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GEORGIA'S USURY LAWS AND INTEREST ON INTEREST: THE NEED TO TRANSCEND THE NINETEENTH CENTURY

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INTRODUCTION

In many respects Georgia's usury laws raise more questions than they answer. Many provisions are poorly drafted creating ambiguity and uncertainty. One commentator has identified the problem with Georgia's usury laws, noting that "[a]fter more than two hundred years of legislative changes, the present Georgia [usury] statute can at best be described as an assortment of sometimes archaic provisions and at worst as an exhibition of poor draftsmanship. There is no apparent design to [Title 7], and many sections are needlessly confusing."[1]

Unfortunately, such poor draftsmanship has affected a number of modern and sophisticated financing techniques—techniques not yet conceived at the time most usury statutes were adopted. These techniques, many of which needlessly fall within the purview of Georgia's usury laws, include issuing to the lender of warrants to purchase stock of the borrower or other "equity

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1. Note, *Developments in Georgia Law Debtor-Creditor Rights*, 12 GA. L. REV. 814, 921 (1978).

kickers," issuing "payment in kind" notes or other "deferred interest" notes, issuing capital appreciation bonds, and capitalizing interest in connection with the restructuring or consolidation of corporate debt.

The concept of regulating the interest charged on loans can be traced back to Biblical times.[2] Many of today's usury laws were, in large part, enacted at a time when a "Dickensian" view of lenders prevailed—a time when lenders were viewed as evil money changers exacting unconscionably high interest from unwary and unsophisticated Bob Cratchetts.

During that time, such a view may well have been justified. Today's financial climate, on the other hand, is markedly different. Today is the world of the lender liability suit and the offensive bankruptcy filing. To a certain extent, the tables have indeed been turned. In fact, in the world of corporate finance,[3] it is often the borrower that has the greater leverage. On more than one occasion in the authors' practice, the borrower has drafted the loan documents and directed the lender to "take it or leave it."

Yet Georgia's usury laws do not reflect this reordered state. Certain of Georgia's usury laws continue to frustrate and hinder sophisticated borrowers in their attempts to arrange financing that fits their needs. Lenders, wary of the potential invalidity of their loan documents and the possibility of criminal penalties, often shy away from unusual financing structures and, therefore, fail to provide the flexibility their borrowers sometimes need.

Lenders and borrowers do not have a monopoly on the frustration brought about by Georgia's usury laws. Lawyers

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2. *See generally* RANSOM H. TYLER, A TREATISE ON THE LAW OF USURY, PAWNS AND PLEDGES, AND MARITIME LOANS 35-64 (1873); J. L. Bernstein, *Background of a Gray Area in Law: The Checkered Career of Usury*, 51 A.B.A. J. 846 (1965); Jarret C. Oeltjen, *Usury: Utilitarian or Useless?* 3 FLA. ST. U. L. REV. 169, 171-80 (1975).

3. For usury purposes, the Georgia General Assembly bifurcates financing transactions into two sets—those involving consumers and the financing of consumer goods and services, and those involving sophisticated business people and the financing of any variety of business operations and transactions, the latter of which are called "corporate finance." The Georgia General Assembly has chosen loan transactions in excess of $250,000 as the line of demarcation. The authors have no quarrel with the distinction or the chosen benchmark amount. Interest disclosure and limit laws are now fundamental tenets in the whole array of consumer protection laws generally. The problem lies in that the Georgia General Assembly has not gone far enough. As this Article demonstrates, certain Georgia usury statutes remain that implicate transactions in excess of $250,000; the problems start there.

requested to give opinions to borrowers regarding the legality and enforceability of certain financing structures share in the frustration. Given the uncertainties of the usury laws, lawyers often will not render the requested opinion, or they will only render the opinion with an array of exceptions and qualifications, occasionally "killing" the deal. It is not uncommon to find lawyers who regularly represent banks and commercial lenders shaking their heads in total befuddlement over Georgia's usury laws. Perhaps less dramatic, but no less troubling, is the extensive lawyer-time necessary to research the legality of various loan provisions when rendering legal opinions regarding usury. Georgia's complicated usury laws increase transactional costs—something good for lawyers, at least in the short run, but hardly satisfying for their clients.

This Article focuses on Code section 7-4-17, Georgia's "interest on interest"[4] statute. By its terms, section 7-4-17 prohibits the "charging [of] interest on unpaid interest."[5] There is, however, cause for concern among many practitioners that section 7-4-17 prohibits the charging of interest on interest or compound interest. Whether one reads the statute broadly or by its literal terms, section 7-4-17 clearly poses a number of problems to the world of corporate finance.

Initially, this Article highlights some of the general difficulties with Georgia's usury laws. Second, it demonstrates several statutory loopholes and inconsistencies pervading section 7-4-17 and other usury related statutes. Next, it points out how the Georgia courts have invoked a rather obscure concept to skirt the proscription against charging interest on interest contained in

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4. Some commentators have noted a distinction between "compound interest" and "interest on interest" even though the mathematical computations of the two may be the same. *See* Melvyn Mitzner, *Legislation Proposed to Clarify Law Relating to Interest on Interest Loans*, N.Y. L.J., Nov. 20, 1985, at 41, col. 1. For purposes of this Article, "compound interest" results when the accrued interest on the outstanding principal balance of a loan is added to the principal balance at stated intervals, the aggregate balance of which then itself accrues interest. "Interest on interest" refers to an occurrence when the interest that accrues on the outstanding principal balance of a loan becomes due and is unpaid. Such past due interest then accrues interest. The distinction, subtle as it may be, is highlighted because of its relevance to Georgia law regarding § 7-4-15, the statute on liquidated demands, and § 7-4-17, the statute prohibiting the charging of interest on past due interest. Furthermore, it is worthwhile to point out that the prohibition against charging interest on interest is technically not usury. It is, however, grounded in the same public policy. *See, e.g.*, Madison Personal Loan, Inc. v. Parker, 124 F.2d 143 (2d Cir. 1941).

5. O.C.G.A. § 7-4-17 (1989).

section 7-4-17. The Article then explores the curious real estate exception to the prohibition in section 7-4-17 against the charging of interest on interest. In addition, the Article explains how this real estate exception flies in the face of the stated policy against permitting interest on interest. The Article then applies section 7-4-17 to certain modern financing techniques employed by sophisticated borrowers.

In conclusion, this Article proposes that the Georgia General Assembly repeal section 7-4-17 and adopt legislation similar to that recently enacted in New York, which authorizes the charging of interest on interest in transactions of $250,000 or more. If nothing else, a discussion of section 7-4-17 will make practitioners more aware of Georgia's usury statutes and the potential pitfalls arising therefrom.

I. GENERAL PROBLEMS WITH THE USURY LAWS OF GEORGIA

Although this Article focuses on a specific section of the Georgia usury statutes, section 7-4-17, it is worthwhile to point out other problems relating to Georgia's usury provisions. These problems include, but are not limited to, the following: (i) how the terms "interest" and "principal" are defined in the usury statutes and under existing case law, and how those definitions differ depending upon which usury statute one is examining; (ii) the applicability of Georgia's criminal usury provisions to transactions in excess of $250,000; (iii) whether a usury claim requires the borrower to make a showing of specific intent on the part of the lender; and (iv) whether a statute of limitations on a usury claim exists.[6]

A. Defining Principal and Interest Under Georgia Usury Laws

Perhaps one of the most difficult issues practitioners face is determining what constitutes "interest" under the usury statutes.

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6. O.C.G.A. § 7-4-10(d) (1989) sets forth the statute of limitations for usury claims: "No plea or action for the recovery of such forfeiture shall be barred by lapse of time shorter than one year." *Id.* Exemplary of much of the draftsmanship during the midnineteenth century, the statute does not expressly prohibit usury claims arising after the expiration of one year following the payment of the alleged usurious interest. It only prohibits the barring of a claim arising less than one year after such payment—suppose three years had gone by. In any event, the statute does not bar the raising of the usury defense in connection with a suit brought against a debtor. *See* Doyle v. Southern Guar. Corp., 795 F.2d 907 (11th Cir. 1986).

Interest, under the Georgia usury laws, includes more than merely a per annum percentage charged against the principal balance of a loan. Interest is defined in section 7-4-2(a)(3) as "*a charge for the use of money* computed over the term of the contract at the rate stated in the contract or precomputed at a stated rate on the scheduled principal balance or *computed in any other way or any other form.*"[7] The emphasized language has

7. O.C.G.A. § 7-4-2 (1989) (emphasis added). Section 7-4-2 reads as follows:
(a)(1)(A) The legal rate of interest shall be 7 percent per annum simple interest where the rate percent is not established by written contract. Notwithstanding the provisions of other laws to the contrary, except Code Section 7-4-18, the parties may establish by written contract any rate of interest, expressed in simple interest terms as of the date of the evidence of the indebtedness, and charges and any manner of repayment, prepayment, or, subject to the provisions of paragraph (1) of subsection (b) of this Code section, acceleration, where the principal amount involved is more than $3,000.00 but less than $250,000.00 or where the lender or creditor has committed to lend, advance, or forbear with respect to any loan, advance, or forbearance to enforce the collection of more than $3,000.00 but less than $250,000.00.

(B) Where the principal amount is $250,000.00 or more, or the lender or creditor has committed to lend, advance, or forbear with respect to any loan, advance, or forbearance to enforce the collection of $250,000.00 or more, the parties may establish by written contract any rate of interest, expressed in simple interest terms or otherwise, and charges to be paid by the borrower or debtor.

(C) Nothing contained in this subsection shall be construed to prohibit the computation and collection of interest at a variable rate or on a negative amortization basis or on an equity participation basis or on an appreciation basis.

(a)(2) Where the principal amount involved is $3,000.00 or less, such rate shall not exceed 16 percent per annum simple interest on any loan, advance, or forbearance to enforce the collection of any sum of money unless the loan, advance, or forbearance to enforce the collection of any sum of money is made pursuant to another law.

(a)(3) As used in this Code section, the term "interest" means a charge for the use of money computed over the term of the contract at the rate stated in the contract or precomputed at a stated rate on the scheduled principal balance or computed in any other way or any other form. Principal includes such charges to which the parties may agree under paragraph (1) of this subsection. Amounts paid or contracted to be paid as either an origination fee or discount points, or both, on any loan secured by an interest in real estate shall not be considered interest and shall not be taken into consideration in the calculation of interest and shall not be subject to rebate as provided in paragraph (1) of subsection (b) of this Code section.

(b)(1) Upon acceleration of the maturity of any loan, advance of money, or forbearance to enforce the collection of any sum of money upon which interest has been precomputed, unearned interest shall be rebated to the debtor in such amount as would result in the rate of interest earned

caused problems for many lenders trying to discern what constitutes interest within the meaning of the Georgia usury statutes. The courts have interpreted this definition quite broadly, so that charges other than traditional interest may constitute interest.[8]

In April 1983, the Department of Banking and Finance issued an interpretation which, in part, discusses whether particular fees and charges constitute interest within the Georgia usury laws.[9] While the interpretation provides some guidance on what specific fees and charges constitute interest, reliance on the Department's interpretation involves some risk that a court may not find the Department's interpretations persuasive.

The statutory definition of "principal" provides a possible loophole regarding the issue of what constitutes interest.

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being no greater than the rate of interest established by the original contract. In the case of a loan in which the principal and the interest for the entire term of the loan are included in the face amount of the loan and the loan is to be paid back in weekly, monthly, quarterly, semiannual, or yearly installments, with the interest and principal portions of each installment determined under the pro rata method, any such rebate shall be determined on the pro rata method.

(b)(2) Unless stipulated in the contract, there shall be no prepayment penalty.

(c) Nothing contained in this Code section shall be construed to amend or modify the provisions of the "Georgia Industrial Loan Act," the "Retail Installment and Home Solicitation Sales Act," "The Credit Card and Credit Card Bank Act," the "Insurance Premium Finance Company Act," Part 5 of Article 3 of Chapter 12 of Title 44, relating to pawnbrokers, and, except as provided in Code Section 7-4-3, the "Motor Vehicle Sales Finance Act."

Id.

8. *See* Moore v. Comfed Sav. Bank, 908 F.2d 834 (11th Cir. 1990) (discount points constitute interest within the meaning of § 7-4-18); Norris v. Sigler Daisy Corp., 394 S.E.2d 353 (Ga. 1990) (origination fee constitutes interest within the meaning of § 7-4-18); Bank of Lumpkin v. Farmers State Bank, 132 S.E. 221 (Ga. 1926) (compensating balance requirement renders loan usurious); Williams v. First Bank & Trust Co., 269 S.E.2d 923 (Ga. Ct. App. 1980) (service charge found to constitute interest); Knight v. First Fed. Sav. & Loan Ass'n, Savannah, 260 S.E.2d 511 (Ga. Ct. App. 1979) (mandatory escrow account may be considered interest). *But see* Camilla Cotton Oil Co. v. Spencer Kellogg & Sons, 257 F.2d 162 (5th Cir. 1958) (late fees or delinquency charges not interest); Reid v. National Bank of Ga., 256 S.E.2d 82 (Ga. Ct. App. 1979) (compensating balance not interest); Gentry v. Consolidated Credit Corp., 184 S.E.2d 692 (Ga. Ct. App. 1971) (insurance and loan fee are not interest); Sledd v. Pilot Life Ins., 183 S.E. 199 (Ga. Ct. App. 1935) (requirement that borrower obtain insurance does not constitute a "charge" for use of money lent).

9. Georgia Dep't of Banking and Fin., Interpretations of H.B. 128—Interest (Apr. 1983) (unpublished manuscript). *But see Moore*, 908 F.2d at 842 (Eleventh Circuit opts for a contrary position to that held by the Department of Banking and Finance).

"Principal," as defined in section 7-4-2(a)(3), "includes such charges to which the parties may agree under paragraph (1) of this subsection."[10] This definition invites the parties to agree that all charges and fees associated with a loan transaction are principal. However, the ease with which parties could waive the usury laws by contractual agreement suggests that a court may not readily accept such an argument.[11]

The Georgia Supreme Court recently found in *Norris v. Sigler Daisy Corp.*[12] that the definition of interest for purposes of section 7-4-2 is different from the definition of interest under section 7-4-18, the criminal usury statute, thus adding to the uncertainty surrounding what constitutes interest. According to the court in *Norris*, the definition of interest contained in section 7-4-2(a)(3) applies only to section 7-4-2(a). Moreover, the court found that the definition of interest for purposes of section 7-4-18 was broader than the definition found in section 7-4-2(a)(3): "O.C.G.A. § 7-4-18(a) prohibits 'any rate of interest greater than 5 percent per month, either directly or indirectly, by way of commission for advances, discount, exchange, or the purchase of salary or wages; by notarial or other fees; or by any contract, contrivance, or device whatsoever.' "[13] At least one conclusion can be drawn from the *Norris* decision: Loans (other than loans not evidenced by a writing) in excess of $3,000 that are challenged as usurious would be interpreted based on the broad definition of interest contained in section 7-4-18. The definition of interest contained in section 7-4-18 would be invoked because section 7-4-2(a) provides that "the parties may establish by written contract any rate of interest"[14] for loans greater than $3,000. Accordingly, section 7-4-18 remains, for usury purposes, as the only substantive limit on the amount of interest allowed to be charged for loans greater than $3,000.

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10. O.C.G.A. § 7-4-2(a)(3) (1989).

11. Practitioners in Georgia often employ an "Agreement Regarding Interest and Charges." In this agreement, the borrower stipulates that various charges to be paid by the borrower to the lender in connection with the loan, such as origination fees, discount points, and the like, do not constitute interest. In any event, the enforceability of the "Agreement Regarding Interest and Charges" has not been tested, and some practitioners question its enforceability.

12. 392 S.E.2d 242 (Ga. 1990).

13. *Id.* at 243.

14. O.C.G.A. § 7-4-2(a) (1989).

Sophisticated lenders are, for these and other reasons, very concerned about the problem of defining interest. In many loan transactions, for instance, the lender receives an equity stake (often in the form of a warrant or option to buy stock) in the enterprise to which it is lending money. There is a strong argument that such equity stakes will be considered interest in light of the broad definition of interest in *Norris*. Adding to the confusion, there is the problem of determining how to make the required disclosure under section 7-4-2.[15]

A greater problem, however, is presented by the criminal usury statute, section 7-4-18, which prohibits the charging or collecting of interest in excess of five percent per month.[16] If the borrower provides the lender with warrants or other "equity kickers," such as preferred stock, phantom stock, or stock appreciation rights that appreciate in value over time, there is a possibility that the value of the warrants or other equity kickers could exceed the five percent limit of section 7-4-18.

In another example, many loan agreements provide for a prepayment fee if the loan is repaid before its stated maturity. This fee is imposed by the lender to recoup the interest income that would have been received if the loan had remained

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15. O.C.G.A. § 7-4-2(a)(1)(A) (1989) requires disclosure "in simple interest terms" for loans more than $3,000 but less than $250,000. Subsection (a)(1)(B) requires disclosure "in simple interest terms or otherwise" for loans of $250,000 or more. *Id.* Must one therefore predict the value of the warrant and approximate a projected yield under § 7-4-2(a)(1)(A) and (B)?

16. O.C.G.A. § 7-4-18 (1989). Section 7-4-18 provides:

> Criminal penalty for excessive interest.
>
> (a) Any person, company, or corporation who shall reserve, charge, or take for any loan or advance of money, or forbearance to enforce the collection of any sum of money, any rate of interest greater than 5 percent per month, either directly or indirectly, by way of commission for advances, discount, exchange, or the purchase of salary or wages; by notarial or other fees; or by any contract, contrivance, or device whatsoever shall be guilty of a misdemeanor; provided, however, that regularly licensed pawnbrokers, where personal property is taken into their actual physical possession and stored by them, may charge, in addition to said rate of interest, not exceeding 25¢ at the time the property is first taken possession of by them for the storage of said property.
>
> (b) This Code section shall not be construed as repealing or impairing the usury laws now existing but shall be construed as being cumulative thereof.
>
> (c) Nothing contained in Code Section 7-4-2 or 7-4-3 shall be construed to amend or modify the provisions of this Code section.

Id.

outstanding to its original maturity date. Often, these fees are expressed as a percentage of the principal of the loan being prepaid. Thus, a one-year $1 million loan may provide for a five percent prepayment fee in the loan agreement. If the loan is prepaid one month after it is made, there is a real chance that the prepayment fee would be characterized as interest, as that term is broadly defined by section 7-4-18, resulting in interest charges in excess of five percent per month, thereby risking criminal sanctions.[17]

B. Applicability of the Criminal Usury Statute to Loans in Excess of $250,000

In 1988, the Georgia General Assembly amended section 7-4-2 by adding subsection (a)(1)(B). Section 7-4-2(a)(1)(B), which deals with the disclosure requirements for loans of $250,000 or more, was apparently added to soften the disclosure requirements for large loan transactions. Section 7-4-2(a)(1)(A), on the other hand, which deals with the disclosure of interest on loans of more than $3,000 but less than $250,000, is prefaced by the language "[n]otwithstanding the provisions of other laws to the contrary, *except Code Section 7-4-18.*"[18] This language explicitly makes subsection (a)(1)(A) subject to the criminal usury statute, section 7-4-18.

By contrast, section 7-4-2(a)(1)(B) does not contain a similar subordination clause regarding section 7-4-18. The negative implication is that loans in excess of $250,000 are not subject to section 7-4-18. Such an argument, however, is weakened by subsection (c) of section 7-4-18 which provides that "[n]othing contained in Code Section 7-4-2 or 7-4-3 shall be construed to amend or modify the provisions of this Code section."[19] Thus, subsection (c) seems to indicate that each subsection of section 7-4-2 is subordinate to section 7-4-18. The interplay between these sections is but another example of the inconsistencies and poor draftsmanship exhibited throughout Georgia's usury statutes.

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17. *Cf. In re* Dent, 130 B.R. 623 (Bankr. S.D. Ga. 1991); *In re* Evans, 130 B.R. 357 (Bankr. S.D. Ga. 1991).

18. O.C.G.A. § 7-4-2(a)(1)(A) (1989) (emphasis added).

19. O.C.G.A. § 7-4-18(c) (1989).

C. *The Intent Requirement*

It appears well settled that there are four elements to a usurious transaction under Georgia law:

> 1. The existence of a loan or forbearance of money either express or implied;
> 2. An understanding that the principal of the loan or forbearance shall or may be returned;
> 3. Such loan or forbearance provides for a greater profit than is authorized by law; and
> 4. That the transaction was entered into with the intent to violate the law.[20]

The cases suggest that items three and four are mutually exclusive, thereby giving credence to the argument that the required intent may have to be more than merely the intent to charge interest in excess of legal limits. Furthermore, some cases suggest that a malevolent intent to circumvent legal limits is necessary to establish a usury claim: "It is clear that under the law of Georgia for usury to exist there must be an intent to circumvent the usury laws."[21]

The cases that articulate the four requirements are civil cases, which suggests that the necessity of proving a specific intent on the part of the lender to charge interest in excess of the legally established limits may not be confined to criminal cases. On the other hand, despite this case law, practitioners representing lenders should obviously be wary of the intent requirement.

II. THE PROBLEM OF INTEREST ON INTEREST

Georgia is in the minority of jurisdictions having a usury statute prohibiting the charging of interest on interest.[22] As previously mentioned, the curious language of section 7-4-17 does

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20. *See* Henson v. Columbus Bank and Trust Co., 770 F.2d 1566 (11th Cir. 1985); Duderwicz v. Sweetwater Sav. Ass'n, 595 F.2d 1008 (5th Cir. 1979); *In re* Curtis, 83 B.R. 853 (Bankr. S.D. Ga. 1988); Bank of Lumpkin v. Farmers State Bank, 132 S.E. 221 (Ga. 1926).

21. Camilla Cotton Oil Co. v. Spencer Kellogg & Sons, 257 F.2d 162, 165-66 (5th Cir. 1958). *See also* Eiberger v. West, 281 S.E.2d 148 (Ga. 1981) (lender unaware it was violating usury statute is a defense); Holt v. Rickett, 238 S.E.2d 706 (Ga. Ct. App. 1977).

22. *See* Martin E. Gold, *New York Approves Law Legalizing Compound Interest*, 62 N.Y. ST. B.J. 26, 28 (1990).

not, on its face, prohibit compound interest or the charging of interest on interest. Instead, section 7-4-17 prohibits the charging of interest on unpaid interest. Specifically, this section provides:

> When a payment is made upon any debt, it shall be applied first to the discharge of any interest due at the time, and the balance, if any, shall be applied to the reduction of the principal. If the payment does not extinguish the interest then due, no interest shall be calculated on such balance of interest and interest shall be calculated only on the principal amount up to the time of the next payment. Notwithstanding the foregoing restrictions against charging interest on unpaid interest, on loans having first priority on real estate and on loans secured by the pledge or assignment of instruments evidencing loans having first priority on real estate, the parties by written contract may lawfully agree that unpaid interest when due shall be added to the unpaid principal balance of the indebtedness and that the increased principal balance of the indebtedness bear interest pursuant to the terms of the contract.[23]

Arguably, section 7-4-17 is so poorly drafted that it fails to achieve its intended purpose.[24] A literal reading of the language of section 7-4-17 suggests that the statute is only triggered by an insufficient payment. That is to say, the prohibition against charging interest on interest is only triggered when a scheduled payment on a loan does not discharge the interest then due.

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23. O.C.G.A. § 7-4-17 (1989). What is remarkable about this section is that the statute remains virtually identical to its original enactment in 1863, except for the addition of the third sentence, the real estate exception, in 1982. In 1863, Georgia Code § 2028 provided:

> When a payment is made upon any debt it shall be applied first to the discharge of any interest due at the time, and the balance, if any, to the reduction of the principal. If the payment does not extinguish the interest then due, no interest shall be calculated on such balance of interest, but only on the principal amount up to the time of the next payment.

Id.

24. It is fundamental that statutes prohibiting the charging of interest on interest or compound interest are grounded in consumer protection, that is, to protect the unwary and ignorant consumer from the overreaching, oppression, and unfair surprise of unscrupulous lenders. "Interest on 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." Connecticut v. Jackson, 1 Johns. ch. 13, 17, 7 Am. Dec. 471 (N.Y. Sup. Ct. 1814). However, the various loopholes and limited applicability of § 7-4-17, on its face, demonstrate the failure of the statute to address its intended purpose.

Thus, if the borrower regularly pays the full amount of all scheduled payments of interest when due, including interest on accrued interest, the statute is not triggered because the payment extinguishes the interest then due. Under the same reasoning, a demand loan, single installment, or "bullet" loan providing that interest is compounded at stated intervals, but only due and payable on demand or on a specified maturity date, would not trigger the prohibition in section 7-4-17. Because interest on such a loan is due on the maturity date of the loan, or on demand, the parties are able to completely escape this section's proscription.[25]

It is not clear what the Georgia General Assembly intended when it adopted section 7-4-17. A substantial number of courts and practitioners, however, have always assumed that the statute was intended to prohibit the mere charging of interest on interest.[26] In fact, real estate mortgage lenders and brokers, who have often been at the forefront of developing innovative financing techniques, were so uncertain as to the meaning of section 7-4-17 that they pressed their lobby to obtain an exception to the statute. First-priority mortgage loans are now outside the operation of section 7-4-17.

III. RELATIONSHIP OF CODE SECTION 7-4-17 TO SECTIONS 7-4-9 AND 7-4-2

A. Code Section 7-4-9

Section 7-4-9, in the archaic style typical of Georgia's usury statutes, provides that "[i]nterest from date, if the debt is not punctually paid at maturity, may be recovered when so stipulated in the contract, provided interest has not already been included in the principal amount."[27] While it is not abundantly clear what the Georgia General Assembly intended when adopting section 7-4-9, the Georgia courts have read this provision to permit a lender to charge interest on defaulted

25. *See* Spillers v. First South Bank, 365 S.E.2d 151 (Ga. Ct. App. 1988).

26. *See In re* Terry, 780 F.2d 894 (11th Cir. 1985); Hilary P. Jordan, *Evidencing the Debt and Usury Law Issues, in* SECURED FINANCING: STRUCTURING, NEGOTIATING, AND DOCUMENTING SECURED LOAN TRANSACTIONS 08-i, 08-17, 08-23 to -24 (Institute of Continuing Legal Educ. in Ga. ed., 1988).

27. O.C.G.A. § 7-4-9 (1989).

interest payments.[28] One commentator, in a highly thoughtful and comprehensive work on the subject of Georgia's usury statutes, agrees that the charging of interest on past due interest may be permissible:

> If the loan is not secured by a first priority interest in real property, it is somewhat of an open question in Georgia as to whether or not interest may be charged on past-due interest. A literal reading of O.C.G.A. §7-4-17 would appear to prohibit all forms of interest-on-interest. On the other hand, an argument can be made that §7-4-17 was intended by the Georgia General Assembly to apply *only to pre-default* situations since its language contemplates an ongoing credit relationship between the borrower and the lender (*i.e.*, "interest shall be calculated only on the principal amount up to the next payment . . .").[29]

Whether the Georgia usury statutes draw a distinction between charging interest on interest in predefault and postdefault situations is an open question. It is clear, however, that sections 7-4-17 and 7-4-9 do not work well together.

B. Code Section 7-4-2

As indicated previously, section 7-4-2(a)(1)(B) provides that, with respect to loans in excess of $250,000, "the parties may establish by written contract any rate of interest, expressed in simple interest terms *or otherwise.*"[30] Because compound interest or interest on interest terms are the logical alternative to "simple interest terms," section 7-4-2(a)(1)(B) would appear to permit the charging of compound interest or interest on interest. This theory is further bolstered by section 7-4-2(a)(1)(C) which provides that "[n]othing contained in this subsection shall be construed to prohibit the computation and collection of interest . . . on a negative amortization basis."[31]

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28. *See, e.g.*, Hardy v. G.A.C. Fin. Corp., 205 S.E.2d 526 (Ga. Ct. App.), *aff'd* 208 S.E.2d 453 (Ga. 1974); Walton v. Johnson, 97 S.E.2d 310 (Ga. 1957).

29. Jordan, *supra* note 26, at 08-24 (emphasis added). Mr. Jordan practices at the law firm of Kilpatrick & Cody in Atlanta, Georgia, where he is a recognized expert in financing transactions.

30. O.C.G.A. § 7-4-2(a)(1)(B) (1989) (emphasis added).

31. *Id.* § 7-4-2(a)(1)(C) (1989). Negative amortization loans are loans for which the rate at which interest is contractually earned is greater than the rate at which interest must be paid by the borrower. The difference between the amount of interest

Negative amortization loans contain features that many usury laws were designed to prohibit.[32] The unwary borrower would find that, at the end of the term of the loan, after perhaps years of payments, the outstanding balance has actually increased. Further, when the borrower refinances this balance, interest on accrued interest will be the indirect result. Yet section 7-4-2(a)(1)(C) permits this unfortunate result for the borrower. Therefore, can it not also be read to permit the charging of interest on interest?

It is difficult to square section 7-4-17 with section 7-4-2. If the General Assembly intended sections 7-4-2(a)(1)(B) and (a)(1)(C) to permit the charging of compound interest or interest on interest, section 7-4-17 should be removed from the books. Perhaps, however, the General Assembly did not intend section 7-4-2(a) to be read as overriding section 7-4-17. As previously discussed, section 7-4-2(a)(1)(A), which deals with loans of more than $3,000 but less than $250,000, is prefaced by the language "[n]otwithstanding the provisions of other laws to the contrary, except Code Section 7-4-18."[33] By contrast, section 7-4-2(a)(1)(B) does not contain similar "notwithstanding" language. "[B]y not including the 'Notwithstanding' lead-in Section 7-4-2(a)(1)(B), it would appear that the Georgia General Assembly intended that any otherwise applicable usury limit remain in effect on transactions of $250,000 or more."[34]

In fact, reliance on the "or otherwise" language of section 7-4-2(a)(1)(B) or the language of subsection (a)(1)(C) to conclude that the charging of compound interest or interest on interest for loans in excess of $250,000 is permissible under Georgia law, may be a bit impetuous. Section 7-4-2(a)(1) may be more properly characterized as a disclosure statute rather than a substantive limit on the amount of interest that may be charged. First, section 7-4-2(a)(1)(A) incorporates section 7-4-18, the substantive usury limit. Second, section 7-4-2(a), as originally adopted, applied to all loans, not just loans of more than $3,000 and less

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that is accruing on the loan and the amount of interest that is actually paid is added to the final principal payment on the loan. Thus, the outstanding balance of the loan increases throughout the term of the loan.

32. *See Negative Amortization Mortgages; A Disaster If Rates Stay High*, AM. BANKER, March 17, 1982, at 4.

33. O.C.G.A. § 7-4-2(a)(1)(A) (1989).

34. Jordan, *supra* note 26, at 08-40.

than $250,000, and required that the interest rate "be expressed in simple interest terms."[35] Unfortunately, in sophisticated transactions, interest rates are often not easily expressed in such terms. Loans in such sophisticated transactions bear interest at rates based upon various domestic and overseas deposit rates known as "CD" or "LIBOR" rates or complicated government securities rates. Arguably, the Georgia General Assembly responded to the concerns of lawyers that such sophisticated interest rates could not be expressed "in simple interest terms" by adopting section 7-4-2(a)(1)(B) as an exception to the simple interest terms disclosure requirement. Now, interest on loans of $250,000 or more may be expressed "in simple interest terms or otherwise."[36] A court may simply interpret section 7-4-2 as not overriding the prohibition against charging compound interest found in section 7-4-17, but merely as accommodating lenders in sophisticated transactions by not requiring them to calculate to a per annum percentage basis the complex interest rate formulas often employed in such transactions.[37] As one can see, the relationship between sections 7-4-17 and 7-4-2 remains murky and confused.

IV. LIQUIDATED DEMANDS

In some cases, Georgia courts have invoked section 7-4-15—the provision regarding "liquidated demands"—to overcome the application of section 7-4-17. Section 7-4-15 provides:

> All liquidated demands, where by agreement or otherwise the sum to be paid is fixed or certain, bear interest from the time the party shall become liable and bound to pay them; if payable on demand, they shall bear interest from the time of the demand. In case of promissory notes payable on demand, the law presumes a demand instantly and gives interest from date.[38]

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35. 1983 Ga. Laws 1146.

36. O.C.G.A. § 7-4-2(a)(1)(B) (1989).

37. A very common formula for a loan based upon the interest rate offered by the lender for deposits with the lender is:

$$\frac{\text{[Base CD Rate]}}{\text{[100\% - CD Reserve Percentage]}}$$

plus the Assessment plus CD Margin.

38. O.C.G.A. § 7-4-15 (1989).

A liquidated demand is one which is an amount fixed and certain—a sum which cannot be changed by proof.[39] " 'Liquidated' is that which is made clear, certain, manifest . . . . A debt is liquidated when it is certain what is due and how much is due . . . ."[40] Thus, section 7-4-15 appears to permit the execution of any type of debt instrument, even one evidencing accrued but unpaid interest which then bears interest, as long as the instrument clearly sets forth the amount of the accrued but unpaid interest that now constitutes the principal of the liquidated demand.

In *Byrd v. Equitable Life Assurance Society*,[41] the plaintiff claimed that a contract allowing interest on interest was usurious where the interest on the debt was evidenced by separate semi-annual "interest notes." These interest notes bore interest after maturity at a specified rate. Finding that the interest charged on the interest notes was not usurious, the court stated:

> The charging of interest on these interest notes when they were past due is said to constitute usury, because interest cannot be legally exacted on interest. There is no merit in this contention. Liquidated demands bear interest. When an obligation to pay interest is put in the form of an interest note, that note becomes a liquidated demand; and when it is not paid at maturity it bears interest as such, certainly if the parties have contracted that it should. This has been settled law in Georgia since an early date.[42]

The case law addressing the issue of liquidated demands permits the charging of interest on interest if a separate instrument or promissory note in the principal amount of the accrued interest is executed by the borrower.[43] This new note may then bear interest at an interest rate specified therein, effectively circumventing the proscription in section 7-4-17.

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39. *See* Nisbet v. Lawson, 1 Ga. 275 (1846).

40. Roberts v. Prior, 20 Ga. 561, 562 (1856).

41. 196 S.E. 63 (Ga. 1938).

42. *Id.* at 71 (citing O.C.G.A. § 7-4-15 (1989)) (citation omitted).

43. *See* Hardy v. G.A.C. Fin. Corp., 205 S.E.2d 526 (Ga. Ct. App.), *aff'd*, 208 S.E.2d 453 (Ga. 1974); Byrd v. Equitable Life Assurance Soc'y, 196 S.E. 63 (Ga. 1938); Union Sav. Bank and Trust Co. v. Dottenheim, 34 S.E. 217 (Ga. 1899); Butler v. First Nat'l Bank, Tenn., 785 S.E. 772 (Ga. Ct. App. 1913).

Similarly, the Attorney General of Georgia has rendered an unofficial opinion[44] to the effect that it is not unlawful to accrue interest on unpaid interest for a commercial account provided the unpaid interest is structured as a liquidated demand. The focus of the Attorney General's opinion, and the critical factor which settles whether the deferred interest notes violate the provisions of section 7-4-17, is the existence of a separate document or liquidated demand.

Obviously, a process which requires the borrower to continuously execute new notes is cumbersome. Furthermore, the use of a liquidated demand is an unfamiliar concept to most lenders and borrowers and their counsel. Such unfamiliarity leads, quite understandably, to skepticism regarding their validity. While the execution of an additional note may serve notice to the borrower that interest is now accruing on interest, it can be argued that sophisticated borrowers in the marketplace do not need such notice. Accordingly, while the use of the liquidated demand may constitute one clear method to circumvent the arguable prohibition in section 7-4-17 against the charging of interest on interest, it is hardly a satisfying one.

V. THE REAL ESTATE EXCEPTION

Another curious problem with Code section 7-4-17 is the 1982 amendment contained in the last sentence of that section.[45] The real estate exception to section 7-4-17, which permits the parties to agree to charge interest on interest on loans secured by a first priority mortgage on real estate, is diametrically opposed to the original purpose of the statute. The intent of section 7-4-17 is clearly grounded in consumer protection. Section 7-4-17 protects the unwary consumer from the hidden dangers and dramatic effects of interest on interest or compound interest calculations. Yet one wonders why the General Assembly would enact an exception to the prohibition against charging interest on interest when the consumer's homestead, often the consumer's largest and most precious asset, is put at risk. Perhaps a powerful real estate lobby is a logical explanation.[46]

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44. Op. Ga. Att'y. Gen. 212, 212-14 (1983).

45. O.C.G.A. § 7-4-17 (1989).

46. It could be argued that permitting real estate lenders to charge interest on interest facilitates the purchase of new homes by first-time buyers. If the lender were allowed to charge interest on interest, the lender could structure the loan such that

VI. APPLICATION OF CODE SECTION 7-4-17

The confusing language of section 7-4-17 becomes more pernicious as one recognizes its potential application to a variety of sophisticated business transactions—an area traditionally not regulated by consumer protection laws. Despite the number of limitations, exceptions, and loopholes related to section 7-4-17, many lawyers conclude that this section prohibits the charging of interest on interest generally, including transactions in excess of $250,000. Because such a conclusion is entirely reasonable, it is important to describe those transactions that lawyers may conclude are illegal. The obstacles presented by application of section 7-4-17 can be illustrated by three financing techniques. These techniques differ considerably from the mere charging of interest on interest in the ordinary course of a loan. The usual commercial loan does not typically provide for predefault interest on interest. Thus, concerns arising from the application of section 7-4-17 do not often arise in this context. However, the following, more unusual loan structures may have section 7-4-17 implications: capitalizing interest in debt restructuring transactions, issuing payment-in-kind or deferred interest notes, and issuing capital appreciation bonds. The charging of postdefault interest on interest is also briefly discussed.

A. Capitalizing Interest

Capitalizing interest is a common debt restructuring device. In a typical situation, the borrower may default on the interest payments due under its loan because of poor cash flow or because a default occurs under the borrower's senior loan documents, thereby freezing payments to the borrower's subordinated lender. If the borrower is an otherwise strong company and is likely to be successful in the long run, the lender will often negotiate with the borrower to restructure its debt. Often the lender will

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all or a portion of the interest payments could be deferred to a later date when the buyer was in a better position to make interest payments. It seems that this is precisely the evil against which interest on interest statutes are intended to protect. With the exponential possibilities of interest on interest, the overextended home buyer could find himself unable to pay the accrued interest with the attendant risk of losing his home. In fact, New York's new statute discussed in this Article does not permit the compounding of interest on loans secured by a residence. *See infra* notes 48-50 and accompanying text.

condition the restructuring on the borrower's promise to pay the accrued but unpaid interest on the loan. To accommodate the borrower in this type of situation, lenders will frequently "roll up" or capitalize the principal and past due interest into a new loan. The principal amount of the new loan will be amortized over an agreed upon term and will bear interest at an agreed upon rate.

This restructuring technique is commonly used and, given the economic climate, its use is likely to increase. Arguably, such a technique implicates the prohibition in section 7-4-17 against the charging of interest on unpaid interest. Because of the uncertainties surrounding the legality of capitalizing interest, the lender may decide to pursue alternatives to this form of restructuring that are less attractive to the lender, the borrower, or both. On the other hand, the lender may simply give up its right to receive interest on accrued interest. More detrimentally, the lender, frustrated at being unable to recoup lost interest, may take more aggressive approaches with the borrower which may disadvantage all concerned.

B. Payment-In-Kind Notes

Deferred interest or payment-in-kind (PIK) notes are promissory notes issued by the borrower in lieu of cash payments of principal, interest, or both, that are due under the original note. PIK notes are likely to be issued by start-up companies, highly leveraged companies, or companies with tight, short-term cash flows. In these situations, the borrower may not have enough cash on hand to make interest payments. Rather, the borrower issues a note in a principal amount equal to the cash payment then due. Often, a loan agreement that contemplates the issuance of PIK notes will give the borrower the option to pay the interest when due in cash or to execute such a note in the amount equal to the past due principal or interest. Again, this type of financing arguably implicates section 7-4-17 because the issuance of such a note produces the net effect of providing the lender with interest on interest.

A deferred interest or PIK note, however, would likely constitute a liquidated demand under section 7-4-15 and, therefore, be entirely valid under Georgia case law.[47] But few

47. *See supra* notes 41-43 and accompanying text.

Georgia lawyers are aware of this somewhat obscure concept known as a liquidated demand. Rather, what they have been taught is that interest on interest may be usurious. Accordingly, many practitioners quite reasonably shy away from utilizing deferred interest or PIK notes—a financing tool that can be most useful.

C. *Deep Discount/Capital Appreciation Bonds*

Deep discount or capital appreciation bonds are a form of borrowing used in corporate finance. Such bonds are offered at a deep discount, that is, they are offered at a substantial discount from the face value of the instrument, and often bear high rates of interest. Investors buy these bonds because they receive interest based upon the face amount of the bond, not the amount of principal actually paid by the investor to purchase the bond. The economic effect of this financing technique is equivalent to interest on interest. On the other hand, borrowers issue such bonds because the initial cash principal and interest payments are relatively small. Once more, this type of financing arguably implicates section 7-4-17.

These various financing techniques are hardly the evil the Georgia General Assembly sought to prevent in 1863 when it adopted the predecessor to section 7-4-17. In fact, these techniques are often proposed by the borrower in troubled situations. Still, the prohibition in section 7-4-17 against charging interest on unpaid interest causes many nervous lenders to refrain from their use or, at a minimum, requires lender's counsel to expend an inordinate amount of time and energy to assess the legality of these techniques.

D. *Postdefault Interest on Interest*

Most loan agreements contain the following language in the postdefault interest clause: "If the Borrower shall fail to pay any principal, interest or other amount when due, such amount (*to the extent permitted by applicable law*) shall bear interest." The italicized phrase is a reflection of the drafter's uncertainty over whether interest may be charged on past due interest, even in a default situation. As indicated, Georgia law[48] and the equities of

48. *See supra* notes 28-29 and accompanying text.

the situation appear to permit the lender to charge interest on past due interest. On the other hand, the borrower most needs the protection of the usury laws when it is in default; yet Georgia laws allow the charging of interest on interest in this situation. Many lawyers, however, are justifiably uncertain as to this conclusion. Thus, much time and effort is spent when the lender calls and queries counsel in this regard.

VII. RECENT NEW YORK LEGISLATION

Given New York's status as the financial capital of the world, it is surprising that for many years New York had a prohibition against charging interest on interest. Realizing that the relationship of borrowers and lenders and their relative sophistication and bargaining power has changed,[49] the New York legislature recently adopted a statute explicitly permitting the charging of interest on interest.[50]

The new statute is intended to cover any agreement that provides for compound interest, including agreements such as mortgages, partnership agreements, leases, and the like. The statute permits the charging of interest on interest regardless of the distinctions between charging interest on past due interest or charging compound interest. In this statute, New York included

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49. *See* Gold, *supra* note 22.

50. N.Y. GEN. OBLIG. LAW. § 5-527 (McKinney Supp. 1991):

> Enforceability of compound interest.
>
> 1. A loan or other agreement providing for compound interest shall be enforceable. For purposes of this subdivision, the term "compound interest" shall mean the accruing of interest upon unpaid interest irrespective of whether such unpaid interest is added to the principal debt.
>
> 2. The provisions of this section shall not be applicable to any loan or other financing agreement where the original principal debt is in an amount of two hundred fifty thousand dollars or less, or to any loan or other financing agreement secured primarily by a one or two family owner-occupied residence. For purposes of this subdivision the term "residence" shall include a lessee's interest in a proprietary lease granted by a cooperative housing corporation.
>
> 3. Notwithstanding the provisions of subdivision two of this section, nothing in this section shall affect the maximum rate of interest which may be charged, taken or received as provided by law, or be construed to limit, impair or otherwise affect any loan or other agreement which is, or would be, enforceable without reference to this section, including but not limited to an agreement made pursuant to section six-f of the banking law.

Id.

consumer protection exceptions for loans of $250,000 or less and loans relating to residential real estate.[51] Finally, the New York statute makes it clear that the legalization of compound interest computations does not affect the maximum rate of interest that may be charged under existing law. Georgia should follow New York's lead and clarify the law in this area.

VIII. A CALL FOR LEGISLATIVE CHANGE

It has been shown that section 7-4-17 is poorly drafted, contains many loopholes, and is inconsistent with other provisions of Georgia's usury statutes. This has caused confusion and unnecessary concern, not to mention increased transactional expense among borrowers, lenders, and their counsel. It has often served to frustrate attempts to design creative relationships between borrowers and lenders. In addition, the prohibition in section 7-4-17 against charging interest on interest simply does not comport with the financing techniques used by sophisticated borrowers. Accordingly, section 7-4-17 should be repealed. Furthermore, because the Georgia General Assembly does not maintain any legislative history, Georgia should adopt a statute similar to the statute recently passed in New York to avoid any additional confusion regarding the purpose behind removing section 7-4-17. The current state of affairs with respect to the maze of Georgia's usury statutes requires no less than an affirmative declaration by the Georgia General Assembly on this point.

51. As noted earlier, Georgia takes a diametrically opposed position with regard to loans secured by real estate. In Georgia, the only express exception to the prohibition against charging interest on unpaid interest is an exception for a loan secured by a first priority mortgage on real estate.