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ENFORCEABILITY OF INTEREST ON INTEREST IN COLORADO

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This article is intended to be an examination of all the law in Colorado relevant to the question, "Is a prior agreement to compound interest, if such interest is not paid on accrual, enforceable in Colorado?"

The validity of such an agreement under usury laws is not considered except to distinguish the problem here involved from the problem in the usury cases. Neither does this article deal with the validity of increasing the rate of interest on default of either interest or principal.

Promissory notes which include a provision for compounding interest are in common usage in the state of Colorado. Examples of such provisions are the following:

> If principal and interest are not paid when due, to bear interest at the rate of .... per cent per annum payable annually.
>
> Upon failure to pay any installment of principal or interest when due, the entire balance owing hereon . . . shall draw interest . . .
>
> Makers and endorses agree that if this note is not paid promptly at maturity, that unpaid principal and defaulting interest shall bear interest . . .[1]

Apparently from the common usage these provisions enjoy, the public is of the opinion that such provisions are binding. The law, however, is not as certain as this opinion would indicate.

STARE DECISIS

The first indication that the Colorado court would not allow contracting in advance to pay interest on interest appeared in an 1881 case involving the plaintiff's right to interest on rents wrongfully withheld. The court analogized between rents and interest in this language:

> The earlier authorities were emphatic in their refusal of interest in such (rent) cases. The doctrine was 'interest is a compensation for the use of moneys; rents a compensation for the use of lands; compound interest (though agreed to by the parties) will never be allowed; so neither will interest be allowed on rent in arrears.' [2]

The reference to compound interest was actually dictum and no Colorado authority was cited. The dictum was cited a year later

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[1] Taken from form notes currently in use in Denver, Colo.

[2] Filmore v. Reithman, 6 Colo. 120 (1881).

when the court reversed a decree of the lower court on grounds that the amount of interest was reached by compounding interest under the legal interest statute. The court held such action was not warranted under the statute. The words "moneys after they come due," appearing in the statute, were interpreted to not include interest due.[3]

Shortly thereafter came the leading case of *Hochmark v. Richler*[4] which left no doubt concerning the state of the law. In this case a loan of $150 was obtained and the note was given a face value of $177 which included $27 interest. The note was to draw interest at 3% per annum on the face value if not paid at maturity. The court refused to enforce the 3% interest on the $27 stating this was compound interest and not enforceable in this state.[5]

The law set out in the *Hochmark* case has never been expressly overruled and has been recognized in a number of subsequent cases.[6] The effect on the validity of the contract, as a whole, is made clear by the *Hochmark* case and is to be differentiated from the effect of usury. The rule of the case is based on a public policy against interest on interest and not on interest which aggregates more than the legal rate. The ruling is not as drastic as in usury cases and results only in non-enforcement of the amount of interterest which is attributable to interest on interest. The court states:

> The fact that compound interest was thus provided for did not, however, as counsel contends, render the entire contract usurious and void. Courts upon grounds of public policy, simply decline to enforce payment of the interest upon interest.[7]

It should also be noted that the case goes further than holding compound interest, strictly speaking, is not recoverable, and concludes that any interest on interest is not recoverable. The distinction betwen compound interest and interest on interest is made clear in the following language:

> There are two distinct methods of computing what is loosely termed compound interest. By the first method periodical rests are made and at each rest the principal and the accrued interest thereon are combined into a new principal which bears interest until the next rest and so on; this method results in giving interest not only on the principal and on the interest on the principal, but

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[3] Denver Brick and Mfg. Co. v. McAllister, 6 Colo. 261 (1882).

[4] 16 Colo. 263, 26 P. 818 (1891).

[5] See also Beckwith v. Beckwith, 11 Colo. 568, 19 P. 510 (1888), to the same effect as the principal case.

[6] Lake County v. Linn, 29 Colo. 446, 88 P. 839 (1902); Wigton v. Elliott, 49 Colo. 115, 111 P. 713 (1910).

[7] Note 4, *supra*.

> also in giving interest on the interest on the interest and so on *ad infinitum* until payment, and this is what is meant by compound interest when the term is used in its strict sense. By the other method the accrued interest is not combined with the principal but each installment of interest on the principal becomes itself a new principal which bears simple interest, but no interest is allowed on the interest on interest, and, although this method is also sometimes called compound interest it has been more correctly described as a middle course between simple and compound interest, and has been distinguished from compound interest.[8]

Although the term "compound interest" is used in the *Hochmark* case, it is clear from the facts that the court was dealing only with interest on interest, or as it is sometimes called "annual interest." [9] Thus, if no annual interest is allowed, *a fortiori*, no compound interest is allowed.

EXCEPTIONS TO THE HOCHMARK RULE

The *Hochmark* case indirectly mentions this exception to the general rule, "There was in the present case no such gross delinquency or intentional misconduct on the part of appellant as justified an exception to the foregoing rule." [10]

In addition to this exception, the Colorado court has added these exceptions in following decisions:

1. Coupons representing interest on a municipal bond are subject to interest on the coupons themselves.[11]
2. Coupons representing interest on a promissory note are subject to interest on the coupons themselves. (Distinguished from exception number 1 in that this is a private obligation.)[12]
3. An agreement executed after interest accrues to subject such accrued interest to a charge of interest on itself, is valid.[13]
4. An agreement made and payable in another state where interest on interest is allowed will be enforced in Colorado even though such agreement would have been invalid if made in Colorado.[14]

THEORY BEHIND THE LAW

The reason for the *Hochmark* decision was clearly public policy, but the basis behind the public policy is not so easily ascertained. Reliance is placed on *Parsons on Contracts*.[15] Parsons states:

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[8] C.J.S. (Interest) Sec. 1, p. 10.
[9] 37 A.L.R. 332.
[10] See also Filmore v. Reithman, *supra*, note 2.
[11] Lake County v. Linn, *supra*, note 5.
[12] Parker v. McGinty, 77 Colo. 458, 239 P. 10 (1925).
[13] Wigton v. Elliott, *supra*, note 5.
[14] Baxter v. Beckwith, 25 Colo. App. 322, 137 P. 901 (1914).
[15] Although the court cites volume two of this work it is believed the proper citation is Vol. 3, 6th edition (1873), Sec. 150 *et seq.*

> Upon the whole, although it seems to be well settled that compound interest cannot be recovered, as such, even if it be expressly promised, we are inclined to think, that the only rule of law against the allowance of compound interest is this: that the courts will not lend their aid to enforce its payment, unless upon a promise of the debtor made after the interest, upon which interest is demanded, has accrued; and this rule is adopted, not because such contracts are usurious, or savor of usury, unless very remotely; but upon grounds of public policy, in order to avoid harsh and oppressive accumulations of interest. And for the reason that this aversion of our law to allow money to beget money has of late years very much diminished, we do not think it absolutely certain, that a bargain in advance for the payment of compound interest, in all its facts reasonable and free from suspicion of oppression, would not be enforced at this day in some of our courts. It has, indeed, been held that an agreement to pay interest on accrued interest, is not invalid.

Thus we perceive the basic theory to be, "Prior agreements to compound interest on default are harsh and oppressive." It appears that agreements made after the accrual of interest are equally harsh and oppressive since the result achieved is the same. One difference is, however, readily ascertainable. The debtor has a choice at the end of each period when there is no prior agreement. Of course, it is not a choice without some amount of coercion in the form of a debt due and owing with possible judgment and execution on failure to agree to compounding the interest. It is also ironic to note that if a judgment were obtained, the judgment would undoubtedly include the amount of the interest, and the court would allow the legal rate of interest on the full amount of the judgment, until satisfied. Thus the debtor finds himself paying interest on interest regardless of the alternative he chooses.

The theory in favor of allowance of interest on interest is well expressed in *Hale v. Hale*:[16]

> If it be assumed that it was stipulated in the original contract that the interest should be paid, we hold that there is nothing illegal or immoral or contrary to policy in such an agreement. The interest is both legally and equitably due at the expiration of the period limited for its payment; and if, instead of paying the interest, it be converted into principal by the previous agreement of the parties, we think there can be no objection to enforcing such an agreement.

[16] Hale v. Hale, 1 Coldw. (Tenn.) 233, 78 Am. Dec. 490 (1860). A note on this case is found in 37 A.L.R. 328.

Thus we have the opposing theories. One on the premise, "Do not kick a man when he is down," and the other on the premise, "The creditor is being deprived of money he is legally entitled to have and therefore the creditor should receive the value of the use of this money."

THE LAW TODAY

As we have seen the Colorado court has come to the aid of the debtor in past years on grounds of public policy. (This is a rather unexpected result when you consider that the same public policy is not offended by a cognovit provision in a note.) Yet public policy is a changing standard and perhaps the modern trend in favor of interest on interest mentioned, but not followed, in *Parsons on Contracts* (1873) *supra,* and reiterated in *Hochmark v. Richler* (1891) *supra,* has been adopted in Colorado.

A statement made by Mr. Justice Burke in a 1942 case might be interpreted as adopting the trend. The statement was, "Compound interest is allowable only when definitely agreed upon." [17] Mr. Justice Burke cites *Denver Brick & Mfg. Co. v. McAllister, supra,* as authority for his position. As mentioned earlier in this article, it is authority only for the proposition that the legal interest statute does not provide for compounding the interest provided in that statute. In fact, *Denver Brick & Mfg. Co.* expressly follows *Filmore v. Reithman, supra,* which was the first case stating the general rule against interest on interest.

The statement made by Mr. Justice Burke was not necessary to the decision and therefore must be weighed as dictum in considering its effect on prior decisions. Also it must be held that the words "compound interest" as used by Justice Burke must mean the compounding of interest by agreement entered prior to the accrual. The Colorado court has, in effect, held that the words "compound interest" indicate a prior agreement. The Court expressly stated that an agreement after accrual of interest to add such accrued interest to the principal and charge interest on the whole is not compounding interest. Thus by inference there must be a prior agreement in order to constitute compound interest. Note this language:

> In brief, as applied to the facts of this case, the law is that after interest becomes due, it may, by agreement, be turned into principal and bear interest. Such an arrangement is not compounding interest.[18]

Apparently then, considering this language, Justice Burke's statement amounts to an assertion that an express agreement to compound interest on accrual is enforceable.

There has been no judicial interpretation of this language in Colorado and no express interpretation by any court. The Fed-

[17] Tarabino Real Estate Co. Inc. v. Tarabino, 109 Colo. 425, 126 P. 859 (1942).
[18] Wigton v. Elliott, 49 Colo. 115, 111 P. 713 (1910).

eral District Court for the District of Missouri did have occasion to construe Colorado law with respect to compound interest in 1944, two years after Justice Burke's dictum. That court followed the *Hochmark* case and refused to allow interest on interest.[19] The dictum was not mentioned and probably not considered.

Although the Missouri Federal Court's decision is in no way binding on the Colorado court it indicates that a Supreme Court decision will be necessary to detrmine the present state of the law in Colorado concerning compound interest. In the opinion of the writer, the time is ripe for an attack upon the doctrine establishing the non-enforceability of interest on interest. The court may well seize upon Justice Burke's dictum to establish a current public policy in favor of interest on interest.

AMENDMENT OF SUPREME COURT RULE

Effective April 15, 1954, the rule relating to the Supreme Court Library was amended to read as follows:

> Rule 262. Supreme Court Library. No books may be removed or withdrawn from the library by any person, except members of the court for use in their chambers.

Members of the Bar are asked to search their office as well as their conscience, for the following volumes, missing from the library:

Vol. 4, Nebraska Revised Statutes, 1943.

Vols. 508, 598, 1282, 1448, 1531 and 1611 of the bound volumes of Abstracts and Briefs. These volumes cannot be replaced and the co-operation of the Bar is solicited in effecting their return to the library.

FLOYD F. MILES, Librarian.

CONFERENCE DATE SET

The Annual Judicial Conference of the Tenth Circuit will be held at the Stanley Hotel, in Estes Park, Colorado, Monday, Tuesday and Wednesday, July 12, 13 and 14, 1954. Reservations can be made by writing Mr. George Stobie, Manager of the Hotel. All members of the Bar are cordially invited to attend.

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[19] Lee v. Equitable Life Assurance Society of the U. S., 56 F. Supp. 362 (1944).