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THE INTEREST ON INTEREST RULE IN NEW YORK

INTEREST on interest is the interest paid upon interest due upon the original principal sum. A review of the New York cases which have dealt with the question of the right of a creditor to collect interest on interest reveals that the courts of this state have used the terms "interest on interest" and "compound interest" interchangeably. It is to be noted that compound interest is the interest paid when the unpaid interest due upon the principal is added to the principal and the resulting sum is the basis for the next payment upon which the ensuing interest is computed. The latter method of figuring interest results in interest *ad infinitum*.[1]

The generally accepted rule, with the exception of New York, is that past due interest coupons bear interest at the legal rate obtaining in the state in which the same are due. This is true even in the absence of a covenant to pay interest on interest, the law implying such a covenant.[2] Interest is allowed on the theory that such coupons are not mere incidents of the principal debt, but represent separate and distinct contracts for the payment of money, when due, according to their terms, and, like other promises of a similar character, bear interest after default in payment.[3] Prior to *Erie Railroad v. Tompkins*,[4] the federal courts applied this

[1] *In re* Wisconsin Ry. Co., 63 F. Supp. 151 (D. C. Minn. 1945).
[2] Note (1921) 27 A. L. R. 89.
[3] Hamilton v. Wheeling Pub. Serv. Co., 88 W. Va. 573, 107 S. E. 401 (1921).
[4] 304 U. S. 64, 82 L. ed. 1188 (1938).

rule as a matter of general commercial law. Under New York law, compound interest may only be collected upon the basis of a promise made after the interest upon the principal has accrued. Therefore, an agreement to pay compound interest made when the debt is created is void and unenforceable.[5] As stated by the Court in *Lemnos Broad Silk Works Inc. v. Spiegelberg,*[6] "an agreement to pay compound interest if made at a time prior to the due date of simple interest, is against public policy, as over avaricious, and therefore void." Where the coupons are detached and separately owned the New York courts have held that they bear interest irrespective of any provision in the bond for the payment of interest thereon.[7] The above exception to the New York rule is well stated in *Williamsburgh Savings Bank v. Town of Solon,*[8] where the court said:

> Interest, as a rule, follows the principal without becoming principal, and cannot be compounded by force merely of the contract; but that general rule has been modified somewhat by an exception growing out of the character and purpose of interest coupons. They may become separate and independent instruments. When they do the exception is for the first time needed and for the first time applies. Until they do the promise is merely to pay interest and is governed by the usual rule. They do not become separate and independent instruments until they are utilized as such. Before that occurs and while they remain in the hands of the holder of the bonds the occasion for the exception has not arisen and the exception does not apply.

In *Williamsburgh Savings Bank v. Town of Solon, supra,* the bondholders contended that they were entitled to interest upon the overdue interest coupons attached to the bond and still in the hands of the bondholders. The Court of Appeals refused to grant interest on the coupons, holding that to do so would "result in an award of compound inter-

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[5] State of Connecticut v. Jackson, 1 Johns. Ch. 13, 7 Am. Dec. 471 (1814); Young v. Hill, 67 N. Y. 162, 23 Am. Rep. 99 (1876); Newburger-Morris Co. v. Talcott, 219 N. Y. 505, 114 N. E. 846 (1916).

[6] 127 Misc. 855, 217 N. Y. Supp. 595 (1926).

[7] Long Island Loan & Trust Co. v. Long Island City & Newtown R. R. Co., 85 App. Div. 36, 82 N. Y. Supp. 644 (1903), *aff'd,* 178 N. Y. 588, 70 N. E. 1102 (1904).

[8] 136 N. Y. 465, 32 N. E. 1058 (1893).

est which we have held not to be recoverable, except upon some new and independent agreement made upon sufficient consideration." Thus the court held that the "compound interest rule" is to be applied in "interest on interest cases." The rule of the *Williamsburgh* case was reaffirmed by Mr. Justice Cardozo in *Continental Securities Co. v. New York Central & H. Railroad Co.*,[9] where he said: "it makes no difference that the promise to pay interest is represented by coupons. Until detached and separately negotiated, a coupon is merely an incident of the bond without greater force (than) any other promise for the payment of interest" and in *Newburger-Morris Co. v. Talcott:*[10] "the charge of compound interest was correctly disallowed. The rule is settled that a promise to pay interest upon interest is void if made at a time before simple interest has accrued."

In *State of Connecticut v. Jackson*[11] there had been no agreement of the parties for any but interest on the debt, but the master had computed a sum which included compound interest, or interest on interest. Chancellor Kent remitted for correction the master's report and his instructions forbade the imposition of simple interest on interest. In discussing the soundness of the New York rule disallowing interest on interest the Chancellor said:

> Interest upon interest, promptly and incessantly accruing, would, as a general rule, become harsh and oppressive. Debt would accumulate with a rapidity beyond all ordinary calculation and endurance. Common business cannot sustain such overwhelming accumulation. It would tend also to inflame the avarice and harden the heart of the creditor. Some allowance must be made for the indolence of mankind, and the casualties and delays incident to the best-regulated industry; and the law is reasonable and humane which gives to the debtor's infirmity, or want of precise punctuality, some relief in the same infirmity of the creditor. If the one does not pay his interest to the uttermost farthing at the very moment it falls due, the other will equally fail to demand it with punctuality. He can, however, demand it, and turn it into principal when he pleases; and we may safely leave this benefit to rest upon his own vigilance or his own indulgence.

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[9] 217 N. Y. 119, 125, 111 N. E. 484, 486 (1916).
[10] 219 N. Y. 505, 114 N. E. 846 (1916).
[11] 1 Johns. Ch. (N. Y.) 13, 7 Am. Dec. 471 (1814).

In *Toll v. Hiller* [12] it is stated that for special reasons courts will not allow interest upon interest unless there is a special agreement to pay interest thereon after the original interest has become due and payable.

It may be well to point out that the New York cases holding an agreement to pay interest upon interest, or compound interest to be invalid, are not predicated on the assumption that such an agreement is usurious but upon what is said to be a consideration of public policy. In *Stewart v. Petree,*[13] the court said:

The receiving of interest upon interest is not a violation of the statute of usury, as no more than seven per cent is in such cases taken or received. It is true that an agreement in advance for the payment of interest upon interest, as the same shall accrue, cannot be enforced, not because it is usurious, but for the reason that such an agreement is regarded in this State as against public policy — as one that may be made oppressive to the debtor; but a prospective agreement, after the interest has accrued, to pay interest thereon, is valid; and money paid for compound interest cannot be recovered back.

Under the doctrine of *Erie Railroad Co. v. Tompkins, supra,* the federal courts must apply the law of the state embracing the particular federal district as distinguished from the general commercial law theretofore applied by the federal courts, if it be different. Thus state law applies to the question of interest on interest.

The federal cases on this point seem to be in conflict. In *Columbus, S. & H. R. Co. Appeals,*[14] the court held that in New York interest on interest is not collectible. In that case Judge Luron said: "The decree of the circuit court allowed interest upon the undetached matured coupons. This is excepted to upon the ground that the principal and interest is made payable in New York. The doctrine of the New York courts seems to be that interest upon interest is not allowed under the law of that state, but that an exception exists growing out of the character and purpose of interest coupons upon commercial obligations 'when they become separate and independent instruments.' In *Williamsburgh Savings Bank v. Town of Solon,* 136 N. Y. 465, 32

[12] 11 Paige (N. Y.) 228 (1844), *see also,* Van Berchooten v. Lawson, 6 Johns. Ch. (N. Y.) 313 (1822).
[13] 55 N. Y. 621 (1874).
[14] 109 Fed. 177 (C. C. A. 6th, 1901).

N. E. 1058 (1893) it was held that, until they do, this exception from the general rule has no application." In *American Brake Shoe and Foundry Co. v. Interborough Rapid Transit Co.*,[15] it was decided that under New York law, the provision of a trust indenture for seven percent interest on interest coupons after maturity, was enforceable as not in violation of New York's public policy.

Judge Patterson, after reviewing the decisions of the New York courts at page 955, said:

It thus appears that the New York courts have not rendered a decision on the validity of a covenant by a borrowing corporation to pay simple interest on overdue coupons. The argument for invalidity rests on the cases dealing with agreement for compound interest. But the reasons that led the New York courts long ago to condemn agreements for compound interest have only a remote bearing on agreements for simple interest on overdue coupons. On the other hand there are strong reasons for concluding that a covenant to pay simple interest on overdue coupons is valid in New York. *If there were a public policy against the allowance of such interest, the court in the Williamsburgh case would hardly have sanctioned recovery of interest on a coupon held by one who did not hold the bond, where there was not even a covenant to pay such interest.* The common appearance of a covenant of this character in contracts for the issuance of corporate bonds and notes indicates its general acceptance by the commercial community. In other states the covenant has uniformly been held valid at common law, even where as in New York agreements in advance for compound interest are not generally recognized. (Citing cases.) It is also significant that by the impressive weight of authority in other jurisdictions overdue coupons are held to draw interest as matter of law, without the assistance of express agreement to that effect by the debtor. 33 *Corpus Juris,* page 205; *Williston on Contracts,* Section 1417; *Daniel on Negotiable Instruments,* Section 1914. Finally it is to be borne in mind that in general parties may make what contracts they please. The law enforces the contract as it is written, unless it is contrary to statute or to settled public policy. The burden is on him who asserts invalidity to prove it, and in this case the burden of proving that the covenant to pay interest on overdue coupons is invalid by New York law has not been sustained. The decision is that the covenant is valid and enforceable under New York law, and that interest at 7 percent should be paid on the outstanding coupons. (Italics added.)

[15] 26 F. Supp. 954 (S. D. N. Y. 1939).

It is to be noted that Judge Mack, who had previously considered the identical situation under the Federal Law prior to *Erie Railroad Co. v. Tompkins,* had reached a contrary conclusion as to New York law.[16]

But, under New York law, the indenture provision for interest after maturity on the other two classes of interest coupons is unenforceable, as violative of the public policy of that state.

However, under the doctrine of *Swift v. Tyson*[17] Judge Mack applied the so-called federal common law and allowed interest on interest but noting as pointed out above that under New York law no such allowance could be made.

The authority of Judge Patterson's opinion is weakened because of its seeming conflict with the opinion on the same subject matter of two other distinguished federal jurists, as previously pointed out in this article, namely: Judge Mack of the Second Circuit Court of Appeals, sitting as a district judge in *American Brake Shoe & Foundry Co. v. Interborough Rapid Transit Co.,*[18] and Judge Lurton of the Sixth Circuit who wrote the opinion in *Columbus S. & H. R. Co. Appeals, supra.*

In *Transbel Inv. Co., Inc. v. Roth,*[19] which is in conflict with the decision reached by Judge Patterson, it was held that the public policy of New York prohibits contracts prospectively contemplating the payment of interest on interest and that the general rule in New York is identical in interest on interest and compound interest cases. Thus the federal court refused to approve Judge Patterson's view that compound interest and interest on interest are essentially different.

Two decisions of special masters in reorganization proceedings are often referred to in considering the New York law on the question of interest upon interest. In both the Brooklyn Rapid Transit Co. and the Seaboard Air Line R. Co. reorganizations, interest on interest was allowed because

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[16] American Brake Shoe and Foundry Co. v. Interborough Rapid Transit Co., 11 F. Supp. 419 (S. D. N. Y. 1935).
[17] 16 Pet. 1 (1842).
[18] 11 F. Supp. 419 (S. D. N. Y. 1935).
[19] 36 F. Supp. 396 (S. D. N. Y. 1940).

of an express provision in the mortgage. In the *Brooklyn Rapid Transit Co.* case the mortgage provided:

Article VI, Sec. 15, that in case default shall be made in payment of the principal, whenever and however it may become due, the mortgagor shall pay the whole amount then due and payable on all bonds and coupons then outstanding, *with interest upon the overdue principal and installments of interest at the rate of 5% per annum.* (Italics added.)

The reports of the masters in both of these cases recognize that in the absence of a covenant to pay interest on interest, none can be allowed in New York, and the allowance of interest in the reorganization proceedings seems to be based on the general rule rather than the minority rule as followed in New York.

In an opinion written by Judge Nordbye in *Re Wisconsin Central Railway Company,*[20] New York law was considered on the question of allowing interest upon the overdue interest coupons attached to the debtor's bonds. The mortgages securing the bonds referred to expressly provided that interest was to be paid upon defaulted coupons. After analyzing the leading New York cases on the point Judge Nordbye said:

The entire problem seems to have been stated quite succinctly by Judge Clancy in *Transbel Investment Co. v. Roth, supra,* at page 398, when he held that the general rule denying collection of compound interest also pertained to the collection of interest on interest, and said:

"It appears though that the rule has been consistently stated as a public policy that interest on interest has been described as compound interest because it differs from compound interest not in character or quality but only quantity and that no case in New York has whittled the policy down one jot or tittle. So we accept the policy as we find it. *Erie R. Co. v. Tompkins, supra.*"

In view of these premises, therefore, it would seem that this Court is required to conclude that it must apply the New York compound interest rules to the instant interest on interest cases. Both the Court of Appeals and the Supreme Court of New York have adopted and applied this rule. So, unless an exception or distinction

[20] *In re* Wisconsin Ry. Co., 63 F. Supp. 151 (D. C. Minn. 1945).

can be established, none of the bondholders noted above seem entitled to interest on the overdue coupons.

The claimants here contend that the instant situation is distinguishable from the general situation which has come before most of the New York courts, because an express promise was made here by the debtor. But, as noted, the promise was made when the contract was executed. True, the *Williamsburgh* case contains no express promise to pay interest on interest. But, on the other hand, it says nothing which indicates that a different rule would result if an express promise to pay interest on the coupons had been made before their due date. In fact, the opinion states the rule in a way which would seem to exclude such an inference. Only one exception is noted when the interest coupons are held by the owners of the bonds and that is the execution of a "new and independent agreement made upon sufficient consideration" after the interest has accrued. And the rule of *Young v. Hill,* upon which the *Williamsburgh* case is based, declares that a promise to pay compound interest made when the contract is executed, is not sufficient to justify recovery of compound interest. Moreover, the purpose of the rule denying compound interest and interest on interest seems to prevent the promise here from becoming operative. The rule exists because such interest "may serve as a temptation to negligence on the part of the creditor and a snare to the debtor, and prove in the end oppressive and even ruinous." *Young v. Hill, supra; Bishop v. Mowry,* (1835) 5 Paige Ch. 98. It is based upon public policy. *Toll v. Hiller, supra.* Certainly, an express promise made when the contract is made does not urge the negligent creditor to any greater efforts or invigorate the unwary debtor any more in interest on interest cases than it does in compound interest cases. Nor does it seem to cause the resulting burden to be any less oppressive. The mere fact that some debtor promises beforehand to pay interest on interest does not prevent negligence or unwariness. Apparently, the New York courts assumed that a promise after the interest has accrued would avoid the negligence of the creditor who does not collect promptly, in that the debt would already be due; that is, the unwary debtor would know when he made the promise that the debt was due and realize the predicament in which he finds himself. The promise made when the mortgage was executed would not of itself raise an obligation which would permit distinction to be made from the general rule that interest on coupons in the bondholders' hands cannot be collected except upon a promise made after the interest accrues.

Judge Nordbye's conclusion that a covenant made prior to the accrual of interest, to pay interest on interest, is con-

trary to the public policy of New York, and is therefore unenforceable, is sound.

In *American Fuel & Power Co. et al.*[21] the above conclusion was reaffirmed where the court after referring to the fact that in New York a covenant made prior to the accrual of interest, to pay interest on interest, is contrary to the public policy of the state, and is therefore unenforceable, said:

> Though the opinions usually speak of "compound interest", no intentional distinction between "compound interest" in a technical sense and simple "interest upon interest" is apparent. The bar against the allowance of interest upon interest, unless agreed upon after the interest has become due and payable, seems to rest upon disapproval of a hard and oppressive exaction tending to usury, without reference to difference in degree.

The foregoing analysis of cases which have dealt with the policy of New York with reference to the right of a creditor to collect interest on interest requires the conclusion that in New York interest on interest cases are governed by the same rules which govern compound interest cases. In view of the fact that many mortgages are executed and delivered in New York and even a larger number of the bonds are payable in New York it might not be amiss to point out to future draftsmen that the charging of interest upon interest, pursuant to an agreement made before the interest has accrued, is contrary to the public policy of New York.

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[21] 151 F. (2d) 470 (C. C. A. 6th, 1945).