, c. 9 (1545) (Eng.).

94. *Id.*

95. BROWN & KEEST, *supra* note 38, § 2.2.1, at 20; MURRAY, *supra* note 43, at 45; WEBB, *supra* note 44, § 5, at 4 .

96. 5 & 6 Edw. 6, c. 20 (1552) (Eng.).

97. 13 Eliz., c. 8 (1570) (Eng.).

98. Ackerman, *supra* note 36, at 82.

99. 21 Jac., c. 17 (1624) (Eng.).

100. 12 Car. 2, c. 13 (1660) (Eng.).

101. 13 Ann., c. 15 (1713) (Eng.).

102. Interestingly, in the mid-1800s, many European countries abolished their usury restrictions. England repealed all laws against usury in 1854, followed by Denmark in 1855, Spain in 1856, Holland in 1857, Belgium in 1865, and Prussia in 1867. Ackerman, *supra* note 36, at 82.

103. *Id.* at 85.

104. *Id.*

105. *Id.*

states.[106] By 1886, every state had a usury statute with an interest rate ceiling, usually between six and eight percent.[107]

C. New York's Usury Statutes—From Colonial Days to the 1960s

New York's first usury law was passed in 1717, which expired after five years.[108] Another usury act was passed in 1737 which voided usurious obligations and imposed upon the lender a penalty of triple the value of the money loaned, with one half of the forfeiture to be paid to the king and the other half to the borrower.[109] After New York became a state, the legislature passed a usury law in 1787 which retained the essential provisions of the colonial act.[110] The new law limited the amount of the penalty to the unlawful excess interest, giving one half to the borrower and the other half to the state for use by the poor of the town where the offense was committed.[111] Despite the fact that usurious loans were voided in these early statutes, the New York courts recognized the borrower's moral obligation to repay the money which he had received.[112] The courts of equity went so far as to require the borrower to repay or offer to repay the loan, together with lawful interest, in order to obtain relief.[113]

In 1827, a commission for revising New York's statutes was formed proposing various changes to the usury law.[114] One of the proposals was to permit the lender to recover the money actually loaned, while voiding the recovery of any interest.[115] The borrower would then be able to collect three times the amount of the interest in excess of the legal limit.[116] However, the legislature rejected

106. *Id.*

107. *Id.*

108. Curtis v. Teller, 143 N.Y.S. 188, 192 (N.Y. App. Div. 1913) (citing 1 Colonial Laws, p. 909, c. 328); *see also* People v. Brown, 603 N.Y.S.2d 256, 261 (N.Y. Sup. Ct. 1993) ("Usury statutes have existed . . . since colonial times.") (citing *Curtis*, 143 N.Y.S. at 188).

109. *Curtis*, 143 N.Y.S. at 192 (citing 2 Colonial Laws, p. 980, c. 660).

110. *Id.*

111. *Id.* (citing Laws 1787, c. 13; Revised Acts of 1801 (1 K. & R. 57); Revised Laws of 1813 (1 R. L. 64)).

112. *Id.*

113. *Id.* (citing Early v. Mahon, 19 Johns. 147 (N.Y. 1821); Fanning v. Dunham, 5 Johns. Ch. 122 (N.Y. Ch. 1821)).

114. *Curtis*, 143 N.Y.S. at 193 (citing Revisers' Report of R. S. pt. 2, c. 4, tit. 3; 3 R. S. (2d Ed.) p. 611 et seq.).

115. *Id.*

116. *Id.* However, the action had to be brought within one year of the offense. *Id.*

these proposals,[117] providing instead that no court of equity could require the repayment of the loan as a condition to granting relief to the borrower.[118] Despite the legislature's attempts to eliminate the requirement that the borrower pay back the loan as a condition of obtaining any relief, the courts of equity still struggled to find a way to make the borrower repay the loan principal.[119] It was a principle, so just and so long applied, that courts of equity were unwilling to withdraw from that doctrine unless required to do so by "clear and positive statutory enactment."[120] Throughout the 1820s and 1830s, the debate raged among lawmakers and judges. Some contended that the borrower should return the principal of a usurious loan, while others were opposed to the lender receiving anything, going so far as calling for criminal sanctions.[121] By 1837, the hardliners had won out, with the passing of an even more stringent usury law.[122] The new usury statute provided that all usurious contracts and obligations were void.[123] A court of chancery could not require the borrower to pay the principal or lawful interest as a condition of granting relief.[124] Furthermore, the lender could be compelled to deliver all obligations and securities without the borrower paying back anything.[125] The civil usury statute also made the taking of usury a misdemeanor.[126] In 1881, usury was further made a misdemeanor in the penal code.[127]

One of the most significant amendments to New York's usury law occurred in 1850. In *Dry Dock Bank v. American Life Insurance & Trust Co.*,[128] the New York Court of Appeals held that a loan issued to a corporation that violated the legal rate of interest was usurious and void.[129] In effect, this allowed corporations to

117. *Id.* (citing R. S. pt. 2, c. 4, tit. 3; 1 R. S. 771, § 1 et. seq.).

118. *Id.* (citing 1 R. S. pp. 772, 773, § 8).

119. *Id.* at 193-95 (citing Henry v. Bank of Salina, 5 Hill 523, 533-37 (N.Y. 1845); Livingston v. Harris, 11 Wend. 329 (N.Y. 1833)).

120. *Id.* at 194.

121. *Id.* at 195.

122. Laws 1837, c. 430 (1837), *revising* R. S. pt. 2, c. 4, tit. 3 § 5; *see Curtis*, 143 N.Y.S. at 195.

123. *Curtis*, 143 N.Y.S. at 196 (citing Laws 1837, c. 430 § 1).

124. *Id.* (citing Laws 1837, c. 430 § 4).

125. *Id.* (citing Laws 1837, c. 430 § 5).

126. *Id.* (citing Laws 1837, c. 430 § 6).

127. *Id.* at 197 (citing N.Y. PENAL § 2400 (1881), *as amended by* Laws 1881, c. 676 (1881)).

128. 3 N.Y. 344 (1850).

129. *Id.* at 362.

employ a usury defense against their own negotiated loans.[130] This shocked the business community, which had always considered corporate obligations excluded from usury, since they were negotiated at arm's length.[131] In immediate response to the decision, New York became the first state to enact a statute that barred corporations from presenting usury defenses against their contractual obligations.[132] This move was widely followed by other states.[133] In 1909 the entire usury statute was reenacted in the General Business Law.[134] The law was essentially the same except that the provision for criminal liability, in existence since 1881 in both the civil and criminal usury statutes, was finally omitted from the civil statutes.[135] In 1963, all of New York's civil usury statutes were consolidated in the General Obligations Law.[136]

D. A New Era in New York's Usury Enforcement—The New Criminal Usury Statute

The criminal usury provisions in the New York penal statutes were, however, generally ineffective because of the many exceptions that applied.[137] In 1965, a state commission was formed to investigate the loan sharking activities of organized crime in New York.[138] The commission determined that to protect citizens, there was a need to make the possession of loan shark records a criminal

130. Paul Golden, *Evolution of Corporate Usury Laws Has Left Vestigial Statutes That Hinder Business Transactions*, N.Y. ST. B.J., May 2001, at 20 (discussing New York's outdated corporate usury statutes).

131. *Id.*

132. *Id.* The statute provided that, "[N]o corporation shall hereafter interpose the defense of usury in any action." *Id.* The law is now codified in N.Y. GEN. OBLIG. LAW § 5-521(1) (McKinney 2000).

133. Golden, *supra* note 130, at 20.

134. N.Y. GEN. BUS. LAW § 30, art. 25 (1909), *as amended by* Laws 1909, c. 25 (1909).

135. Curtis v. Teller, 143 N.Y.S. 188, 196 (N.Y. App. Div. 1913). Furthermore, the new laws contained provisions made to conform to the fact that the court of chancery had been abolished, calling what was formerly a bill in equity a complaint. *Id.*

136. N.Y. GEN. OBLIG. LAW §§ 5-501-5-531; *see* Szerdahelyi v. Harris, 490 N.E.2d 517, 521 (N.Y. 1986).

137. People v. Brown, 603 N.Y.S.2d 256, 261 (N.Y. Sup. Ct. 1993) (citing *Szerdahelyi*, 490 N.E.2d at 521, and Hammelburger v. Foursome Inn, Inc., 431 N.E.2d 278, 282 (N.Y. 1981)). For example, usury was a misdemeanor offense and applied only "when loans of $800 or less bearing more than the authorized rate of interest, [were] made to individuals by unlicensed lenders," or "only when tools, implements of trade or household goods [were] taken as security." *Szerdahelyi*, 490 N.E.2d at 522 n.3 (citing N.Y. PENAL LAW § 2400 (1963)).

138. *Szerdahelyi*, 490 N.E.2d at 522; STATE COMMISSION OF INVESTIGATION, THE LOAN SHARK RACKET (1965) [hereinafter LOAN SHARK REPORT].

offense and to increase the grade of offense for usurious lenders who used "roughing up tactics" to enforce payment.[139] The investigation also noted that loan sharks made it a policy to loan to corporations, or required that individual borrowers incorporate or set up dummy corporations before being granted a usurious loan.[140] These devices were used by loan sharks to evade the usury law as the borrowing "corporation" could not present a usury defense.[141] Through these practices, lenders could demand usurious rates of interest from desperate and unsophisticated borrowers cloaked under a corporate veil.[142] The legislature responded by enacting sections 2401 and 2402 of the Penal Code, which upgraded to felonies loans with interest rates over twenty-five percent.[143] The legislature also allowed corporations to present a usury defense if the loan violated criminal usury[144] because loan-sharking had "become a major source of revenue," and legitimate businesses were being over taken by loan sharks, a trend which existing laws could not prevent.[145] It was further found that, "[t]he criminal loan shark can, and generally does, conduct his business wholly within the law."[146] By passing the criminal usury statute, the legislature was supported by the general policy concerns of New York's usury regime, as the New York Court of Appeals noted:

> The purpose of usury laws, from time immemorial, has been to protect desperately poor people from the consequences of their own desperation. Law-making authorities in almost all civilizations have recognized that the crush of financial burdens causes people to agree to almost any conditions of the lender and to consent to even the most improvident loans. Lenders, with the money, have all the leverage; borrowers, in dire need of money, have none. In recognizing this problem, the courts have drawn a delicate balance by both enforcing legitimate business obliga-

139. *Szerdahelyi*, 490 N.E.2d at 522; *Hammelburger*, 431 N.E.2d at 282; LOAN SHARK REPORT, *supra* note 138, at 22, 29, 81-84.

140. *Hammelburger*, 431 N.E.2d at 283; *see* Schneider v. Phelps, 359 N.E.2d 1361, 1364-65 (N.Y. 1977) (finding that the usury laws could be easily avoided by establishing a corporation, usually with no corporate assets and no other business, and making the loan directly to the corporation, with the sole purpose of the 'dummy' corporation to serve as a paper conduit for the loan).

141. *Hammelburger*, 431 N.E.2d at 283; *supra* notes 128-32 and accompanying text.

142. *Schneider*, 359 N.E.2d at 1364-65.

143. Criminal usury is now codified at N.Y. PENAL LAW §§ 190.40-190.42 (McKinney 2000).

144. N.Y. GEN. OBLIG. LAW § 5-521(3) (McKinney 2000).

145. People v. Brown, 603 N.Y.S.2d 256, 261 (N.Y. Sup. Ct. 1993) (citing 1965 N.Y. Laws 328, at 47).

146. *Id.* at 261 (citing 1965 N.Y. Laws 328, at 48).

> tions and by protecting impoverished debtors from improvident transactions drawn by lenders and brought on by dire personal financial stress.[147]

The civil[148] and criminal[149] usury statutes enacted in 1965 remain in effect today. Civil usury does not apply to any loan over $250,000, but such loans are subject to criminal usury.[150] A loan of $2,500,000 or more is exempt from all usury restrictions, including criminal usury.[151] This last provision is geared toward substantial commercial loans and is a major reason that New York law often governs many multistate loan transactions.[152] The penalty for a usurious loan in New York is the forfeiture of all principal and interest; essentially, the loan becomes wholly void.[153] The borrower can also recover the usurious portion of the interest previously paid.[154] Criminal usury in New York is still defined as charging twenty-five percent or more for a loan, and is a Class E felony with the penalty of imprisonment of up to four years.[155] A loan with an interest charge that exceeds twenty-five percent, together with conduct that is part of "a scheme or business of making or collecting usurious loans," will result in a Class C felony charge and imprisonment of up to fifteen years.[156]

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147. Schneider v. Phelps, 359 N.E.2d 1361, 1364-66 (N.Y. 1977), *quoted in* Seidel v. 18 East 17th St. Owners, Inc., 598 N.E.2d 7, 9 (N.Y. 1992) ("[The purpose of] statutes prohibiting usurious loans . . . is 'to protect desperately poor people from the consequences of their own desperation.'"); *see also Brown*, 603 N.Y.S.2d at 261 (criminal usury was designed "to stop the professional loan sharks from obtaining control of legitimate businesses and oppressing the poor") (quoting 32 N.Y. JUR. 2D *Criminal Law* § 1052 (1979)).

148. N.Y. GEN. OBLIG. LAW §§ 5-501-5-531 (McKinney 2000).

149. N.Y. PENAL LAW §§ 190.40-190.42 (McKinney 2000).

150. N.Y. GEN. OBLIG. LAW § 5-501(6)(a) (McKinney 2000).

151. *Id.* at § 5-501(6)(b).

152. Joshua Stein, *Confusury Unraveled: New York Lenders Face Usury Risks in Atypical or Small Transactions*, N.Y. ST. B.J., Aug. 2001, at 25, 27 (summarizing New York's various cross referencing usury statutes).

153. The statute reads:

> All bonds, bills, notes, assurances, conveyances, all other contracts or securities whatsoever . . . whereupon or whereby there shall be reserved or taken, or secured or agreed to be reserved or taken, any greater sum, or greater value, for the loan . . . of any money . . . than is prescribed in section 5-501, shall be void.

N.Y. GEN. OBLIG. LAW § 5-511(1) (McKinney 2000).

154. *Id.* § 5-513; Stein, *supra* note 152, at 26.

155. N.Y. PENAL LAW §§ 70.00(2)(e), 190.40 (McKinney 2000).

156. *Id.* §§ 70.00(2)(c), 190.42.

II. The Mandatory Versus Discretionary Standard in Usury Remedies

While New York's usury prohibitions intend to protect the desperate and needy from exploitation by superior bargaining parties, the harsh penalties for violating usury sometimes interfere with this lofty purpose. One such example is the ongoing litigation involving Venture Mortgage Fund. The results from these cases, from the bankruptcy court all the way to the Second Circuit Court of Appeals, show the effect of the harsh mandatory forfeiture standard of New York's usury laws. This is in contrast with other states, such as Massachusetts, that have adapted a discretionary usury remedy standard. This Part explores New York's mandatory standard by analyzing the recent decisions involving the bankruptcy of Venture Mortgage Fund and how the various courts have resolved the cases' usury law implications. This Part will also look at recent Massachusetts decisions that have analyzed Massachusetts's discretionary standard.

A. The New York Usury Approach: The Mandatory Standard

Under New York's usury law, the remedy for usury is the forfeiture of the entire loan principal.[157] Furthermore, the statutory language that all usurious loans "shall be void,"[158] has recently been interpreted by the courts involved in the *In re Venture Mortgage* bankruptcy[159] as leaving no room for a reviewing court to impose other remedies in cases of usury violations. These decisions portray the effects of New York's mandatory usury remedy regime.

1. *The Venture Mortgage Fund Bankruptcy*

Theodore Brodie was a successful businessman who developed a relationship with attorney David Schick.[160] During the summer of 1992, Schick proposed that Brodie advance him $500,000, which he would maintain in an escrow account[161] until repayment, at an an-

157. N.Y. Gen. Oblig. § 5-511(1) (McKinney 2000); *supra* note 153 and accompanying text.

158. N.Y. Gen. Oblig. § 5-511(1).

159. *In re* Venture Mortgage Fund, L.P., 282 F.3d 185 (2d Cir. 2002); *In re* Venture Mortgage Fund, L.P., 245 B.R. 460 (Bankr. S.D.N.Y. 2000).

160. *In re Venture Mortgage Fund*, 245 B.R. at 460. Brodie had retained Schick as counsel for several loan transactions involving Brodie lending substantial sums of money to investors. *Id.*

161. An escrow account is a bank account held in trust or as security, that is returnable to the depositor or third party on the fulfillment of a condition. Black's Law Dictionary 545 (7th ed. 1999). The money was eventually placed in an IOLA, or

nual interest rate of twenty percent.[162] Schick explained that he needed money in an escrow account so that he could bid on mortgage pools offered for sale by the Federal Deposit Insurance Corporation ("FDIC") and the Resolution Trust Corporation ("RTC").[163] Brodie agreed, after which Brodie received a $500,000 promissory note signed by Schick on behalf of Mortgage Venture Ltd. ("Venture").[164] The note called for twenty percent per annum interest payments to be paid monthly, and the entire principal was due in December 1992.[165] However, Schick did not return the principal in December 1992, but continued to pay Brodie the monthly interest payment throughout 1993, 1994, and 1995.[166]

In late 1995, Schick called Brodie and proposed to return $300,000 of the principal, while rolling over the remaining $200,000 balance into another, similar escrow transaction.[167] The rollover was to pay two and a quarter percent per month or twenty-seven percent annually.[168] The note called for monthly interest payments of $4,500, and repayment of the entire principal on March 21, 1996.[169] Brodie received his monthly interest payments in January, February, and March 1996, but after March, he did not receive any

"interest on lawyer account," authorized by New York law, which permits an attorney to deposit nominal client and trust funds into an unsegregated, interest-bearing account. *In re Venture Mortgage Fund*, 245 B.R. at 466 n.3.

162. *In re Venture Mortgage Fund*, 245 B.R. at 466.

163. *Id.* at 466 n.2. In order to convince the FDIC or the RTC that Venture Mortgage Fund was a serious investor in mortgage portfolios, Schick had to maintain bank accounts showing substantial sums at his disposal. *Id.* at 469. He assured Brodie that the investment was virtually risk free, with the only danger being the unlikely risk that the bank might fail. *Id.* at 466.

164. *Id.* Because Brodie and Schick were Orthodox Jews, they also executed a *shtar iska*, or *heter iska*. *Id.* A *heter iska* structures a transaction as a type of joint venture under Jewish Law, to avoid the Jewish Law prohibition against charging interest on a loan. *Id.* The money advanced is treated as a contribution to the venture, but the lender is entitled to an accounting, which involves an onerous process requiring two trustworthy witnesses. *Id.* If the process is not followed, the borrower is required to pay a fixed monthly returns, called *iska* payments, and the lender is required to waive any further profits. *Id.* *See generally* YISROEL REISMAN, THE LAWS OF RIBBIS 378-418 (1995) (discussing the laws of usury, known as *ribbis*, in Jewish Law, and the details of executing a *heter iska* according to Jewish Law).

165. *In re Venture Mortgage Fund*, 245 B.R. at 466.

166. *Id.*

167. *Id.*

168. *Id.* Brodie agreed to the deal, thanking Schick "for his benevolence." *Id.* Schick further acknowledged that he was Brodie's lawyer and assured Brodie that the transaction was legal. *Id.*

169. *Id.*

further interest payments from Schick, and was never repaid the $200,000 loan principal.[170]

ATTASCO was a company formed by two brothers, Allen and Leonard Sausen.[171] The Sausen brothers first met Schick in the fall of 1993, in connection with some simple mortgage transactions.[172] In 1994, after consulting with Theodore Brodie about his investments with Schick, the Sausen brothers decided to invest with Schick as well.[173] In July 1995, through one of Schick's associates,[174] the brothers participated in a loan transaction with Schick, with which they were extremely satisfied.[175]

In December 1995, Schick proposed the same type of mortgage portfolio investment that attracted Brodie,[176] where Schick would borrow money from the Sausens for ninety to one hundred and twenty days, maintain the money in an attorney's escrow account, and pay the brothers substantial interest payments.[177] However, Schick advised the Sausens that, in order to participate, they had to be ready to act within forty-eight hours of Schick's request.[178] Schick also explained to the brothers that, while he usually worked with clients with substantial means and liquidity, he would be will-

170. *Id.*

171. *Id.* at 468. Allen was engaged in the business of exporting appliances and electronics, while Leonard was a partner with David Brodie, Theodore Brodie's son, in a manufacturing business. *Id.* Like Brodie and Schick, the Sausen brothers were Orthodox Jews. *Id.*

172. *Id.* Schick assigned the Sausen mortgage transactions to an associate at the firm, who later acted as the Sausens' intermediary between them and Schick on the brothers' investment transactions. *Id.*

173. *Id.* at 468. Leonard also investigated Schick's reputation and was satisfied to learn that Schick was an Orthodox Jew, an attorney, an expert in real estate, and a person regarded as honest and trustworthy. *Id.*

174. The Sausens did not deal directly with Schick in making the investment, but rather relied exclusively on Schick's associate. *Id.* The Sausens did not retain attorneys because they trusted the associate based on Theodore Brodie's recommendation. *Id.* The associate assured them that the Regal documents were the same as those prepared by Schick in other similar transactions, and the brothers claimed they had no reason to question the legality of the loan. *Id.* at 469.

175. The brothers loaned money to Regal Trade, an entity that Schick used for his investments. *Id.* at 468. Allen contributed $350,000 and Leonard $150,000; the payments were held in escrow by Schick for ninety days at twenty-four percent interest per annum. *Id.* at 468 n.7. The Sausens received their interest payments and principal as promised, "confirming their faith in Schick." *Id.* at 469.

176. *Supra* notes 161-65 and accompanying text.

177. *In re Venture Mortgage Fund*, 245 B.R. at 469. This time, the Sausens dealt directly with Schick, instead of going through the associate, because they felt more comfortable dealing with Schick, and they thought that by cutting out the associate, they could receive whatever compensation he would otherwise get as his part of the deal. *Id.*

178. *Id.*

ing to do business with them because he had "a relationship" with them.[179] In late December 1995, the brothers, through ATTASCO, wired $1.1 million loan in exchange for a promissory note calling for interest at the monthly rate of two and a quarter percent, or twenty-seven percent annually, and the return of the principal in April 1996, as well as a *shtar iska*.[180] The brothers never asked an independent attorney to review the loan documents, nor did they request or receive legal advice from Schick.[181] In February 1996, the Sausens further invested $850,000 with Schick.[182] The brothers did not consider it unusual to receive a twenty-seven percent return on an essentially risk-free investment, because they had to have the money ready at a moment's notice.[183] Although the Sausens received the March interest payment, they did not receive the April payment.[184] The brothers called Schick several times, and when they finally reached him, he told them that he had bad news: it was all over, and all of the money was gone.[185]

2. *The Venture Mortgage Fund Scam*

In early May 1996, federal law enforcement officials began to investigate David Schick for accusations that he swindled millions of dollars from real estate investors and defrauded people through bogus investments.[186] After a short investigation, federal officials charged Schick with swindling victims out of nearly $14 million using bogus real estate schemes. Officials also suspected that Schick's

179. *Id.* The brothers told Schick that they were neither wealthy, nor sophisticated investors, and any money that they had to invest represented savings for their children. Thus, they did not want to do anything that was risky. *Id.*

180. *Id.* Because the Sausens and Schick were Orthodox Jews, they had to execute a *shtar iska*. *Supra* notes 164, 171 (describing a *shtar iska*).

181. *In re Venture Mortgage Fund*, 245 B.R. at 469. The Sausens never signed a retainer agreement with Schick, nor did they receive a bill from or pay a fee to Schick for legal services. *Id.* at 470 n.11. Still, the brothers believed that Schick was acting as their legal counsel when he assured them that he would protect their interests and that the documents were completely legal. *Id.* at 470 n.12. They never discussed with Schick, or anyone else, whether the interest rate was legal under New York law. *Id.* at 470.

182. *Id.* Schick told them that he would use the same documents, and that everything, including the payment terms, would remain the same. *Id.*

183. *Id.* at 471.

184. *Id.*

185. *Id.*

186. Joseph P. Fried, *Lawyer Is Investigated in Real Estate Fraud*, N.Y. TIMES, May 9, 1996, at B4 (discussing the initial fraud allegations brought against Schick).

fraud extended to more than $50 million.[187] They continued to investigate Schick's participation in what appeared to be a web of activities that may have caused his victims to lose a total of $100 million.[188] Officials suspected Schick of engaging in a multitude of schemes, from promises of risk-free investments yielding tremendous profits, to selling multiple mortgages on property he did not own, to simply stealing money entrusted to him.[189] The majority of the schemes were essentially similar to the Brodie[190] and Sausen schemes,[191] in which Schick used investor money, supposedly secure in escrow accounts, for the purchase of packages of mortgages.[192] Schick assured his investors that the investments were risk-free, because he would arrange to resell the mortgages at a profit simultaneously with the purchase.[193]

While most of his victims appeared to be individual, relatively unsophisticated Orthodox Jews, it also appeared that he had been able to defraud more sophisticated investors. Such investors included Vindola Ltd., a British organization, which he defrauded out of $7 million,[194] the original founders of the Snapple company, and a Swiss bank which loaned Schick $3 million for four months.[195] Officials also suspected that "much of what was taken from later investors went to pay back earlier investors in a failed pyramid scheme[,]" and that, "some funds may have been used to pay back investors in legitimate deals that suffered losses."[196] The news shocked the close-knit "Orthodox Jewish community, [which] survives through tradition and trust, and [where] the name Schick symbolized both."[197] David Schick was known as a "doer of goods deeds," energetic in charitable work, and a giver of money and free legal advice to established charities, earning him respect throughout the community.[198] According to law enforcement officials, this

187. Joseph P. Fried, *U.S. Says Brooklyn Lawyer Stole Millions Using Property Schemes*, N.Y. TIMES, May 23, 1996, at B4 (discussing the federal investigation into Schick's frauds).

188. *Id.*

189. Matthew Purdy, *The Man with Two Faces; In an Orthodox Jewish World of Honor, a Fraud Case Shocks*, N.Y. TIMES, June 16, 1996, at 23 (discussing the effect of Schick's frauds on the Orthodox Jewish community).

190. *Supra* notes 161-65 and accompanying text.

191. *Supra* notes 176-82 and accompanying text.

192. Purdy, *supra* note 189, at 23.

193. *Id.*

194. Fried, *supra* note 187, at B4.

195. Purdy, *supra* note 189, at 23.

196. Fried, *supra* note 187, at B4.

197. Purdy, *supra* note 189, at 23.

198. *Id.*

was part of the scam, first capturing people's respect and then taking their money.[199] "When Schick had early success as a real estate investor, word spread so fast through the Orthodox Jewish" communities that in time, "wealthy Jews around the globe were entrusting him with millions" of dollars for his investments.[200]

In November 1997, Schick pleaded guilty in the federal courthouses in White Plains and Brooklyn to charges of swindling investors out of more than $80 million through his bogus mortgage and real estate schemes.[201] It was not clear as to what motivated Schick, a man noted for his "investment savvy and good works," to commit the frauds.[202] Further puzzling officials was the whereabouts of the missing money, and how much was taken for Schick's own personal gain and enrichment.[203] Officials charged that Schick, "typically used the investors' money either to replace funds that he had improperly depleted from his attorney escrow accounts or to repay investors from earlier transactions."[204] These activities created a "snowball effect" that could not be stopped.[205] Thus, while Schick's "original intentions were good" and "his modus operandi was not criminal," due to "unrelated losses stemming from a 1988 'problem' which came back to 'haunt' him," he began to use fraudulent means to stay afloat.[206] What was most clear was that Schick's failed Ponzi scheme[207] created, "a wide swath of financial wreckage among the duped investors."[208]

3. *The Bankruptcy Proceedings*

In May 1996 several of the swindled investors filed an involuntary Chapter 11 petition against Schick and Venture Mortgage Fund, freezing his assets.[209] To date, there have been numerous proceedings relating to the Schick/Venture Mortgage Fund bank-

199. *See id.*
200. *Id.*
201. Joseph P. Fried, *Brooklyn Lawyer Pleads Guilty in Fraud Case*, N.Y. TIMES, Nov. 13, 1997, at B3 (discussing the results of the federal investigation of Schick).
202. *Id.*
203. *Id.*
204. *Id.*
205. Purdy, *supra* note 189, at 23.
206. *Id.*
207. "A fraudulent investment scheme in which money contributed by later investors generates high dividends for the original investors, whose example attracts even larger investments." BLACK'S LAW DICTIONARY 487 (7th ed. 1999).
208. Fried, *supra* note 201, at B3.
209. *In re* Venture Mortgage Fund, L.P., 282 F.3d 185, 188 (2d Cir. 2002); Purdy, *supra* note 189, at 23.

ruptcy.[210] After the various Schick-related bankruptcy cases were filed, Brodie submitted proofs of his $200,000 claim against the Venture Mortgage Fund and Schick, while ATTASCO filed a secured claim in the Venture bankruptcy case in the amount of $2,462,750, which consisted of $1,950,000 of principal and accrued interest.[211] The trustees challenged and denied the Brodie and ATTASCO claims as usurious loans,[212] which are void under New York law.[213] Because the interest promised by Schick to both claimants amounted to twenty-seven percent per annum, the bankruptcy court found it was above the twenty-five percent usury limit and therefore violated New York's criminal usury statute.[214] Thus, Brodie and the Sausen brothers forfeited their principal as well as interest.[215] The bankruptcy court, in an opinion by Chief Judge Stuart M. Bernstein, agreed with the trustees in bankruptcy and denied Brodie and the Sausen brothers their claims for their loan principal.[216]

Brodie and the Sausens argued that, based on the historical public policy purpose of New York's usury statute,[217] their transactions should not be classified as usury.[218] They argued that the usury laws were designed to thwart loan sharking and unscrupulous moneylenders,[219] while they were not loan sharks and Schick was not a needy or desperate borrower.[220] Furthermore, they were the victims of Schick's fraudulent scheme.[221] Brodie and the Sausens also argued that Schick and Venture Mortgage Fund were estopped

210. *E.g.*, *In re* Schick, 246 B.R. 41 (Bankr. S.D.N.Y. 2000); *In re* Schick, 235 B.R. 318 (Bankr. S.D.N.Y. 1999); *In re* Schick, 234 B.R. 337 (Bankr. S.D.N.Y. 1999); *In re* Schick, 232 B.R. 589 (Bankr. S.D.N.Y. 1999); *In re* Schick, 223 B.R. 661 (Bankr. S.D.N.Y. 1998); *In re* Schick, No. 96-B-42902, 1998 WL 419320 (Bankr. S.D.N.Y. July 22, 1998); *In re* Schick, No. 97-CIV- 9300, 1998 WL 397849 (Bankr. S.D.N.Y. July 16, 1998); *In re* Schick, 215 B.R. 13 (Bankr. S.D.N.Y. 1997); *In re* Schick, 215 B.R. 4 (Bankr. S.D.N.Y. 1997); *In re* Schick, No. 96-B-42902, 1997 WL 465217 (Bankr. S.D.N.Y. Aug. 12, 1997).

211. *In re* Venture Mortgage Fund, L.P., 245 B.R. 460, 471 (Bankr. S.D.N.Y. 2000).

212. *Id.* at 471.

213. N.Y. GEN. OBLIG. LAW § 5-511(1) (McKinney 2000); *supra* text accompanying note 153.

214. N.Y. PENAL LAW § 190.40 (McKinney 2000); *supra* text accompanying note 155.

215. *In re Venture Mortgage Fund*, 245 B.R. at 478.

216. *Id.*

217. *Supra* notes 137-47 and accompanying text.

218. *In re Venture Mortgage Fund*, 245 B.R. at 475.

219. *Id.* at 475; *supra* note 147 and accompanying text.

220. *In re Venture Mortgage Fund*, 245 B.R. at 475.

221. *Id.* They argued that they placed their trust, money, and reliance in Schick's reputation, knowledge, and ability. *Id.*

from asserting a usury defense because they relied on a "special relationship" with Schick when he induced them to lend him the money.[222]

While the court was aware of their plight,[223] it ultimately rejected these arguments based on two arguments.[224] First, the trustees satisfied their prima facie burden of proving usury by showing that the note on its face reserved an illegal rate of interest.[225] Sec-

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222. *Id.* Under New York law, the New York Court of Appeals has recognized that

> [A] borrower may be estopped from interposing a usury defense when, through a special relationship with the lender, the borrower induces reliance on the legality of the transaction . . . . Otherwise, a borrower could void the transaction, keep the principal, and achieve a total windfall, at the expense of an innocent person, through his own subterfuge and inequitable deception.

Seidel v. 18 East 17th St. Owners, Inc., 598 N.E.2d 7, 11 (N.Y. 1992), *quoted in, In re Venture Mortgage Fund*, 245 B.R. at 475. Another New York court expressed the rule as follows:

> A borrower, who, because of a fiduciary or other like relationship of trust with the lender, is under a duty to speak and who fails to disclose the illegality of the rate of interest he proposes, is estopped from asserting the defense of usury where the lender rightfully relies upon the borrower in making the loan.

Abramovitz v. Kew Realty Equities, Inc., 580 N.Y.S.2d 269 (N.Y. App. Div. 1992) (holding that defendants were estopped from asserting a usury defense where they induced the plaintiff to advance them $650,000 at twenty-five percent interest to further their real estate interests by taking advantage of plaintiff's long-standing friendship and trust in his attorney). Brodie and the Sausens claimed that they had "relied" on Schick in furnishing the loan documents and the interest rates, and they were now being penalized for the interest rate that the debtor himself furnished. Furthermore, they asserted that Schick's conduct and representations were intended to, and did, in fact, influence them to their injury, and Schick could not now absolve himself from a loan which he himself had proposed. *In re Venture Mortgage Fund*, 245 B.R. at 475.

223. *In re Venture Mortgage Fund*, 245 B.R. at 478 ("It was unfortunate for the claimants that something that seemed too good to be true, in the end, was neither too good nor too true.").

224. *Id.* ("But they have failed to offer any legal or factual reason to except themselves from the usury defense asserted by the trustees for the benefit of the other unpaid creditors in these cases.").

225. *Id.* at 474. Criminal usury requires proof that the lender knowingly charged annual interest exceeding twenty-five percent on a loan or forbearance. It is only necessary to show intent to charge a rate above the legal rate, rather than a specific intent to violate the usury statute. *Id.* at 473. While usurious intent is generally self-evident, it is usually up to the jury to determine intent. WEBB, *supra* note 44, § 33, at 33. If the contract calls for excessive interest, intent is virtually shown, or at least imputed by the doctrine of res ipsa loquitur. *Id.* at § 35, at 35; *see* BLACK'S LAW DICTIONARY 1305 (6th ed. 1990) (defining res ipsa loquitur as "a test to determine whether a defendant has . . . committed an attempt, based on whether the defendant's act itself indicated to an observer what the defendant intended to do."). However, it is generally agreed that in most usury regimes there is no need to prove actual intention to violate the usury law; ignorance of the law is not a defense. LEYMASTER, *supra* note 38, § 2.2.6, at 10, 11; WEBB, *supra* note 44, § 41, at 42.

ondly, under New York's general principles of statutory construction, the clear and unambiguous language of a statute should be construed so as to give effect to the plain meaning of the words.[226] Because New York's criminal usury statute does not distinguish among types of borrowers or lenders, their relative knowledge and sophistication, or the purpose of the loan, general equitable considerations could not change the result.[227] The court also rejected the claimants' reliance defense based on a "special relationship" with Schick.[228] In Brodie's case, the court concluded the rollover was a business transaction between the two, and that Brodie did not seek or pay for any legal advice from Schick.[229] Similarly, the Sausens never sought legal advice from Schick, but rather they understood that they were involved in business deals with Schick.[230] Furthermore, the court found that Brodie and the Sausens did not naively place an unquestioned trust in Schick,[231] nor did they appear concerned about the legality of a specific interest rate.[232] The court concluded that Brodie and the Sausen brothers had failed to except themselves from the usury defense asserted by the bankruptcy trustees.[233]

4. *The Appeal*

Brodie and the Sausens appealed their case to the United States District Court for the Southern District of New York. In an opinion by Judge Berman, the district court affirmed the bankruptcy court's conclusion.[234] The claimants then further appealed to the United States Court of Appeals for the Second Circuit. The Sec-

226. *In re Venture Mortgage Fund*, 245 B.R. at 475.

227. *Id.* at 474-75.

228. *Id.* The court stated that, for a reliance defense to succeed, the lender must prove: (1) a "special relationship" with the borrower; (2) a representation by the borrower that the transaction was legal; (3) an intent by the borrower to induce reliance on the representation; (4) actual reliance; and (5) injury. Examples of a "special relationship" would include an attorney-client relationship, a fiduciary or trust relationship, or a longstanding friendship or similar relationship. *Id.* In addition, it is usually characterized by superior knowledge, experience, or sophistication that enables the borrower to induce the lender to make the loan at a usurious rate. *Id.* The fact that the borrower suggests the interest rate, standing alone, will not allow the lender to prevail against a usury defense. *Id.* at 476.

229. *Id.*

230. *Id.* at 477 ("They pursued him as a source of investment, not legal advice.").

231. *Id.*

232. *Id.*

233. *Id.* at 478.

234. *In re* Venture Mortgage Fund, L.P., 282 F.3d 185, 189 (2d Cir. 2002), *aff'g* 245 B.R. 460 (Bankr. S.D.N.Y. 2000).

ond Circuit affirmed the decision of the district court.[235] The Second Circuit's analysis mirrored that of the bankruptcy court. The court noted that, although Schick could not be described as desperately poor and the claimants could not be described as loan sharks,[236] New York's usury laws do not recognize these distinctions.[237] Furthermore, the court found that the bankruptcy court did not clearly err in finding that, although Schick was a lawyer whom the claimants had once consulted on an unrelated matter and was a person they trusted to assure the legal enforceability of the loans,[238] there was no "special relationship" between Schick and the claimants.[239] The court also concluded that neither Brodie nor the Sausen brothers relied on Schick for any advice that the loan transactions conformed to the law.[240]

5. *The Criminal Versus Civil Usury Distinction*

The Second Circuit's opinion is notable for its dicta regarding whether a loan is void if it violates New York's criminal usury statute without violating New York's civil usury statute.[241] While this assumption went unchallenged in both the Southern District and the bankruptcy court, the Second Circuit felt that it remained an open question under New York law.[242] The court felt the need to discuss the issue because: (1) it is likely to arise again and is of potential importance in the bankruptcy courts; (2) New York courts have not recognized the issue; and (3) the opinion might otherwise be misread to settle or foreclose the issue in the federal courts of the Second Circuit.[243] Thus, the court wanted to emphasize that the ruling reflected no implicit resolution of the issue.[244]

The court began its analysis by pointing out that a close reading of the complex and cross-referencing usury statutes indicated that only those loans that violate the civil usury statute should be void.[245] There is nothing in the criminal usury statute that provides

235. *Id.*
236. *Id.* at 188. "[I]f anything, [they were] the victims of the transactions." *Id.*
237. *Id.*
238. In addition to drafting the loan documents himself. *Id.*
239. *Id.*
240. *Id.* at 188-89.
241. *Id.* at 189 ("The following is therefore dictum.").
242. *Id.* at 190.
243. *Id.*
244. *Id.*
245. *Id.* at 189; *supra* note 153 (quoting the language of New York's civil usury remedies statute). § 5-511 voids a loan that violates the civil usury statute, as enacted in N.Y. GEN OBLIG. § 5-501 (McKinney 2000), but says nothing about a loan that

for voiding, and the court determined that it remained unclear whether the New York legislature intended that criminally usurious loans of $250,000 or greater should be voided as well.[246] However, one who commits criminal usury should not be in a better position than a usurer who charges a non-criminal rate of interest.[247] The Second Circuit noted that the New York Court of Appeals had suggested such a result, based on the legislative history to the criminal usury statute which stated that, "it would be most inappropriate to permit a usurer to recover on a loan for which he could be prosecuted."[248] On the other hand, the Second Circuit also recognized that borrowers of large loans do not likely need or deserve financial protection.[249] Moreover, the greater the amount of the loan, the more unsettling the forfeiture becomes to financial arrangements.[250] Thus, the Second Circuit concluded that because Brodie's $200,000 loan violated both the civil and the criminal usury statutes,[251] and was thus void.[252] The Sausens' loans violated only the criminal usury statute[253] because they exceeded $250,000.[254] Therefore, whether there was any authority for voiding the two Sausen loans remains an open question.[255]

The Second Circuit decided that although the Brodie and the Sausens were victims of an elaborate scam, they could not recover their loan principal under New York's usury law. The Second Circuit left open whether there is statutory authority to void a loan that violates only New York's criminal usury statute, but the possibility remains that a creditor may lose his principal, even when equity suggests otherwise. While the facts in *In re Venture Mortgage Fund* may lead to the conclusion that such situations are rare, it is

violates the criminal usury statute, as enacted in N.Y. PENAL § 190.40 (McKinney 2000). *See* N.Y. GEN OBLIG. § 5-511(1) (McKinney 2000) ("whereupon or whereby there shall be reserved or taken, or secured or agreed to be reserved or taken, any greater sum, or greater value, for the loan . . . of any money . . . than is prescribed in *section 5-501*, shall be void") (emphasis added). Thus, there appears to be no specific statutory authority for voiding a loan that violates the criminal usury statute but that does not violate the civil usury statute. *In re Venture Mortgage Fund*, 282 F.3d at 189.

246. *In re Venture Mortgage Fund*, 282 F.3d at 189.

247. *Id.*

248. Hammelburger v. Foursome Inn, Inc., 431 N.E.2d 278, 283 (N.Y. 1981) (quoting 1965 N.Y. Laws 328, at 46-50).

249. *In re Venture Mortgage Fund*, 282 F.3d at 189.

250. *Id.*

251. *Supra* text accompanying note 150.

252. *In re Venture Mortgage Fund*, 282 F.3d at 189.

253. *Supra* text accompanying note 150.

254. *In re Venture Mortgage Fund*, 282 F.3d at 190 n.4.

255. *Id.* at 190.

conceivable that there are other situations where principles of equity should nullify the result of New York's usury regime.

B. The Massachusetts Usury Approach: The Discretionary Standard

Like New York's usury law, the remedy for usury in Massachusetts is the forfeiture of the entire loan principal.[256] However, unlike New York's mandatory standard, the Massachusetts statute states that usurious loans "may be declared void."[257] In a series of landmark cases, such as *Beach Associates, Inc. v. Fauser*[258] and *Begelfer v. Najarian*,[259] the Massachusetts courts have interpreted Massachusetts's usury statutes as imposing a discretionary, rather than mandatory, usury remedy. These decisions portray the effects of Massachusetts's discretionary usury remedy regime.

1. *The Beach Associates Case*

Beach Associates involved a South Carolina corporation, Beach Associates, Inc., a real estate development company, that desired to purchase land in Massachusetts.[260] It wished to borrow $100,000 for "bridge" financing from Fauser and others, who were investors in real estate dealings.[261] The contract term was for three years with interest payments of one and a half percent per month, plus a finder's fee of one-half percent per month, for a total rate of twenty-four percent per annum.[262] This was in excess of Massachusetts's twenty percent interest usury limit.[263] Eight months later, Beach Associates was unable to secure long-term financing for its project and stopped making payments.[264] Beach Associates argued that because the loan violated Massachusetts's usury statute,[265] the entire loan should be declared void pursuant to Massachusetts

256. *Infra* note 266.
257. MASS. GEN. LAW ch. 271, § 49(c) (2001).
258. Beach Assocs., Inc. v. Fauser, 401 N.E.2d 858 (Mass. App. Ct. 1980).
259. Begelfer v. Najarian, 409 N.E.2d 167 (Mass. 1980).
260. *Beach Assocs.*, 401 N.E.2d at 860.
261. *Id.*
262. *Id.*
263. MASS. GEN. LAW ch. 271, § 49(a) ("[W]hoever in exchange for either a loan of money or other property knowingly contracts for . . . interest and expenses the aggregate of which exceeds an amount greater than twenty per centum per annum . . . shall be guilty of criminal usury . . . .").
264. *Beach Assocs.*, 401 N.E.2d at 861.
265. *Supra* note 263.

law.[266] It based its argument on the fact that, although the statute's language stated that a usurious loan "may be declared void,"[267] this language must be construed as mandatory, and therefore judges have no choice but to void such transactions in their entirety.[268] It also claimed that because Massachusetts's criminal usury statute was drafted as a response to "the vicious offense of loan sharking," the intent of the legislature was to void such usurious loans.[269] However, the court disagreed and held that the usury remedy provision was not to be construed as mandatory.[270]

2. *The Begelfer v. Najarian Case*

The Supreme Judicial Court of Massachusetts adopted the *Beach Associates* ruling in *Begelfer v. Najarian*.[271] The case involved a group of individuals who were in the business of buying, selling, renting, constructing, and renovating residential properties.[272] To further their interests, they executed nine notes for a total loan of $300,000.[273] Richard Najarian, who owned a pharmacy, was asked by two other investors to participate in the loan.[274] After he agreed, the developers executed a promissory note in the amount of $30,000, with interest at the rate of fifteen percent per year on the unpaid balance until paid.[275] Later, the note was extended, increasing the interest rate to seventeen percent per year.[276] However, there were overdue charges that brought the effective rate of interest to over twenty percent.[277] After about a year, when the developers could not make the payments, they claimed a usury defense, arguing that the statutory language required any usurious

266. MASS. GEN. LAW ch. 271, § 49(c) ("Any loan at a rate of interest proscribed under the provisions of paragraph (a) may be declared void by the . . . superior court in equity upon petition by the person to whom the loan was made.").

267. *Id.*

268. *Beach Assocs.*, 401 N.E.2d at 862.

269. *Id.* at 862 n.5. In 1970, the governor of Massachusetts recommended the passage of a usury law to provide an effective tool against organized crime, as the usury law was designed to protect the necessitous debtor from outrageous demands by lenders. Begelfer v. Najarian, 409 N.E.2d 167 (Mass. 1980) (citing Goldstock & Coenen, *supra* note 1, at 180-84).

270. *Beach Assocs.*, 401 N.E.2d at 862 ("We find nothing . . . which lends support to the plaintiffs' claim that . . . a court must, at the borrower's request, void a loan on the basis of excessive interest.").

271. Begelfer, 409 N.E.2d at 167.

272. *Id.* at 170.

273. *Id.*

274. *Id.*

275. *Id.*

276. *Id.*

277. *Id.* at 173.

loan be declared void, and that they were thus relieved of any obligation to pay back the principal.[278]

The *Begelfer* court agreed with the *Beach Associates* holding and held that there was no apparent legislative intent that a usurious loan must be declared void, unless the circumstances and conditions of the agreement would cause the integrity of the loan itself to be questionable.[279] Furthermore, the appropriate remedy is derived by balancing a number of factors, including the importance of the public policy against usury; whether a refusal to enforce the term will further that policy; and the gravity of the misconduct involved.[280] The court concluded that, in the *Begelfer* case, the proper equitable remedy was to strike the default provision of the note as offensive to the statute, but preserve the obligation to repay the loan principal.[281] According to the court, "Such a remedy is a proper accommodation between enforcing the public policy underlying the prohibitions of the act and preventing an undeserved windfall to the plaintiffs."[282] The *Beach Associates* and *Begelfer* standards remain the law in Massachusetts today.

III. Usury's Equitable Policy and New York's Usury Remedies—A Tale of Opposites

Case law and statutory history suggests that New York's usury regime was geared towards the protection of the unsophisticated and desperate borrower.[283] Thus, New York does not allow a corporation to claim the defense of usury on a loan agreement.[284] Loans over $250,000 are exempt from civil usury,[285] and loans over $2,500,000 are exempt from all usury restrictions.[286] As the New York Court of Appeals has indicated, society is better off with free financial markets, so long as "desperate" borrowers are protected.[287] However, this framework leads to some confusion. For example, while loans over $250,000 are exempt from civil usury, they are still subject to criminal usury. This leads to a strange re-

278. *Id.*
279. *Id.* at 174.
280. *Id.*
281. *Id.*
282. *Id.*
283. *Supra* notes 137-147 and accompanying text.
284. *Supra* notes 128-132 and accompanying text.
285. *Supra* notes 148-152 and accompanying text.
286. *Supra* notes 148-152 and accompanying text.
287. Golden, *supra* note 130, at 24 (citing Schneider v. Phelps, 359 N.E.2d 1361, 1364-65 (N.Y. 1977)).

sult where a lender may issue a $1,000,000 loan to a corporation, at a fully negotiated rate exceeding twenty-five percent, and thereby commit a crime.[288]

This Part first examines how the courts have adhered to the public policy behind the usury laws, and how New York's harsh usury remedies can lead to inequitable results. Then, this Part analyzes specifically the *In re Venture Mortgage Fund* decisions to determine if the decisions by the bankruptcy court and the Second Circuit represent the counterproductive nature of the usury remedies. Finally, this Part looks at other usury remedy regimes, especially those found in Massachusetts, and argues that remedies based on a discretionary standard are the most effective tools to combat usury, and at the same time, preserve equitable results.

A. New York Courts' Attitude Toward the Forfeiture of Principal Remedy

Despite early case law to the contrary, the usury remedy of forfeiture of the entire loan principal still remains the law in New York.[289] Despite early commissions set up to propose changes to the usury laws that suggested that the "forfeiture of principal" remedy be abandoned,[290] the New York legislature has declined to soften the harsh remedy. This was a source of friction between the legislative and judicial bodies in New York, with the legislature taking a hard line approach, while the judiciary had looked to more equitable principles.[291] The courts have frequently concluded that, while New York's usury remedies may be harsh, they are at the mercy of the clear language of the usury statutes. As one early New York court stated:

> The taking of [usury] for the loan or forbearance of money is prohibited and renders the contract void. The ostensible object of the statute is to protect the weak, the needy, and the unwary from the rapacity of the avaricious. The penalty is severe. Perhaps unnecessarily so. That, however, is for the lawmaking body. The courts must apply the law as they find it.[292]

With all this statutory history in mind, the justification for unilaterally voiding a usurious contract without discussing the equitable considerations, the nature of the parties involved, or the nature of

288. *Id.*
289. *Supra* Part I.C.
290. *Supra* notes 114-115 and accompanying text.
291. *Supra* notes 119-121 and accompanying text.
292. Universal Credit Co., v. Lowell, 2 N.Y.S.2d 743, 746 (N.Y. City Ct. 1938).

the negotiations, must be examined. The New York usury statute completely ignores these considerations. As is evident from the recent *In re Mortgage Venture Fund* decisions, this problem is not remote, and the Second Circuit even noted that the problem may frequently arise.[293] By analyzing the equitable concerns raised by the *In re Venture Mortgage* decisions, the problems with New York's current usury regime may be identified, and measures to correct them can be proposed.

B. Equitable Considerations of *In re Venture Mortgage*

From the bankruptcy court to the Second Circuit, the *In re Venture Mortgage* courts all recognized that Brodie and the Sausens were wronged.[294] The courts admitted that the harsh criminal usury statutes were enacted in 1965 to combat the growing problem of organized crime and usury, and that usury was designed to stop loan sharks who used "roughing up tactics" to enforce payment, obtained control of legitimate businesses, and oppressed the poor.[295] The courts realized that neither Brodie, nor the Sausens fit the description of the classic loan shark.[296] Nevertheless, the courts correctly held that in the face of clear legislative language, they were powerless to override legislative intent with equity concerns.[297]

However, the courts could have found for Brodie and the Sausens by using the "special relationship" defense raised by the claimants.[298] The courts rejected these claims.[299] It is possible that they were reluctant to adopt a broad "special relationship" standard that would undermine legislative intent. The statute does not make any distinction as to what type of usurer is involved, merely grouping all usurers under one umbrella, leading to the forfeiture of the loan principal, the courts were reluctant to broaden the "special relationship" test and circumvent the statute.[300]

The courts, however, with the possible exception of the Second Circuit, minimized the extent of how Brodie and the Sausens were in fact victims. It seems that they were duped by a criminal. The courts failed to elaborate on the extent of Schick's fraud, even

293. *Supra* note 244 and accompanying text.
294. *Supra* notes 223, 236 and accompanying text.
295. *Supra* notes 139-142 and accompanying text.
296. *Supra* notes 223-227, 236 and accompanying text.
297. *Supra* notes 225-227 and accompanying text.
298. *Supra* note 222 and accompanying text.
299. *Supra* notes 228-233 and accompanying text.
300. *Supra* notes 228-233 and accompanying text.

though the evidence suggests that it was enormous. Schick defrauded many innocent people out of a staggering $80 million, and possibly more, including many experienced and sophisticated business entities.[301] Furthermore, Brodie and the Sausens did to a large extent rely on Schick's representations because they were all part of the tight-knit Orthodox Jewish community.[302] The trustee's drive to exclude Brodie's and the Sausens' claims, "for the benefit of the other unpaid creditors in [the bankruptcy] cases"[303] seems laughable when most of the creditors were in fact put in the same position, had invested in similar transactions,[304] and had the same fraud claims against Schick.[305] Brodie and Sausen gave their hard earned savings to a man who may never have had any intention of returning it.[306] All the other creditors did the same. They all lost their money to a savvy thief's scam.[307] However, unlike the other investors, New York's usury law brands Brodie and the Sausens as criminals because were promised a few percentage points more, ensuring that they will never see their money again. In light of these considerations, the results in the *In re Venture Mortgage* cases can hardly be considered equitable.

C. How to Rectify the Problem: The Case for Judicial Discretion

The underlying problem with the New York usury statutory regime seems to revolve around the long-standing friction between the legislature and the courts.[308] The legislature, in an effort to crack down on loan sharking and other predatory practices,[309] devised the harshest usury remedy available under the circumstances: the forfeiture of the entire loan principal, by declaring that all usurious loans "shall be void."[310] This unilateral declaration of usurious loan avoidance leaves no room for any leeway by a reviewing court. In the legislature's defense, this remedy creates a substantial deterrent effect. Yet, in situations such as the Brodie and Sausen

301. *Supra* Part II.A.2.
302. *Supra* note 173 and accompanying text. Indeed, most of Schick's fraudulent activities were at the expense of his own community. *Supra* Part II.A.2.
303. *In re* Venture Mortgage Fund, L.P., 245 B.R. 460, 478 (Bankr. S.D.N.Y. 2000), aff'd 282 F.3d 185 (2d Cir. 2002).
304. *Supra* notes 190-92 and accompanying text.
305. *Supra* Part II.A.2.
306. *Supra* Part II.A.2.
307. *Supra* Part II.A.2.
308. *Supra* notes 112-22 and accompanying text.
309. *Supra* Part I.D.
310. N.Y. GEN. OBLIG. LAW § 5-511(1) (McKinney 2000); *supra* note 153.

loans, courts should make an exception to this harsh rule to prevent an otherwise inequitable result. Brodie and the Sausens were arguably not loan sharks, but, after *In re Venture Mortgage Fund*, the New York courts appear set to treat them as such anyway. Furthermore, although the other creditors behaved similarly to Brodie and the Sausens, because of just a few percentage points of interest, they were not branded "usurers" and were thus able to recover their investments. Surely that small difference does not create the distinction between a true loan shark and an innocent creditor. Thus, the solution is to construct a statutory framework that takes these case-by-case factors into account when fashioning a usury remedy. Under New York's current regime, such an analysis is not possible.

A solution to this dilemma is to allow a court to use its discretion when meting out usury remedies. This would satisfy the legislature's desire to curtail loan sharks while at the same time sparing the harsh usury remedies from relatively harmless offenders. As the statute now reads, that all usurious loans "shall be void,"[311] a New York court is forced to apply the forfeiture of principal remedy for all usurious loans, regardless of the circumstances involved. This unilateral declaration could easily be changed to a discretionary tone, such as adopting a "may be declared void" standard. This would grant a reviewing court a full arsenal of usury remedies, ranging from a harsh forfeiture of principal remedy for the most egregious offenses, to more benign remedies, such the forfeiture of the total interest or the forfeiture of the illegal interest only, as have been applied in New York's early usury case law.[312]

This is a workable approach and has been adopted by other states, most notably Massachusetts. The Massachusetts courts have crafted equitable solutions by a careful reading of the Massachusetts usury statutes. The statutory framework in Massachusetts grants a court the necessary tools to provide for the widest range of possible usury remedies. Unlike New York's mandatory standard,[313] which unilaterally imposes a single harsh usury remedy, Massachusetts's discretionary standard does not compel a court to impose a mandatory avoidance of the usurious contract.[314] Instead, a Massachusetts court may examine each usury contract on a case-by-case factual analysis to determine the appropriate remedy.

311. N.Y. GEN. OBLIG. LAW § 5-511(1); *supra* note 153.

312. *Supra* notes 112-20 and accompanying text.

313. N.Y. GEN. OBLIG. LAW § 5-511(1); *supra* note 153.

314. *Supra* notes 266-82 and accompanying text.

For example, the *Beach Associates* court drew a distinction between different lenders.[315] Where a loan is made by an unlicensed lender, the loan itself offends the usury statute in respect to its goal "to prohibit the unlicensed business of making small loans," and creating a basis for voiding the loan.[316] However, where the loan is made by a licensed lender, the statute wishes only "to prevent an excessive rate of interest."[317] Thus, in this case the court was allowed to uphold the basic validity of the loan, and to grant the borrower relief commensurate with his injury.[318] It is within the discretion of the judge, based upon all the facts and circumstances surrounding the loan, to either void it entirely, to demand a refund, to credit any excessive interest paid, to reform the contract, or to provide any other relief consistent with equitable principles.[319] The court found that the judge's decision to simply reform the contract by reducing the interest rate, rather than void the entire loan principal, was an adequate remedy in equity.[320] The court looked to such factors as the following: the interest rate was agreed upon by all the parties after negotiation; the plaintiffs never complained about the transaction until after they were unable to make the payments; and the parties freely entered into the transaction at arms-length.[321] Because of the statutory construction of Massachusetts's usury statute, the judge may exercise discretion when fashioning an equitable remedy and granting relief, which can include harsh measures such as voiding the loan, or if equity requires a less severe remedy, a reduction of the excessive interest rate charged to a rate that is legally permissible.[322]

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315. Beach Assocs., Inc. v. Fauser, 401 N.E.2d 858, 862 (Mass. App. Ct. 1980):

> The distinction between . . . [w]here the loan is by an unlicensed lender the statute['s] . . . goal [is] 'to prohibit the unlicensed business of making small loans' [hence the loan is void] . . . [but] where, however, the loan is by a licensed lender, [the statute's goal is] 'to prevent an excessive rate of interest' on the small loan . . . . [T]he court [is allowed to] uphold the basic validity of the loan where the loan itself is inoffensive, and to grant the borrower relief commensurate with his injury.

316. *Id.*

317. *Id.*

318. *Id.*

319. *Id.* at 864.

320. *Id.*

321. *Id.*

322. *Id.* at 861, 864.

D. The Discretionary Usury Remedy Standard—Restoring Equitable Principles to New York's Usury Regime

The Massachusetts approach, namely a statutorily authorized discretionary standard, would remedy a situation such as Brodie and the Sausen brothers found themselves in. A usury provision mandating that any usurious loan "may be declared void," allows the courts to utilize their full range of equitable powers, including having the option to void the loan, in order to reach an appropriate result in each particular case. The courts may take into consideration circumstances such as coercion, threat of violence, or a situation where a desperate debtor was taken advantage of by an unscrupulous lender. It would be within the discretion of the judge, based on all the facts, circumstances and conditions surrounding the usurious loan, to void it, to rescind it, to refund, to credit any excessive interest paid, to reform the contract, or to provide any other relief as equity requires.

This suggestion does not advocate a major overhaul of New York's usury regime, such as would be required with an unconscionability standard to usury enforcement.[323] An unconscionability standard[324] is worrisome, and legislators may be reluctant to put too much power into the hands of the judiciary and essentially leave it up to the judge to decide in each case whether the usury law has in fact been violated. By only allowing for judicial discretion in fashioning usury remedies, but not to determine if usury was actually committed, the legislature can preserve the integrity of the usury law while still allowing some leeway in fashioning equitable results.

If a discretionary approach had been adopted, an equitable result could have been easily achieved in *In re Venture Mortgage Fund*. While the facts are not the same as in the *Beach Associates* and *Begelfer* cases,[325] the factors applied by the latter courts could easily have been applied to both Brodie and the Sausens. Both parties freely entered into this transaction at arms-length.[326] Schick never complained about the transaction until the trustee brought up the usury claim in bankruptcy. There were no circumstances or conditions that would have caused the integrity of the loan itself to be questionable. There was no coercion or threat of

323. *Supra* notes 14-22 and accompanying text.
324. *Supra* note 19.
325. *Supra* Part II.B.
326. *Supra* Part II.A.1.

violence. Finally, Schick was not a desperate debtor who was being taken advantage of by an unscrupulous lender.[327]

Furthermore, it is in the legislature's best interest to clarify New York's usury statute. As the Second Circuit pointed out, from a careful reading of the usury statutes it appears, and a court may later find, that if a loan violates only the criminal usury law, the loan is not void.[328] However, because Brodie and the Sausens never raised the issue, the Second Circuit did not rule on it.[329] Thus, it remains an open question, and there is the danger that if a court is confronted with a true loan shark whose loan violates only criminal usury, it may find that the loan should not be void. It is thus in the legislature's best interest to preserve a court's option of voiding a loan if it violates criminal usury only; however, the legislature should proceed with caution and allow judges the discretion to provides an appropriate remedy.

The legislature may be hesitant to give courts discretion in fashioning usury remedies. However, they can still provide for effective usury enforcement while still ensuring equitable results. For example, the legislature can continue the harsher penalties for anyone who knowingly makes usurious loans to desperate debtors, while providing for lesser punishments when the loans are made on an equal, or almost equal, footing. To combat loan sharks, New York's usury statutes should also contain harsher penalties for making usurious loans with the threat of violence. Finally, the legislature can adopt a broader reliance defense to usury, such as when a creditor relies on the debtor to furnish an acceptable interest rate that will trigger less severe remedies.

CONCLUSION

In light of the historical and policy considerations behind New York's usury laws, the current usury regime can lead to inequitable results. It is important for the legislature to revisit this area and provide for remedies that allow for judicial discretion, such as provided by Massachusetts. By preserving the harsh remedies, but allowing for judicial discretion, the usury laws will in no way lose

327. *Supra* note 236 and accompanying text.
328. *Supra* notes 241-255 and accompanying text.
329. *Supra* notes 244-255 and accompanying text. This question would have affected the Sausen brothers' loans, as their loans violated only New York's criminal usury statute, but not the civil usury statute. *Supra* notes 253-254 and accompanying text. It would not have affected Brodie's loans which violated both the civil and criminal usury statutes. *Supra* notes 251-252 and accompanying text.

their effectiveness; while at the same time preventing the cases where a strict interpretation of the law would lead to inequitable and unfair results. The statutes can be drafted to ensure that the real "loan sharks" are brought to justice and pay the full price for their actions, while allowing the relatively harmless offenders to escape the harsh penalties that do not fit their crimes. It is time for New York to take a hard look at their outdated and wholly archaic usury statues, and realize that a few harsh provisions cannot regulate the complexities of the credit world. An equity-based usury regime that allows for equitable discretion by the judiciary has worked in the past, and can work and be adaptive to today's societal needs.