Corporations—Denial of the Defense of Usury Limited

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LEGISLATION

CORPORATIONS—DENIAL OF THE DEFENSE OF USURY LIMITED

Introduction

Almost every known civilization has denounced usury.\(^1\) At one time any agreement whereby a lender received anything of value in return for a loan was condemned as usurious.\(^2\) However, this concept has been modified to the extent that usury is now considered to be only the receipt of a sum greater than that permitted by statute.\(^3\)

The purpose of usury statutes is to protect borrowers from the greed of those who would take advantage of their need by extorting an unconscionable rate of interest in return for a loan. Despite this valuable social and moral purpose,\(^4\) argument has been made in opposition to usury statutes by denying their social necessity.\(^5\) One court has objected to the usury law on the legal ground that it is "... a barbarous act, unworthy of the age and country where it is found, for it abrogated the just and equitable maxim, that a plaintiff, to entitle himself to equity, must do equity, and required the chancery courts to lend their aid to enforce a penalty or forfeiture."\(^6\) In addition, arguments concerning the economic validity of such legislation have long been made. Those who have opposed usury statutes on economic grounds maintain that they are the result of paternalistic governmental action which arbitrarily restricts freedom to contract.\(^7\) Money, it is said, varies in price like other commodities; there is no

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2 See Salin, Usury, in XV ENCYC. SOC. SCI. 193 (1950); Santos, supra note 1, at 502.
3 See note 2 supra. "A bargain under which a greater profit than is permitted by law is paid, or is agreed to be paid to a creditor by or on behalf of the debtor for a loan of money, or for extending the maturity of a pecuniary debt, is usurious and illegal." RESTATEMENT, CONTRACTS § 526 (1932).
4 See Salin, supra note 2, at 193; Santos, supra note 1, at 501.
6 Curtis v. Leavitt, 15 N.Y. 9, 151 (1857).
more reason for controlling the price of money than for regulating the cost of other commercial products. The law of supply and demand should control the rate of interest; it is claimed that if it did, the rate would diminish. On the other hand, proponents of usury laws assert that the economic argument in favor of "free trade in money" is generally put forth by lenders. A refutation of the "free trade" argument was presented by Governor Myron H. Clark in his Annual Message to the Legislature in 1855. He reasoned that money would not be free even if the usury laws were repealed because government would still invest it with an arbitrary valuation. Before freeing money from the restraint of usury laws, he believed that it should be "assimilated" to the products of labor, rather than having an arbitrary valuation placed upon it. As to the anticipated diminution in the rate of interest which is forecast, he stated:

The argument relied upon by the advocates of repeal is, that it will make money cheaper. But wherever this experiment has been tried in our country, the opposite effect has been produced. Even in our commercial metropolises, where are found those who are most strenuous on this subject, that description of paper supposed to be exempted from the taint of usury, can be negotiated only at rates of interest varying from twelve to twenty-four per cent per annum. Borrowing at this onerous rate, leads to almost certain ruin. It may be answered that only in times of pressure are the rates of interest so high. But what, if the power to regulate the whole question resides with capitalists, is to bring down the rates? What is to make money more plentiful and cheap when those who possess it have the power to keep it scarce and dear? There is a given amount of capital among us, seeking investment. If our laws rigidly prohibited the taking of more than the legal rate of interest, that capital would be available for all legitimate business purposes. If loans are made reluctantly at legal rates, it is because usurious ones may be obtained, through the violation or evasion of the laws. There is, however, injustice in forcing lenders to accept a specified rate of interest without considering the risk involved in each transaction. Despite this hardship and the recurring difficulties encountered in enforcing usury laws, it is submitted that their socially beneficial effects give decisive force to the reasoning which favors them.

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8 See Baumgardt, op. cit. supra note 7, at 152-58; Marcy, supra note 7, at 605, 631.
9 See Salin, supra note 7, at 196.
11 Id. at 804.
12 See Birkhead, Collection Tactics Of Illegal Lenders, 8 Law & Contemp. Probs. 78 (1941); Gov. John Jay, Annual Message—1798, in II Messages From The Governors 397, 400 (Lincoln ed. 1909); Gov. Horatio Seymour, Annual Message—1854, IV id. at 709, 731-32.
Recognizing this, New York has developed a statutory scheme designed to prevent unjust exactions of interest. By statute the legal rate of interest is six per cent;\(^\text{13}\) no person may take any greater sum for a loan.\(^\text{14}\) An agreement to pay more is, of course, void and will not be enforced by the courts.\(^\text{15}\) Anyone who has paid a greater sum, or his legal representative, is given the right to recover the excess over six per cent, if an action is brought within one year of the payment.\(^\text{16}\) Moreover, if the borrower brings an action to recover the unlawful amount which he has paid, the courts cannot require him, as a condition precedent, to pay any part of the principal or legal interest which may be due.\(^\text{17}\) The state's interests are asserted by providing that if an action to recover the unlawful amount is not brought by the borrower or his representative within one year from the time of the loan, then within three years, the public welfare official of the town or county where payment was made may bring suit.\(^\text{18}\) In addition, the usurer, in certain instances, may be criminally prosecuted for a misdemeanor.\(^\text{19}\)

Borrowing, by one important institution in New York's vast economic life, however, is not restricted by the usury laws.\(^\text{20}\) Since 1850, corporations, by statute, have not been permitted to "interpose the defence of usury in any action."\(^\text{21}\) Broadly included as a corporation are "... all associations and joint stock companies having any of the powers and privileges of corporations not possessed by individuals or partnerships."\(^\text{22}\) This special consideration resulted from the legislature's abhorrence\(^\text{23}\) of the decision in the case of *Dry Dock Bank v. American Life Ins. & Trust Co.*,\(^\text{24}\) decided in 1850. There, the plaintiff bank had found itself in financial difficulties and, in order to stay in business, borrowed money from the defendant at a usurious rate of interest. The plaintiff was successful in his attempt to have the bills of credit and trust deed which were executed to the defendant declared void because of the usurious loan. Com-

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\(^{13}\) N.Y. GEN. BUS. LAW § 370.

\(^{14}\) *Id.* § 371.

\(^{15}\) *Id.* § 373. There are certain exceptions to the agreement being void which are not pertinent here. *Id.* §§ 372, 379.

\(^{16}\) *Id.* § 372.

\(^{17}\) *Id.* § 377.

\(^{18}\) *Id.* § 372.

\(^{19}\) N.Y. PENAL LAW § 2400.

\(^{20}\) N.Y. GEN. BUS. LAW § 374.

\(^{21}\) Laws of N.Y. 1850, c. 172.

\(^{22}\) *Ibid.*


\(^{24}\) 3 N.Y. 344 (1850).
plete avoidance of liability made apparent the necessity of legislatively preventing the recurrence of such a result.

Judicially it has been felt that the enactment was a complete repeal of usury statutes as they applied to corporations. Because of the decision in the Dry Dock case, the language of the enactment, *proscribing a defense*, has been interpreted to prevent corporations from *affirmatively* acting to void usurious agreements. Since usury was not to be used as a "shield," it could not be employed as a "sword." Similarly, although it had not been expressly provided by the legislature, foreign corporations were denied the right to plead usury. The statute has also been interpreted as denying the defense to a receiver of a corporation because he stands in no better position than the corporation itself. For much the same reason guarantors, sureties, *endorseurs*, *accommodation endorsers* and co-makers of corporate paper have been restrained from pleading usury as a defense. In an action to foreclose a corporate mortgage the defense of usury is unavailable. In one case, the defendant corporation executed a mortgage to secure a bond issue; in the action to foreclose, the fact that the bonds were usuriously discounted was not permitted.

28 Southern Life Ins. and Trust Co. v. Packer, 17 N.Y. 51 (1859).
as a defense. Further, a mortgage based upon a usurious agreement is in no way impaired when the corporate mortgagee assigns part of it to an individual. A shareholder has been denied the right to have a corporate bond and mortgage, executed for a usurious loan, declared void. But if a corporation succeeds to the contract rights of an individual, it may maintain conversion for property pledged with the defendant as collateral for a usurious loan. More recently, the original reason for not allowing corporations to assert the defense has been obscured by rationalizations based upon economic factors. It has been asserted that the function of usury laws is to protect needy individuals. Unlike an individual, a corporation has no sensations and cannot be coerced by its necessities into any legal obligations beyond its defined and limited corporate powers. It is primarily a creature of the law under which capital concentrates for business. . . . An individual may borrow from a need springing from personal necessities, but a corporation becomes a borrower voluntarily to enable it to carry forward some enterprise which affords a reasonable expectation of profits sufficient both to repay the necessary interest and to secure an ultimate emolument to those who own its stock or form its membership."

Jenkins v. Moyse

Criticism of the New York statute has not been directed at its purpose but rather at what is, in the opinion of many, its abuse. Despite this criticism, however, similar legislation has been enacted in seven other states. The leading case of Jenkins v. Moyse aptly illustrates the situation that has been condemned. There, an action

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40 Coffin, Usury in California, 16 CALIF. L. REV. 281, 290 (1928).
in equity was brought to have a mortgage declared usurious and void. The plaintiff had been informed that a loan would not be made to him as an individual because of the limited rate of interest permitted to be exacted and that, in order to obtain the needed funds, a corporation would have to be formed. Realty was to be transferred by the plaintiff to the corporation, and mortgaged by the corporation to the defendant in return for the usurious loan. That the defendant did not offer to lend money to the plaintiff individually controlled the finding that the corporation was not a mere cloak or cover for the usury. It was recognized that the plaintiff, through stock ownership, indirectly benefited from the loan, controlled the property and indirectly suffered because of a foreclosure. Nevertheless, the fact that the loan was made to, and the mortgage executed by, the corporation was thought to be controlling. Holding that the loan was made to the corporation and therefore that usury could not be a ground for voiding the mortgage, the court stated that "[t]he law has not been evaded but has been followed meticulously in order to accomplish a result which all parties desired and which the law does not forbid." 44 It seems obvious that the corporate privilege was being perverted in order to evade the usury statutes. Equally obvious is the fact that the law of this case has been consistently followed. 45

The propriety of permitting a corporation to be formed for the sole purpose of obtaining a loan at a usurious rate of interest is questionable. The statutory privilege of incorporation is attended by prerogatives not afforded individuals or partnerships. 46 Limited liability of shareholders, aggregation of capital, continuous succession, management by directors and transferability of stock are the more common advantages. 47 There is no doubt that a corporation may be formed by an individual in order to obtain one or more of these benefits. However, none of the above so blatantly violates any other statutorily expressed public policy, as does the use of the corporate form to evade the usury laws. The latter is inexcusably destructive of the respect

856 (Sup. Ct. 1922). Commentators have differed as to correctness of the Jenkins case. See, e.g., BALLANTINE, CORPORATIONS §132 (rev. ed. 1946); Note, 5 ST. JOHN'S L. REV. 91 (1930); 30 COLUM. L. REV. 1075 (1930); 38 CORNELL L.Q. 93 (1952); 16 CORNELL L.Q. 90 (1930); 15 MINN. L. REV. 112 (1930); 4 U. CIN. L. REV. 496 (1930).

44 Jenkins v. Moyse, supra note 42 at 324, 172 N.E. at 522.


46 See BALLANTINE, CORPORATIONS §1 (rev. ed. 1946); PRASHKER, CORPORATIONS 91-95 (2d ed. 1949).

47 See PRASHKER, op. cit. supra note 46, at 91-95.

due the laws of the state. Moreover, it is impossible to discern any legislative intent to establish this privilege as an inducement to form a corporation.

Amendment of Section 374

It was the widespread use of corporations to evade the usury laws that prompted the New York Legislature recently to amend the statute which denies the defense of usury to corporations.\(^{49}\) The amendment provides that:

The provisions of this section shall not apply to a corporation, the principal asset of which shall be the ownership of a one or two family dwelling, where it appears that the said corporation was organized and created within a period of six months prior to the execution, by said corporation of a bond or note evidencing indebtedness, and a mortgage creating a lien for said indebtedness on the said one or two family dwelling.\(^{60}\)

It is manifest that the amendment will not completely solve the problem because it is applicable only where the “principal asset” of the corporation is a one or two family dwelling. For example, if the corporation’s sole asset is a three family dwelling, or two one family dwellings, the amendment, prima facie, will not apply. Mortgaging the one or two family dwelling more than six months after incorporation will also take the transaction outside the scope of the amendment. Whether a dwelling is the “principal asset” of the corporation when some other property is owned by the corporation, is a question that has been left to judicial interpretation. Recognizing that usurers have consistently exhibited a flexible deviousness in evading statutory prohibitions,\(^{51}\) courts should be on their guard to prevent the frustration of the amendment’s purpose.

Conclusion

Although the amendment does not offer a completely satisfactory remedy to the harmful device sanctioned by Jenkins v. Moyse,\(^{52}\) it is directed toward that end. Perhaps a more effective amendment would be one that denies the defense of usury only to “trading” or “business” corporations; by such a provision individual borrowers will be protected, while commercial transactions will be left unfettered. For too long usurers have been permitted to oppress small borrowers by imposing a debased corporate form upon them.

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\(^{49}\) N.Y. GEN. BUS. LAW § 374, as amended, Laws of N.Y. 1955, c. 673.

\(^{50}\) Laws of N.Y. 1955, c. 673.

\(^{51}\) See Collins, Evasion And Avoidance Of Usury Laws, 8 LAW & CONTEMP. PROB. 54 (1941).

\(^{52}\) 254 N.Y. 319, 172 N.E. 521 (1930).