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Usury and Consumer Credit

Consumer credit has increased at an astounding rate in this country during the Twentieth Century. From 1945 to the end of 1966 consumer, credit outstanding increased from \$5 billion¹ to \$95 billion,² growing 4½ times faster than our economy as a whole.³ Americans paid \$13 billion in 1966 for the privilege of deferring payments for consumer goods.⁴ As a result of this expansion of credit, an increasing number of debtors, ignorant of proper methods of financing have been left in bankruptcy.⁵ To avoid chaotic financial conditions, it is obvious that some appropriate forms of credit control are imperative.

Interest rates responding to the pressures of supply and demand have fluctuated greatly over many centuries. In the present century, interest rates have ranged from the highest to the lowest in the entire span of history: from 10,000% reported in Berlin to .01% reported in New York—a range of 1 million to 1.⁶ Today, in the United States, all states have statutes pertaining to interest rates. There are statutes which *imply* a rate of interest, where none is expressed in the contract, varying from a low of 4% per annum in North Dakota, to a high of 7% in California, Georgia and Nevada, with 6% per annum being the most common rate. All but three states, Maine, New Hampshire and Massachusetts, limit the amount of interest that parties may agree upon in a loan; these limits run from 4% per annum in North Dakota to 30% per annum in Rhode Island with the 6% - 12% per annum range being the most popular. For violation of the maximum limitation, the lender's penalties vary from forfeiture of the excessive interest, to forfeiture of all interest, to forfeiture of both principal and interest.⁷ Courts are generally in agreement as to the necessary elements to constitute a violation of maximum interest statutes; *i.e.*, 1.) a loan or forbearance of money, 2.) an agreement to return money absolutely, 3.) an agreement to pay in excess of the lawful rate, and 4.) an unlawful interest.⁸

¹ FED. RESERVE BULL. 88 (Jan. 1964).

² Proxmire, *Consumer Credit and the Law*, STUDENT L.J. 5 (Sept. 1967).

³ *Id.*

⁴ *Id.*

⁵ Cavanaugh, *Retail Credit Sales and Usury*, 24 LA. L. REV. 822 (1964).

⁶ Jordan and Warren, *A Proposed Uniform Code for Consumer Credit*, 8 B.C. IND. & COM. L. REV. 441 (1967).

⁷ B. CURRAN, TRENDS IN CONSUMER CREDIT LEGISLATION 15 (1st ed. 1965) [hereinafter cited as CURRAN].

⁸ *In re Bibbey*, 9 F.2d 944 (8th Cir. 1925); *Equitable Credit & Discount Corp. v. Geir*, 342 Pa. 445, 21 A.2d 53 (1941); *Foley, Usury Laws as Applied to Credit Sales—The Need for Revision*, 63 W. VA. L. REV. 42, 43 (1960).

Modern usury statutes exist primarily to protect the naive borrower;⁹ but what about the naive consumer who purchases on credit? Is he protected by the usury statutes or any other form of legislation?

Usury statutes have generally been held inapplicable to credit sales,¹⁰ thereby reducing their effectiveness in protecting the needy from the unscrupulous. Under the "Time Price" doctrine, a vendor can sell his merchandise at one price for cash and at a higher price on credit with the difference in price being compensation to the vendor for his increased risk in the credit sale.¹¹ The difference in price spread over the period of credit extended may give the vendor a greater return than the legal interest rate, but that is of no consequence under the "Time Price" doctrine, because "a credit sale is considered conceptually different from either a loan or forbearance of debt. . . ."¹²

Therefore, if a consumer borrows money to purchase a consumer good and pays interest exceeding the legal rate, he will be protected by usury laws, but if the consumer purchases from the vendor and pays a credit price which exceeds the cash price in the same amount as the interest paid on the loan, he would not be protected under the usury laws. Although it may be difficult to understand why usury laws should not apply in both instances, judicial attitude towards consumers and borrowers as evidenced by the opinion of one court might help explain this paradox: "a purchaser is not like the needy borrower, a victim of a rapacious lender, since he can refrain from the purchase if he does not choose to pay the price asked by the seller."¹³

In recent years, two states, Arkansas and Nebraska, have faced reality by recognizing that vendor-vendee situations involve a loan or forbearance of money and should be regulated by the state's usury laws.

⁹ First Nat'l Bank of Opp v. Cotton, 231 Ala. 288, 164 So. 371 (1935); Merriman and Hanks, *Revising State Usury Statutes in Light of a Tight Money Market*, 27 Md. L. Rev. 1, 8 (1967). See also Shanks, *Practical Problems in the Application of Archaic Usury Statutes*, 53 Va. L. Rev. 327 (1967).

¹⁰ General Motors Acceptance Corp. v. Midwest Chevrolet Co., 66 F.2d 1 (10th Cir. 1933); Dunn v. Midland Loan Fin. Corp., 206 Minn. 550, 289 N.W. 411 (1939); Hafer v. Spaeth, 22 Wash. 2d 378, 156 P.2d 408 (1945).

¹¹ General Motors Acceptance Corp. v. Weinrich, 218 Mo. App. 68, 262 S.W. 425 (1924).

¹² Cavanaugh, *supra* note 5, at 824.

¹³ General Motors Acceptance Corp. v. Weinrich, 218 Mo. App. 68, 262 S.W. 425 (1924).

In 1952, the Arkansas Supreme Court was faced with a typical vendor-vendee situation where usury was presented as a defense by the vendee.¹⁴ In this case, involving the sale of an automobile on credit, the vendee was charged interest at a rate exceeding that state's maximum of 10%.¹⁵ Immediately after the transaction was completed, the vendor transferred the commercial paper to the defendant, General Contract Purchase Corporation, against whom the defense of usury was posed. The Arkansas court upheld this transaction under the "Time Price" doctrine since the parties had relied upon existing case law which upheld the doctrine, but the court gave a caveat that any future cases like this one would be scrutinized to make certain the transaction was a bona fide credit sale instead of a disguise of usury.¹⁶ The court indicated that if the vendor charged more than the maximum rate to the vendee with the intention and assurance of transferring the commercial paper to a finance company and extracted more than the 10% rate, the transaction would be treated as a loan, thereby coming within the purview of the usury limitation. In a later decision,¹⁷ the Arkansas court applied the usury restriction to a credit sale which did not involve the third party finance company as in the earlier case. This case was merely a vendor-vendee credit sale with the vendor retaining the commercial paper. Although the vendor did not transfer the paper to a third party, and it was a bona fide credit sale, usury was held to be a good defense because the finance charge exceeded the lawful interest rate. Thus the court recognized that the difference between the cash price and the credit price amounts to interest paid by the vendee for the vendor's forbearance of debt.

From these and other related cases, it is clear that Arkansas has completely repudiated the "Time Price" doctrine and has faced the credit sale problem squarely by calling the so-called "Time Price Differential" interest, and as such, subject to usury limitations.

Nebraska has faced reality in ignoring the "Time Place" doctrine by applying usury to credit sales. In a 1957 decision,¹⁸ the Nebraska court indicated that if the vendee were not quoted a cash price

¹⁴ Hare v. General Contract Purchase Corp., 220 Ark. 601, 249 S.W.2d 973 (1952).

¹⁵ Ark. CONST. art. XIX, § 13 (1874).

¹⁶ Hare v. General Contract Purchase Corp., 220 Ark. 601, 249 S.W.2d 973 (1952).

¹⁷ Sloan v. Sears Roebuck & Co., 228 Ark. 464, 308 S.W.2d 802 (1958).

¹⁸ McNish v. General Credit Corp., 164 Neb. 526, 83 N.W.2d 1 (1957).

and a credit price, and given a choice between the two, the finance charge would be treated as interest to which usury would be applicable, and, if in excess of the maximum rate, the vendee would have a good defense, even against the third party finance company holding the commercial paper, by treating the vendee as agent of the finance company. In a subsequent case,¹⁹ involving a credit sale under that state's retail installment sales act which allowed finance charges in excess of the usury statute, the court held the installment sales act to be unconstitutional, and the "Time Price Differential" as interest for the forbearance of money in excess of the general usury statute. In still a later case,²⁰ the same court continued to apply usury limitations to credit sales by accepting the fact that when the vendor in a time sale computes the credit price by applying a rate to the cash price, the difference between the two prices is interest paid to the vendor for his forbearance from collecting the debt, and, therefore, subject to usury laws. These cases applying usury laws to credit sales clearly show Nebraska's repudiation of the "Time Price" doctrine.

In addition to the "Time Price" doctrine, there are also other exceptions to the application of usury statutes. One example is the denial of the defense of usury to corporations.²¹ Some courts will overlook the corporate exception and apply the usury laws where it is evident that the lender and borrower have engaged in collusion to set up a corporation for the borrower so that excessive interest rates may be charged.²² Other courts allow the corporate exception to stand if there is a validly existing corporation set up in accordance with the statutes of the state even though the main purpose of the corporation is to allow the incorporators to borrow money paying interest in excess of the maximum rate.²³ The basis for allowing the corporate exception is that corporations are more sophisticated than individuals in the matter of borrowing; therefore, they are less likely to need protection.²⁴

Another method used to obtain effective interest in excess of the maximum rate prescribed by law is the "discount" or "discount and

¹⁹ *Elder v. Doerr*, 175 Neb. 483, 122 N.W.2d 528 (1963).

²⁰ *Lloyd v. Gutzell*, 175 Neb. 775, 124 N.W.2d 198 (1963).

²¹ *E.g.*, W. VA. CODE ch. 47, art. 6, § 10 (Michie 1966).

²² *E.g.*, *Gelber v. Kugel's Tavern, Inc.*, 10 N.J. 191, 89 A.2d 654 (1952).

²³ *E.g.*, *Wergner v. Haines Corp.*, 302 N.Y. 930, 100 N.E.2d 189 (1951); *Rabinowich v. Eliasberg*, 159 Md. 655, 152 A. 437 (1930).

²⁴ *Merriman and Hanks, Revising State Usury Statutes in Light of a Tight Money Market*, 27 MD. L. REV. 1, 9 (1967).

repayment in installment" method devised by Arthur Morris in 1910.²⁵ Under this method the principal and time period are determined; then, by using the maximum interest allowed by statute, the total interest for the period is calculated. Interest is deducted from the principal and the resulting amount is given to the consumer with him paying the full amount of principal at the end of the period. In effect, the principal, for example \$100, is used to compute the amount of interest although the borrower receives the discounted amount, for example \$94, based on 6%. The result is that the borrower pays interest on \$100 but uses only \$94 thereby increasing the effective rate of interest over 6%. Along with this procedure lenders may require that the principal be paid back in equal installments or as under the Morris Plan, the borrower deposits equal sums monthly so that at the maturity date of the loan the loan will be fully paid. Under this repayment procedure, the borrower has the use on the average for the period of the loan, of less than one-half of the principal while paying interest computed upon an amount never received. It should also be noted that the borrower receives no interest on these early payments although he is at the same time being charged for money he is not using. For an example of the operation of this principal, if a borrower asks for \$600 for one year with existing maximum interest rate of 6% he would receive \$600 less \$36 interest or \$564. Already it is easy to see that interest is being computed on \$600 while the borrower is afforded only \$564 to use. If the principal is to be repaid in equal installments of \$50 monthly, the borrower has the use of less than \$300 on the average, yet he is paying interest computed on \$600. Thus, the ultimate effect is that the effective rate yielded to the lender is more than 12%, or twice the maximum rate. Yet, courts have generally held that these methods do not violate usury laws.²⁶

All states, except Arkansas, realizing the high risk in small loans to consumers, have enacted Small Loan laws²⁷ patterned after the Uniform Small Loan Act drafted by the Russell Sage Foundation in 1916.²⁸ Under these acts the borrower is allowed to charge interest in excess of that allowed by usury laws with the rate being expressed in monthly terms—for example, a monthly rate of 3½% producing a yearly rate of 42%²⁹ Lenders first must apply for a

²⁵ CURRAN 6, 52 *et seq.*; Proxmire, *supra* note 2, at 6.

²⁶ CURRAN 52 *et seq.*

²⁷ *E.g.*, W. VA. CODE ch. 47, art. 7a (Michie 1966).

²⁸ CURRAN 16.

²⁹ Proxmire, *supra* note 2, at 6.

license issued by the particular state, and, after acquiring the license, they will usually be under strict supervision. The amount of loans generally is limited to \$300, and the lender is required to disclose all charges to the borrower. Interest is to be computed on the unpaid monthly balance so the discount problem is eliminated. These laws make the small loan business inviting to lenders who would otherwise receive a much smaller return on their capital or resort to violation of usury laws.³⁰

Most states have retail installment sales acts, and all but one state, Tennessee, appear to have motor vehicle installment sales legislation.³¹ Many of these statutes, which require disclosure of charges to the consumer, also provide for interest in excess of the rate expressed in general usury statutes. But, as was noted earlier, because of the excessive interest rate allowed, one court held such an act unconstitutional.³² If the courts will not apply usury statutes to credit sales, then retail installment sales acts which require disclosure of the charges are probably the next best method of protecting the consumer. If the consumer is made aware of the costs of financing, he will be better able to determine which merchant is offering the best deal. But, as indicated by Senator Proxmire, because of the different methods of calculating interest and finance charges, what starts out at 6% per year may cost over 13% in the end.³³

What is the proper way for government to protect the unwise consumer from the unscrupulous lender or seller? Senator Proxmire has a solution in his Truth in Lending Bill³⁴ and the Commissioners on Uniform State Laws have a solution in their Uniform Consumer Credit Code.³⁵

Proxmire's Truth in Lending Bill is designed to protect the consumer by means of disclosure by the lender or seller rather than by setting a maximum interest rate. This proposal covers all credit transactions except the following: credit extended for business or commercial purposes or to governmental agencies or instrumentalities; transactions with broker-dealers registered with the Securities and Exchange Commission; transactions other than in real estate when

³⁰ CURRAN 52 *et seq.*

³¹ CURRAN 93.

³² *Elder v. Doerr*, 175 Neb. 483, 122 N.W.2d 528 (1963).

³³ See Proxmire, *supra* note 2, at 8 for a discussion of different methods of computing finance charges.

³⁴ S. 5, 90th Cong., 1st Sess. (1967).

³⁵ CREDIT CODE (Ten. Draft No. 2 1967).

the amount to be financed exceeds \$25,000; and transactions involving first mortgages on real estate.

Under the provision related to regular credit sales, the seller must inform the purchaser of: the cash price for the goods; the down payment including trade-ins; all charges other than finance charges; the total amount to be financed; the amount of the finance charge; the finance charge expressed as an annual rate if \$10 or more; the number, amount, and due dates of payments; and default or delinquency charges due to late payments.

In relation to an actual loan of money the lender must state: the amount of credit of which the borrower will have actual use; all charges except the finance charge; the total amount to be financed; the finance charge stated as an annual rate if \$10 or more; the number, amount and due dates of payments; and default or delinquency charges due to late payments.

For open end credit accounts, the creditor must state: conditions under which a finance charge will be imposed and the period within which payment may be made without incurring a finance charge; the method used to determine the balance upon which the finance charge will be computed; the percentage rate per period and per annum and any minimum or fixed finance charge; and at what times other charges may be imposed and the method for determining them. In addition, at the end of each billing cycle the creditor must show: the outstanding balance at the beginning of the period; amount and date of each purchase or extension of credit; amount credited during the period; finance charge for that period and the amount of a fixed or minimum charge, if any; the balance on which the finance charge was computed and how that balance was determined; the rate used to determine the finance charge including the annual rate; balance in the account at the end of the period; and at what times payment must be made to avoid additional finance charges. All this information, except that provided at the end of the billing cycle, must be given to the borrower before credit is extended to him.

By using the information afforded to him the potential debtor should be able to evaluate and use the credit available to him more wisely. Senator Proxmire stated that the purpose of the Truth in Lending Bill is "to convert this jumble of finance rates into a simple measure which the consumer can understand and use to make comparisons."³⁶ The Senator feels that the problem existing in the

³⁶ Proxmire, *supra* note 2, at 8.

present consumer credit industry would be eased somewhat by a national law requiring disclosure of rates and methods of computing finance charges.³⁷ What better way can the consumer be educated?

The following discussion of the proposed Uniform Consumer Credit Code will merely touch upon some of its main sections dealing with credit sales.

A consumer credit sale is defined as "a sale of goods or services . . . in which credit is granted by a seller who regularly engages in credit transactions as a seller, the buyer is a person other than an organization, and the goods or services are purchased either primarily for a personal, family, or household purpose or primarily for a farming purpose and the amount financed is \$10,000 or less."³⁸ By this definition, the Code covers most consumer transactions on the ordinary non-business level.

Similar to the Truth in Lending Bill, the Credit Code provides for disclosure of finance charges, but unlike the Proxmire bill the Credit Code provides for maximum rates to be charged for financing. Maximum rates to be charged on credit sales other than retail charge accounts are either \$18 per \$100 per year on the amount below \$300, \$12 per \$100 on the amount between \$300 and \$1,000, and \$8 per \$100 on the amount in excess of \$1,000, or 18% per year calculated on the unpaid balance of the amount financed. For retail charge accounts the maximum finance charges are 2% of the unpaid balance of \$500 or less, and 1½% of the unpaid balance in excess of \$500 with a minimum charge of \$.70 for monthly billing cycles. For cycles different from monthly, a proportionate rate should be used.

Disclosure provisions of the Credit Code, similar to those of the Truth in Lending Bill, require the creditor to make available to the debtor much important data concerning the cost of credit. When sales other than retail charge accounts are involved, the Credit Code requires the creditor to state to the debtor: description of the goods; cash price of the goods; amount of down payment including trade-ins; registration, certificate of title or license fees; description of insurance to be paid for by seller; additional charges; amount financed; amount of the credit service charge; unpaid balance; and the number, amount and due date of first payment and due date of subsequent payments.

³⁷ *Id.* at 11.

³⁸ CREDIT CODE § 2.104 (Ten. Draft No. 2 1967).

If the amount financed exceeds \$300, the creditor must provide the debtor with an approximate rate of the service charge. For retail charge accounts, the seller must state to the purchaser: balance at beginning of cycle; amount of credits; cash price of goods charged to the account during the cycle; amount of service and other charges; balance at end of cycle; amount to be currently paid to avoid delinquency; and at what times service or other charges may be made and the manner in which they are calculated.

Other disclosure requirements of the Credit Code concern rate calculation and advertising. Sellers are required to give the rate charged as a service charge stated in terms of dollars per \$100 per year. For regular scheduled payments, there is a formula provided to determine the rate per billing period. Creditors in their advertisements are required to disclose the rate of the service charge in dollars per \$100 per year, and, if installment payments are involved, the number and amount of installments. Information required to be disclosed by the Credit Code must be given in writing before the sale or within a reasonable time thereafter.

In comparing the Truth in Lending Bill and the Credit Code it appears that the main difference is that the Code sets maximum charges to be made while the Bill is silent on this point. The reason for this difference might properly be explained by Senator Proxmire's belief that state legislation properly deals with fixing rate ceilings.³⁹ Both proposals are primarily concerned with providing the consumer the information needed to show what the actual cost of financing an article will be. If the consumer has this information, it would seem that government has certainly helped to protect him.

There have been usury laws to protect the debtor for many centuries, but courts have refused to use these laws to protect consumers because the two have been considered conceptually different. Today, because of the tremendous amount of credit sales in this country, it is evident that almost everyone resorts to some form of credit buying. Both government and private institutions have recognized the need to protect the consumer from those creditors whose practices are deceptive and have pushed forward to provide legislation covering the consumer credit field. Both pieces of proposed legislation examined assume that an effective method to protect the

³⁹ Proxmire, *supra* note 2, at 11.

consumer is to make him aware of the cost of the choice between cash or credit sale.

Whether the best method to cope with the problem of consumer credit is on the state or national level is beyond the scope of this article, but any method chosen will probably set up uniform laws concerning disclosure of costs. For government to make the consumer aware of costs of credit will be a great step forward and also a proper step without infringing upon legitimate endeavors of private enterprise.

William Douglass Goodwin