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BANKRUPTCY—Usury—Plaintiff's Claim for Compound Interest Ruled Usurious; Simple Interest Disallowed to Give Effect to State's Deterrence Policy. *Zoppo v. KAM Realty Trust*, 1 Bankr. Ct. Dec. 1561 (D. Mass. 1975).

In October, 1971, plaintiff advanced a three year $350,000 loan to KAM Realty Trust, a Massachusetts business trust, and took back a mortgage as security "with interest on the unpaid balance to be paid monthly at the rate of fifteen (15) per cent per annum during said term, but with interest after maturity, default or acceleration at the rate of one and one-half (1½) per cent per month for such time as said principal sum or any part thereof shall remain unpaid."[1] Interest payments were met for the first four months. After a lapse of five months, two additional monthly payments were made. There were no further payments.[2]

On April 28, 1975, KAM Realty Trust filed a Chapter XI bankruptcy petition;[3] and on June 6, 1975, plaintiff sought to foreclose the mortgage.[4] Plaintiff's complaint alleged a debt of $350,000 in principal and accrued interest of $168,104 which included interest on interest at one and one-half per cent per month from April, 1972, through May, 1975.[5]

The debtor-in-possession answered that the interest claimed was usurious and thus the note was void and the mortgage unenforceable.[6] Accountants for both parties agreed that the accrued interest and actual interest paid over the forty-three month period averaged an annual rate of twenty-one to twenty-two per cent.[7]

The bankruptcy court found the loan usurious,[8] but allowed the creditor's claim for the unpaid principal and permitted him to retain the interest already collected.[9]

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1. Zoppo v. KAM Realty Trust, 1 Bankr. Ct. Dec. 1561, 1562 (D. Mass. 1975).
2. *Id.*
3. *Id.* A Chapter XI petition consists of arrangements made between a debtor and creditor. 11 U.S.C. §§ 701-99 (1970). Under this chapter of the Bankruptcy Act, an arrangement shall consist of "any plan of a debtor for the settlement [or] satisfaction . . . of his unsecured debts." *Id.* § 706.
4. 1 Bankr. Ct. Dec. at 1562.
5. *Id.* The decision does not indicate the date of default; but since interest is paid for six months, April, the sixth month of the loan relationship, is regarded as the effective date of default for the purpose of computing the interest on interest claim.
6. *Id.*
7. *Id.*
8. *Id.* at 1565.
9. *Id.*

The Bankruptcy Act allows the trustee-in-bankruptcy to plead the defense of usury to a creditor's claim.[10] A debtor-in-possession in a Chapter XI proceeding, who has all the rights and powers of the trustee,[11] may also assert the defense of usury. There is, however, no federal usury statute,[12] and the Bankruptcy Act defines neither usury nor its effect.[13] To resolve the usury issue the bankruptcy court had to look to the law of the jurisdiction in which the loan arose.[14]

Usury is the charging of interest for the use of money at a rate in excess of that permitted by statute.[15] The Massachusetts rate of interest statute, which has been in effect for more than a century, provides:[16]

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10. 11 U.S.C. § 110(c) (1970).

11. *Id.* § 742.

12. Zoppo v. KAM Realty Trust, 1 Bankr. Ct. Dec. 1561, 1562 (D. Mass. 1975). The need for a federal usury law as a means to develop uniformity in this area is expressed in Comment, *A Federal Usury Law—Uniformity at Any Rate,* 4 U.C. DAVIS L. REV. 421 (1971).

13. Zoppo v. KAM Realty Trust, 1 Bankr. Ct. Dec. 1561, 1562 (D. Mass. 1975). The only section in the act dealing directly with an usurious claim is found in Chapter XIII, Section 656(b). It provides:

> Before confirming any such plan the court shall require proof from each creditor filing a claim that such claim is free from usury as defined by the laws of the place where the debt was contracted.

This requirement was revised by Rule 13-301 of the Bankruptcy Act (1973). This rule provides that any creditor may be required by the court to establish, by affadavit or in such other manner as the court may require before the allowance of the claim, that it is free from any "charge forbidden" by applicable law. The term "charge forbidden" is substituted for "usury" in order to take account of the varying terminology of small loan laws. Rule 13-301 of the Bankruptcy Act, Advisory Committee's Notes. "Applicable law" is substituted for "laws of the place where the debt is contracted" in recognition of the fact that the law of a jurisdiction other than the place where the debt is contracted may sometimes be applicable. *Id.*

14. Security Mortgage Co. v. Powers, 278 U.S. 149, 153-54 (1928); Bryant v. Swofford Bros., 214 U.S. 279, 290-91 (1909). *KAM Realty Trust's* citation of Erie R.R. Co. v. Tompkins, 304 U.S. 64 (1938), for this proposition seems inappropriate because *Erie* governs diversity situations. *See* Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 162-63 (1946).

15. 6A A. CORBIN, CONTRACTS § 1498, at 677 (1962). The common law of England as adopted and approved in the United States, has never forbidden the exaction of usury on loans of money as a matter of general law or public policy. At the present time, usury must be regarded as merely *malum prohibitum*, resting entirely upon statutory regulation and prohibition, and not as *malum per se*. 45 AM. JUR. 2d *Interest and Usury* § 4 (1969). Every state has adopted a usury statute and, as may be expected, there are variations among them. In some states the entire interest is forfeited, in others only the interest in excess of the maximum rate is forfeited. For a brief survey of state sanctions, see Comment, *Usury in the Conflict of Laws: The Doctrine of The Lex Debitoris*, 55 CALIF. L. REV. 123, 232-43 (1967).

16. MASS. ANN. LAWS ch. 107, § 3 (1975).

> If there is no agreement or provision of law for a different rate, the interest of money shall be at the rate of six dollars on each hundred for a year, but . . . it shall be lawful to pay, reserve or contract for any rate of interest or discount. No greater rate than that before mentioned shall be recovered in a suit unless the agreement to pay it is in writing.

Under this statute, it has been held that "[p]arties may contract for, receive or pay any amount agreed upon."[17] The sole caveat is that a party to an agreement cannot recover an amount greater than six percent per annum unless the agreement is in writing.[18] When there is such a writing, it controls and the statutory rate is inapplicable.[19] Because of this rule, Massachusetts was considered, at least until the passage of its criminal usury law in 1970, a "no maximum [interest] rate" jurisdiction.[20]

The Massachusetts criminal usury statute[21] provides that anyone who knowingly contracts for or receives, directly or indirectly, interest in excess of twenty per cent per annum shall be guilty of criminal usury.[22] Since the statute also provides that any loan at a proscribed interest rate may be declared void,[23] it is arguable that the twenty per cent figure was intended as Massachusetts' ceiling for interest rates.[24] Nevertheless, two subdivisions of the statute suggest a contrary conclusion. First, under subdivision (d), one may avoid the statute by notifying the attorney general of his intent to exceed the twenty percent maximum.[25] Second, subdivision (e) provides:

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17. Foley v. Flaherty, 278 Mass. 134, 137, 179 N.E. 599, 600 (1932).

18. *Id.*

19. Manganaro Drywall, Inc. v. Penn-Simon Const. Co., 357 Mass. 653, 658, 260 N.E.2d 182, 185-86 (1970); Foley v. Flaherty, 278 Mass. 134, 137, 179 N.E. 599, 600 (1932). In West Side Motor Express, Inc. v. Finance Discount Corp., 340 Mass. 669, 165 N.E.2d 903 (1960) this rule was held to govern a loan of $15,000 where the interest charged was found to exceed 12 percent per annum. *Id.* at 671, 165 N.E.2d at 904.

20. Comment, *Usury in the Conflict of Laws: The Doctrine of The Lex Debitoris*, 55 Calif. L. Rev. 123, 225 n.524 (1967).

21. MASS. ANN. LAWS ch. 271, § 49 (Supp. 1974).

22. *Id.* § 49(a). Under this provision, a person found guilty shall be punished by imprisonment for not more than ten years or by a fine of not more than ten thousand dollars, or both. *Id.*

23. *Id.* § 49(c).

24. This was the basic premise behind the court's decision in this case. Zoppo v. KAM Realty Trust, 1 Bankr. Ct. Dec. 1561, 1564-65 (D. Mass. 1975).

25. MASS. ANN. LAWS ch. 271, § 49(d) (Supp. 1974). This provision for notice to the attorney general might generate problems of self incrimination similar to those related to the federal occupational tax on wagering. 26 U.S.C. §§ 4401-13 (1970). *See also* Marchetti v. United States, 390 U.S. 39 (1968).

"The provisions of this section shall not apply to any loan the rate of interest for which is regulated under any other provision of general or special law . . . ."[26] Since the criminal statute contains a scienter requirement[27] and there has been no repeal or modification of the earlier rate of interest statute,[28] it would seem that the criminal provisions simply describe a particular crime and are not intended to establish a maximum interest rate for Massachusetts.

In finding the contract usurious, the court focused upon the plaintiff's compound interest demand.[29] Such claims for interest upon interest have long been regarded with disfavor in Massachusetts.[30] This view evolved from an ancient series of decisions considering the merits of compound interest computation. In an early case involving notes payable after a term of years with annual interest, it was decided that judgment for only simple interest could be recovered.[31] Plaintiff had argued that by the terms of the note he was entitled to have the interest due at the end of the first year added to the principal, and to apply the interest rate to the aggregate at the end of the second year, and so on from year to year.[32] The court disagreed, reasoning that plaintiff had waived any claim to compound interest[33] by failing to bring an action at the expiration of each year. The principle was extended when the court refused to enforce an express promise to pay compound interest if the makers of the notes failed to make annual interest payments.[34] Another decision

26. MASS. ANN. LAWS ch. 271, § 49(e) (Supp. 1974).

27. *Id.* § 49(a). It states: "Whoever in exchange for either a loan of money or other property *knowingly* contracts for, charges, takes or receives, directly or indirectly, interest and expenses . . . greater than twenty per centum per annum . . . shall be guilty of criminal usury . . . ." *Id.* (emphasis added).

28. MASS. ANN. LAWS ch. 107, § 3 (1975).

29. 1 Bankr. Ct. Dec. at 1562.

30. *See* Shapiro v. Bailen, 293 Mass. 121, 199 N.E. 315 (1936); Inhabitants of Tisbury v. Vineyard Haven Water Co., 193 Mass. 196, 79 N.E. 256 (1906); Lewin v. Folsom, 171 Mass. 188, 50 N.E. 523 (1898); Hodgkins v. Price, 141 Mass. 162, 5 N.E. 502 (1886).

31. Hastings v. Wiswall, 8 Mass. 455, 456 (1812).

32. *Id.* at 455.

33. *Id.* at 455-56.

34. Henry v. Flagg, 54 Mass. (13 Met.) 64 (1847). *But cf.* De Cordova v. Weeks, 246 Mass. 100, 140 N.E. 269 (1923), where the court held that an agreement for quarterly interests at 18 percent per year to be compounded at maturity meant that the unpaid interest should be added to the outstanding principal only at maturity of the loan. Thereafter, interest on any sum remaining unpaid was to be computed as simple interest. *Id.* at 103, 140 N.E. at 270.

awarded interest as part of damages for wrongful ejectment, but refused to compute the interest on a compounded basis declaring that "[i]t has been repeatedly held in this Commonwealth that it is against the policy of the law to allow compound interest . . . ."[35]

In light of Massachusetts' policy against compounding interest, the court in *Zoppo v. KAM Realty Trust*[36] held that plaintiff's demand for such interest was usurious.[37] Plaintiff's claim for the overdue principal was granted because to void the note would unjustly enrich the debtor-in-possession's other creditors who received the benefit of the entire $350,000 loan.[38] Plaintiff was also permitted to retain the interest already collected since, at fifteen percent, it was paid at a lawful rate and the loan agreement was not usurious on its face.[39] However, interest from the date of default was denied in order to advance the policy of deterrence the court found implicit in Massachusetts' usury law.[40] Summarizing eloquently, the court announced: "[I]n fairness to all, he who seeks to overreach may recover the seed but puts at risk not just a few extra petals but the entire flower."[41]

Apparently, the court made its usury finding solely on the basis of the criminal statute and the certified public accountants' testimony that the agreement would produce interest at a rate greater than twenty percent.[42] It neglected, however, to examine subdivi-

35. Hodgkins v. Price, 141 Mass. 162, 164, 5 N.E. 502, 504 (1886). *But cf.* Ellis v. Sullivan, 241 Mass. 60, 134 N.E. 695 (1922) where the court stated:

> It has long been settled that interest on interest cannot be recovered, although payment has been demanded, because of 'the ancient unwillingness to allow compound interest.'. . . While this is the general rule, it is not always followed. In equity interest may be compounded and in the discretion of the court may be allowed where it is necessary for the purpose of affording a just and equitable accounting, particularly where the person charged with its payment is seeking the aid of the court.

Id. at 64, 134 N.E. at 697 (citations omitted).

36. 1 Bankr. Ct. Dec. 1561 (D. Mass. 1975).

37. *Id.* at 1565.

38. *Id.* Some bankruptcy courts place a higher burden on the creditor to establish that his claim is free from the taint of usury than did this court. This is especially true in a Chapter XIII proceeding involving a usurious claim. *See In re* Williams, 1 Bankr. Ct. Dec. 1567, 1568-70 (D. Ala. 1975).

39. 1 Bankr. Ct. Dec. at 1565.

40. *Id.*

41. *Id.*

42. *Id.* One of the elements which the court never examined was the intent of the lender to violate or evade the maximum rate of interest. This element is one of the essential factors in determining whether usury exists. *See* Interstate Financial Corp. v. Appel, 1 Bankr. Ct.

sion (e) of the criminal usury law which would have compelled a consideration of the applicability of the rate of interest statute. The court thus avoided a difficult determination. No reported Massachusetts decision has resolved the conflict between the criminal usury statute's provision for voiding an usurious agreement and the rate of interest statute's broad language allowing any written, agreed upon interest rate.

Had the plaintiff sued for payment of the debt in a Massachusetts court, that court might have found it unnecessary to resolve the conflict. The original fifteen percent interest rate cannot be regarded as usurious.[43] Since Massachusetts does not permit compounding interest,[44] the default rate of one and one-half per cent per month could only have been interpreted as a simple interest provision for eighteen per cent per year.[45] Thus, there would have been no need to consider the criminal usury statute.[46]

The loan agreement in *KAM Realty Trust* is not usurious under Massachusetts law.[47] Only the plaintiff's claim, which interpreted the default clause as a compound interest provision, raises the possibility of usury.[48] The worst fate plaintiff's claim would have suffered in Massachusetts is the disallowance of the compound interest demand. Generally, however, Massachusetts courts convert the asserted compound interest into simple interest,[49] which, in *KAM*

Dec. 1429, 1430 (D. Ga. 1975).

43. *Cf.* Manganaro Drywall, Inc. v. Penn-Simon Const. Co., 357 Mass. 653, 658, 260 N.E.2d 182, 185-86 (1970); Foley v. Flaherty, 278 Mass. 134, 137, 179 N.E. 599, 600 (1932).

44. *See* note 35 *supra.*

45. Henry v. Flagg, 54 Mass. (13 Met.) 64 (1847); Hastings v. Wiswall 58 Mass. 455 (1812).

46. Furthermore, section 3 of chapter 107 expressly excludes from its scope several sections of chapter 140 dealing with small business loans and consumer credit. Thus under the statutory construction maxim *expressio unius est exclusion alterius* section 3 of chapter 107 should govern this case.

47. Even if the case were prosecuted under the criminal usury statute this would be arguably so. The only rate knowingly contracted for was fifteen percent. The creditor lacked the requisite intent as to the default clause, even if he intended it to be compounded, because he could not have known if, nor for how long, the debtor would have defaulted. Nor could the creditor be guilty of having knowingly received interest at a rate greater than twenty percent since he received only $85,500 over the three year term of the loan. This figure would represent interest at a rate of approximately eight percent per annum, well within the twenty percent maximum.

48. "The problem [usury] develops only after the default and the start of the foreclosure action." 1 Bankr. Ct. Dec. at 1565.

49. Henry v. Flagg, 54 Mass. (13 Met.) 64 (1847); *cf.* Foley v. Flaherty, 278 Mass. 134, 179 N.E. 599 (1932); De Cordova v. Weeks, 246 Mass. 100, 140 N.E. 169 (1923).

Realty Trust, would have resulted in an award of interest at eighteen percent.

The bankruptcy court's denial of simple interest on a theory of deterrence is, ironically in a bankruptcy action,[50] inequitable. Who is to be deterred? The bankruptcy court does not speak for Massachusetts and thus deters none of its creditors. It only addresses the creditors-to-be of future debtors-in-possession. To proclaim a deterrence policy at this stage in the creditor-debtor relationship seems odd since the creditors at this point are the victims of their debtor's insolvency.[51]

While the validity and construction of a creditor's claim are appropriately determined by application of Massachusetts law,[52] the enforcement of a valid claim is a federal question governed by equitable considerations peculiar to bankruptcy law.[53] The court correctly declined to allow the interest on interest demand as contrary to Massachusetts law.[54] However, had the court recognized the validity of the plaintiff's simple interest claim, it could have proceeded to the enforcement issue without struggling with the deterrence policy so "ambivalently" expressed in Massachusetts' criminal usury statute. Enforcement of plaintiff's simple interest claim would have required the court to balance the equities among the creditors, or between the creditors and the debtor-in-possession.[55] Specifically, the court would have had to address two further ques-

50. A bankruptcy court is a court of equity. Bankruptcy Act § 2(a), 11 U.S.C. § 11(a) (1970); *see* Bank of Marin v. England, 385 U.S. 99 (1966). Furthermore, § 2(a)(15) of the Bankruptcy Act, 11 U.S.C. § 11(a)(15), provides a bankruptcy court may

> [m]ake such orders, issue such process, and enter such judgments, in addition to those specifically provided for, as may be necessary for the enforcement of the provisions of this title . . . .

Hence, a bankruptcy court is vested with broad equitable powers.

51. Furthermore, the history of Massachusetts usury law—more appropriately the lack of it—is not one of deterrence. Massachusetts has long been a fortress protecting the policy of freedom of contract, limiting that freedom only with the common law doctrines of good faith, unconscionability, and overreaching. Marvin v. Mandell, 125 Mass. 562 (1878). When interest has been voluntarily and in good faith paid and received at a rate unenforceable under the statute, Massachusetts has refused to permit the payor to recover the excess. *Id.* at 564.

52. Security Mortgage Co. v. Powers, 278 U.S. 149, 153-54 (1928); Bryant v. Swofford Bros., 214 U.S. 279, 290-91 (1909).

53. *See* Vanson Bondholders Protective Comm. v. Green, 329 U.S. 156, 162-63 (1946).

54. *See* note 35 *supra*. Arguably a valid interest on interest provision is inenforceable as a matter of bankruptcy law. Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 165 (1946).

55. Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 165 (1946).

tions; first, did the unpaid interest become due before or after the beginning of the bankruptcy proceedings, and second, would the disposition of the security produce money for the payment of both the principal and the interest due. If simple interest accrues after the bankruptcy petition has been filed, a secured creditor's claim for that interest is denied unless the secured property's value is more than the sum of the principle and the interest earned.[56] To allow the secured creditor such interest where the security is worth less than the amount of the debt would be inequitable to the unsecured creditors.[57] However, where the debtor's assets are sufficient to pay all the creditors, equity allows the payment of the additional interest to the secured creditors.[58] By denying plaintiff's interest claim on the basis of a deterrence theory, the court avoided a decision as to the value of plaintiff's security.

The conflict among the state jurisdictions as to the effect given to an usurious loan obscures bankruptcy's traditional distinction between the allowance and the enforcement of a claim. However, since plaintiff's simple interest claim is valid in Massachusetts, the bankruptcy court should have allowed the claim and relied on well settled bankruptcy principles to decide the enforcement issue. By relying on an unconstrued and unenforced criminal usury statute to invoke a local deterrence policy, the court deprived a good faith lender of the proper determination of his ratable share in the bankruptcy distribution.

Gerald Bohm

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56. *Id.* at 164.
57. *Id.*
58. *Id.*