University of Richmond Law Review

Volume 1 | Issue 1 Article 3

1958

Usury in the Purchase of Negotiable Paper

James H. Barnett Jr.

Usury in the Purchase of Negotiable Paper

James H. Barnett, Jr.

By the law of Moses, a Jewish lender who took interest from a Jew was a usurer. Ancient Jerusalem was not a good place to start a bank. In Virginia today the problem facing a lender is not whether, but how much, interest can legally be taken from a borrower. Va. Code Ann. §§6-346 and 6-347 (1950) provide that all agreements for the loan or forbearance of money at a greater rate than 6 per cent shall be illegal as to all interest. Early statutes against usury in England applied stiff civil and criminal sanctions to offenders. The modern tendency is toward lighter penalties. There are three main lines of authority as to the extent to which usury may be a defense to the borrower. A usurious agreement is (1) void as to principal and interest, (2) illegal as to all interest, or (3) illegal only as to the excess of interest above the legal rate. Virginia followed the first line until 1872, when the second line was adopted with this qualification, that a borrower who has paid the loan and later seeks relief can, if suit is brought within one year thereafter, recover only the excess of interest above the legal rate. Va. Code Ann. §6-350 (1950). The change in attitude against the exaction of high interest is illustrated by sections 6-253 and 6-348 of this Code, which permit industrial loan associations, banks, and brokers to exact from borrowers interest substantially in excess of 6 per cent even though they do not comply with the Small Loan Act (sections 6-274 to 6-338).

This monograph attempts to explore the nature of certain transactions in negotiable paper. In the transactions under consideration the plaintiff admittedly would qualify as a holder in due course under section 62 of the Negotiable Instruments Law, hereafter referred to as the NIL. In *Lynchburg National Bank* v. *Scott,* 91 Va. 652 (1895), it was held that the maker's defense of usury between himself and the payee was not good against a subsequent holder in due course. The validity of that holding is not questioned here. It is important to distinguish the defense asserted in the unusual situations discussed herein from that in the *Scott* case, *supra.* In both, violation of the statute against usury was the defense; in the former, however, the defendant claimed that the plaintiff, a holder in due course, was a participant, though unwilling, in a usurious transaction and was therefore subject to the civil sanctions provided in the usury statute. Since emphasis will be placed on the case law in Virginia with only brief reference to decisions from other states, the reader, if interested, will find helpful discussions in Annot., 43 L.R.A. (N.S.) 211 (1913); Annot., 5 A.L.R. 1447 (1920); 55 Am. Jur., *Usury* §§26 and 27 (1939); 29 A. & E. Enc. Law 473-78 (2d ed. 1896); 1 Daniel, *Negotiable Instruments* c. 23 (6th ed. 1919); Weinstein, "When a Bill or Note Represents an Usurious Contract," 5 Tul. L. Rev. 211 (1931).

What is usury? Except in the three problems herein considered, the test is simple, and no difficulty is met in applying the statutes against usury. The following illustration may be of interest:

Suppose M signs and delivers to P a note for $1000 due one year from date with interest at 10 per cent. Is the provision for interest legal? The following extracts taken from *Graeme* v. *Adams,* 23 Gratt. (64 Va.) 225, 234 (1873), supply the answer:

> Usury can only attach to a *loan* of money; or to the forbearance of a debt. . . . [O]n a contract to secure the price or value of work and labor done or to be done, or of property sold, the contracting parties may agree upon one price if cash be paid, and upon as large an addition to the cash price as may suit themselves, if credit be given; and it is wholly immaterial whether the enhanced price be ascertained by the simple addition of a lumping sum to the cash price, or by a percentage thereon. In neither case is the transaction usurious. It is neither a loan or the forbearance of a debt, but simply the contract price of work and labor done or property sold. . . .

On the other hand, a note for $2000 due one year from date without interest may or may not be usurious depending upon the facts giving rise to its execution. If the maker owed the payee a debt of $1500 now due and gave the $2000 note pursuant to the payee's promise to forbear suit until its maturity, it would be a forbearance at an illegal rate of interest though the note is stated in terms of principal.

I. M, for the accommodation of P, signs and delivers to P a note for $1000 payable to P or order one year from date without interest. P indorses the note in blank and delivers it to X, his agent, to sell at the best price obtainable. H pays X $900 and takes delivery. How much can H at maturity recover from M or from P, (a) when H at the time of negotiation was aware of all facts stated? (b) when H believed it was valid business paper and X was the owner?

(a) Perhaps all courts would hold that H participated in an illegal loan to P because, knowing of the accommodation as well as the agency of X, he knew or should have known that P and X had no enforceable rights against M, the surety for P, and in short that he was really lending $900 to P who has agreed to repay him $1000 one year later. The rights of H would depend upon which main line of authority prevails in the particular jurisdiction.

(b) H appears to be a holder in due course. Will the law accord to him the rights he expected to acquire? Only two views are discussed below.

New York view: H is a lender in a loan transaction. His belief that he was purchasing a business note from X, the owner, would be immaterial. Since the interest P agreed to pay exceeded the legal rate, H has participated in an illegal transaction. This view is supported by the weight of authority. The result is based on the premise that neither P nor X had rights against M, so it could not be a sale; therefore it must be a loan.

The adoption of this premise has led the New York court to conclusions that seem arbitrary at best. Where M. delivers a business note to P on an oral condition that rights will not arise in the payee unless and until M has sold a certain chattel to Y, and P—in violation of this condition, not performed—negotiates the note to H, who pays $900 believing that P has effective rights against M, H is tarred with usury. *Eastman* v. *Shaw,* 65 N. Y. 522 (1875). But suppose P secured the note from M by a fraudulent warranty of a chattel sold and P negotiates the same to H, a holder in due course, who pays $900. H can recover the face amount from M. (The peculiar rule as to the amount H can recover from P is discussed under II below.) If, prior to P's negotiation to H, M had taken effective steps to rescind the delivery of the note, H would, it seems, be a party to a usurious transaction. See *Joy v. Diefendorf,* 130 N. Y. 6 (1891).

Virginia view: H is a purchaser in a transaction of sale. There is no usury. The leading cases, *Taylor* v. *Bruce,* Gilm. (21 Va.) 42 (1829); *Whitworth* v. *Adams,* 5 Rand. (26 Va.) 333 (1827); and *Brummel & Co.* v. *Enders, Sutton & Co.,* 18 Gratt. (59 Va.) 873 (1868), cover 186 pages in the reports and include ten opinions. All in all eleven judges participated, seven voting with the majority while four dissented. All three cases lay down the same broad principle: that H is not a participant in a usurious transaction. Only the *Withworth* case will be discussed here. The five opinions in this case, covering nearly one hundred pages, indicate prolonged discussion, extensive research, and careful consideration. The problem involves the application of some of the cardinal principles of negotiable paper.

The lower court had given judgment for H, the plaintiff, against the maker on a special verdict, which was not set out in the report, though it was fully discussed. It is rather singular that both of the dissenting judges thought that under the special verdict the jury had found that H had notice of the accommodation as well as the agency of X. The three judges who voted for an affirmance of the judgment took the view that H had bought the note "ignorant of the character of the note, of the purpose for which it was made, and of the persons for whose benefit it was sold." Pp. 396-97, 409, 421.

The majority placed the problem under I(b) above. The dissenting judges placed the problem under I(a), but held that even if problem I(b) was applicable, judgment for H should be reversed. See the following extract from the dissenting opinion of Judge Carr at p. 340:

> But, if I should be wrong in this [that under the special verdict H had notice], there are two other grounds, on which, it seems to me, that the appellants must succeed.
>
> 1. This being accommodation paper, was never an available negotiable note, until it was discounted by Johnson [H]; and that discount being at a premium higher than the legal rate, the note was usurious and void; and this, though Johnson did not know that it was accommodation paper.
>
> 2. Though the note should be considered perfect and available as between Wilson & Orr [P] and Whitworth & Yancey [M], yet as the transaction by which it was passed from the payees to Johnson, was a discount beyond legal interest, and so usurious, no subsequent holder could maintain an action on it.

Judge Carr in amplifying the second ground above held that the statute made the indorsement of P void to the same extent as if it had been forged. This was perhaps justified, assuming there was usury, since the statute in 1827 made not only the contract but any transfers under it void. Apparently the Code of 1849 eliminated the provision as to transfers but still made the contract void. If, still accepting the view of the dissent, there was usury, the same result would not have been reached under the Code of 1849. A general indorsement is both a promise and a transfer. The avoidance of the promise leaves the writing still effective as a change of tenor and the delivery pursuant to it is a transfer.

In his dissent Judge Green, but not Judge Carr, agreed that the intent of the lender was material, that if he did not intend to lend it would not be usury. He admitted that according to the law merchant the note in the hands of a holder in due course imported a consideration that could not be questioned, and further the good faith purchaser could deal with an agent as owner; that if these rules were applicable to this case then any inquiry as to facts of usury would be precluded. P. 365. He maintained, however, the novel proposition that the statute against usury had made an exception to the principles of the law merchant and substituted the rules of the common law:

> By the law merchant, a *bona fide* holder of a bill endorsed in blank, may acquire title from a person having himself no title, and even from one who stole the bill. But upon common law principles, no man can transfer more right than he has; and whoever deals with an agent having no title, even without notice of his agency, and with a belief that he is dealing with him as principal, in effect deals with the real principal, and acquires the title or not . . . according to his authority or not. (P. 336).

The majority held that the negotiation to H could not be a loan if H intended to purchase. A distinction was made between a mistake as to the legal effect of a transaction and a mistake as to the facts. This example was given: the payee, believing that a maker can sell his own note, takes the same at a greater discount than the legal rate. The transaction would be a usurious loan even though the parties did not believe they were lending because they "have intentionally done that which the law makes a loan." P. 415.

The following extracts from the opinion of Judge Cabell are in part his answer to the argument of Judge Green:

> The note was unavailable before it was negotiated for value. But whether the note was valid and available afterward, or void for usury, depended, not upon the rate of discount but upon the character of the negotiation as a contract of sale, or a contract of loan. . . . [B]y the rules of the law merchant, every bill imports a consideration not to be questioned, in the hands of a purchaser for valuable consideration; every endorser in blank . . . even if the bill was an accommodation bill, makes it, thereby, payable to bearer, and enables a purchaser for valuable consideration, to deal with him as owner . . . as if the bill had been originally given for full value. . . .

> I readily grant, that the statute of usury does constitute an exception to the rules of the law merchant. . . .
>
> But how far does the exception extend?
>
> . . . [The statute] allows him . . . to give evidence of every fact that will conduce to prove the usury . . . because the question, whether usury, or no usury, depends upon the *intention to lend*: and it is impossible that a man's intention can be proved, in the slightest degree, by *facts of which he had no knowledge*. (Pp. 416-18).

These quotations go to the heart of the problem. Judge Cabell rejected wholly the argument of Judge Green that the statute had grafted upon the law of negotiable paper the common law doctrine of constructive notice as to facts tending to prove usury. He admitted that the statute had curtailed the rights of a holder in due course by affording the maker in a contract of usury an absolute defense, but rejected the argument that this had been brought about through the adoption of the fiction of constructive notice to the holder. Judge Cabell might have used the illustration of a note signed by a married woman. In such case the holder in due course would be denied recovery against her not through the fiction of constructive notice of the marriage, but on the basis that all holders bear the risk that apparent obligors may have the defense of incapacity under the common law.

Williston supports the Virginia rule and criticizes the cases *contra* as follows:

> But such decisions seem to rest upon a misapprehension of the nature of accommodation paper, which should be regarded as subject to the personal defense of lack of consideration while in the hands of the accommodated party, than as having no existence until negotiated by him. 6 Williston, *Contracts* § 1690 (rev. ed. 1936).

Does the accommodated party have something to sell? Accommodation is not an equitable defense, even as against one who buys before maturity with notice, provided the negotiation is not at a discount greater than the legal rate. Consideration will be given below to the situation where the payee of a note signed only by the maker, who has an absolute defense either by common law or statute, negotiates the same to H who takes at a discount greater than the legal rate. There the holder who pays even the face amount admittedly acquires no rights against M. The problem of accommodation paper raises a question, similar to that often debated, as to the extent of the liability of one who, selling a chattel or a negotiable instrument, gives an implied warranty of title. Clearly if the bona fide purchaser did not acquire title by the purchase the warranty is broken. Suppose the seller did not have title, but for one of many possible reasons the purchaser is held to have acquired title. Does he have a right against the seller for breach of warranty on the theory that the warranty was a representation that the seller had title? If the view be taken that the warrantor merely represents or promises that the purchaser will get title, then there is no breach of warranty. Without discussing the two views further, it may be suggested that as a practical matter all the purchaser is interested in is the acquisition of the rights of an owner. The weight of authority under Problem I(b) supports the New York rule.

II. P, the order payee of a valid note for $1000 payable one year from date, indorses the same to H, who pays $900 therefor. Is this usury? How much can H recover from M, the maker? From P?

New York view: This is not usury. H can recover the face amount from M. H can recover from P only the amount paid to him. The majority of jurisdictions which, like New York, find no usury, nevertheless allow H to recover the face amount from P. This is the measure of recovery provided in sections 61 and 66 of the NIL.

Virginia view: Most but not all of the judges in *Whitworth* v. *Adams, supra,* assumed that there would be usury between P and H. Pp. 354, 379, and 419; but see p. 388. If there is usury between P and H, then in 1827 H could not recover anything from P, but today could recover $900 (which is the same result as reached in New York but for quite different reasons). Today in Virginia usurious agreements are illegal as to all interest but not as to principal.

What of H's right against M? If Judge Carr was correct as to the effect of the statute on a usurious transaction, then it was void not only as to the indorser's contract, but also as to the transfer, so title remained in P. Judge Coalter disagreed. Pp. 391-96. Under the present statute it seems clear that H can recover the face amount from M because there was no usury between M and H. In *Moore* v. *Potomac Savings Bank,* 160 Va. 597 (1933), the facts fit the problem as stated in II, above, with this addition, viz., P secured the note from M by fraud. H recovered the face amount from M and the court affirmed the same. The decision is supported by the weight of authority. The court assumed without citing any Virginia case that the transaction between P and H was usurious. *Bank of Radford* v. *Kirby,* 100 Va. 498 (1902) held there was usury between H and P, citing dicta in *Whitworth* v. *Adams, supra; Bell* v. *Calhoun,* 8 Gratt. (49 Va.) 22 (1851); and 3 Minor, *Institutes* 306-08 (1895). In the *Moore* case, the court in dictum suggested that in any event H could recover the principal from M ($900 in problem II). The court discussed the problem on the assumption that it was a loan, but as the trial court had held that it was a sale and the defendant had not shaped his pleadings, instructions, or exceptions on the theory that there was usury, the court said it was useless to pursue the question further. P. 606. The court then quoted from Williston, *Contracts,* but did not include a statement by the author criticizing the Virginia rule. What light does this case throw on the present law in Virginia? Perhaps, to use the expression of backwoods wrestlers, "It was a dog fall."

The Virginia rule, which is not the weight of authority, seems unsound in theory and unrealistic in practice. The owner of a valid bearer note can by a sale without indorsement or by an indorsement without recourse sell at any discount without violation of the usury statute, yet if the purchaser demands and secures a general indorsement the transaction by some alchemy has been changed from a sale into a loan. Suppose S sells a chattel to B for $500 and as an inducement to B gives a warranty of quality. The chattel delivered is not as warranted yet has an admitted value of $400; it is agreed that had the chattel been as warranted its value would have been $600. How much can B, who elects to retain and sue for damages, recover? Two hundred dollars, according to the prevailing view as well as under section 69(7) of the Sales Act. B has not violated the statute. Compare this with problem II, where P sold, not pledged, the note for $900 and as an inducement to the purchaser promised that if the maker didn't perform his contract by paying the face amount he would guarantee that H would realize that amount. Isn't that in substance what S did by his warranty? It is assumed that this is not an attempt to evade the statute by giving the form of a sale to what is in fact a loan. The promise of P may appear to have some of the characteristics of a loan, but the main transaction was a sale to which the promise is subsidiary. One hundred years ago this problem under the severe first line of authority noted at the beginning of this paper would involve a substantial sum. Today under our less severe sanction the amount involved would not in most instances justify litigation.

III. M, in payment of money lost at cards, signs and delivers to P, the payee, a note for $1000 due one year from date. P, before maturity, indorses the same to H, who pays $900 therefor in good faith without notice of the consideration between the maker and the payee. Va. Code Ann. § 11-14 (1950) provides in substance that gaming contracts shall be "utterly void." The weight of authority under the NIL, distinguishing between mere illegality and statutory invalidity, holds that under similar statutes the maker has a legal defense good against a holder in due course. The object of the statutes would appear to be the prevention of gambling transactions by punishing the parties thereto rather than shielding the obligor as one imposed upon. The effect of the prevailing rule is to punish the holder, the only one of the parties deserving protection, while shielding the law-breaking maker. Section 11-14 should be amended to provide that the obligation is void as to all except holders in due course and those who are permitted to claim shelter through them; in that way the cardinal principle of the NIL as well as the object of the statute against gambling can be achieved. The Virginia court has not passed on this point.

In problem I(b) P had something to sell even though he could not recover from M; a holder taking from him, even with notice of the accommodation character of the paper, could recover the face amount from M if he paid at least 94 per cent of that amount, while in problem III M is not liable even to a holder in due course. Williston, who favors the Virginia view, discussed above under problem I(b), has this comment about problem III: "But if the instrument except the endorser's obligation is wholly void, the transaction even though intended as a sale is in effect a loan to him, and where the discount is excessive, has been held usurious." 6 Williston, *Contracts* §1690 (rev. ed. 1936). Only two cases are cited by the author, both from New York. Decisions from New York cannot be persuasive since the courts of that state hold that there is usury in problem I(b). There are no decisions in Virginia covering problem III, and furthermore it should be noted that as long as Virginia follows the minority view discussed above under problem II, the court would never come to grips with the present problem because there would be usury even if M were liable to H. Problem III cannot, it appears, be raised by any set of facts without at the same time bringing in problem II. Such would be the case, for example, if X—a third person—were introduced into problem III between P and H (as where P in the illustration indorsed the note in blank, but it was stolen from him by X, who delivered the same to H, who took as holder in due course). Prior to the adoption of the NIL, both M and P would have a good defense against H. Under section 16 of the NIL, P's defense of lack of delivery would not be good against H; consequently there is substantially the same problem as in problem I(b). The following question remains: Should a court following the majority view under problem II hold that H is a participant in a usurious transaction in problem III?

If H had purchased at a discount less than the legal rate, no question of usury could be raised. A purchase at a large discount does not as a matter of law prevent one from being a holder in due course. At most it is evidence tending to show either lack of good faith or absence of an intent to bargain. *Fleshman* v. *Bibb,* 118 Va. 582 (1916). It is assumed that H is a holder in due course. The majority of the judges in the *Whitworth* case, *supra,* rejected the novel proposition advanced by Judge Green that the statute against usury had grafted upon the law of negotiable paper the common law doctrine of constructive notice.

Is the intent to lend one of the requisites of usury? The authorities generally agree with Judge Cabell (see above) that the intent of the lender, H in the problem, is necessary. Williston, *Contracts* § 1698 (rev. ed. 1936); *Restatement, Contracts* § 526, Special Note. Judge Cabell distinguished between the lender's mistake as to the legal effect of a transaction and his mistake as to a collateral fact. If the transaction between P and H cannot be a sale because P had nothing to sell, and cannot be a loan due to H's mistake as to the validity of M's obligation, what is it? It does not seem helpful to speculate about the nature of this hybrid transaction. Would it not be better to seek the object back of the statute against usury? Granted that it was designed to punish those who have the expectation of high interest that a lending mind begets, the punishment of a holder in due course who has already been impaled on the statute against gambling seems rather outrageous treatment of the most favored plaintiff in the law. The holder in due course generally is accorded the rights he expected to secure. True, there are exceptions under common law, as in the case of infants, married women, and those held to be incompetent in fact to contract, and by statute in the illustrations discussed above and others as a discharge under the bankruptcy law. In other situations this knight in shining armor has prevailed over defenses that would defeat the ordinary plaintiff. It is suggested, therefore, that to test the transaction between P and H by what P has a power to pass is improper. We are dealing with no ordinary claimant; this plumed knight is the champion of the business world. The transactions entered into by him should be judged as to their nature by what they appeared to be and not by facts unknown to him. The cases which defeat a holder in due course because he is considered a participant in a usurious transaction are but a variant of the minority view that a payee cannot be a holder in due course. When a court holds that a subsequent holder in due course cannot recover from a maker who has established that there was usury between him and the payee because the local statute provides that contracts which are tainted with usury shall be "utterly void," the decision raises only a question of policy back of the statute. On the other hand, when a court holds that a holder in due course is subject to the sanctions of a statute against usury because he was a participant, though unwitting, in a usurious transaction, the decision rejects one of the cardinal principles recognized for more than two centuries for the protection of this most favored plaintiff by forcing upon him a transaction he never objectively or subjectively became a party to.

Plea of Confession and Avoidance

No secrets are revealed when it is suggested rumors abound that instructors in Negotiable Paper are at best a queer lot, yet harmless and not to be taken seriously save at examination time. The writer fears he has played into the hands of the Philistines and cannot now rely on the Fifth Amendment. His only comfort comes from the realization that most, if not all, potential readers will be diverted by the title.