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REAL ESTATE UPDATE

Details of the Loan

Usury Avoidance Provisions: Do They Work?

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Surplussage does not vitiate is a maxim some attorneys may recall from law school days, perhaps particularly with reference to the habendum clause in the deed. The thought may indeed have wide application, but it does not help in identifying those provisions accurately denominated as "surplussage." It is likely, though , that the phrase will find application to the commonplace usury avoidance clause in mortgages.

The parties to the mortgage, (certainly the lender) seem to have an inordinate fear that the loan might some day be assailed as usurious. Because no legitimate transaction intends to run afoul of usury proscriptions, it seems a good idea to many to include a contractual clause in the mortgage pursuant to which the parties avow their intention to strictly conform to all laws so that no interest paid is to exceed usury limits and, if by some chance the parties err and excess interest is assessed, all sums so paid or to be paid automatically revert back to the legal limit.

Well, that appears prudent—belt and suspenders and all that; why, though, the special compunction to stave off that was never intended anyway? Apparently the dilemma arises from the troublesome fact that usury is a recondite and conspicuously elusive subject.[1] Even for the numerically challenged, though, the pure computational aspect is not the problem. Case law explains the formula with appropriate clarity.[2] A difficulty, or perhaps more accurately a danger, is identifying the components that will be included in the interest formula: origination fees,[3] points, other discounts,[4] any amount paid as consideration for making the loan or forbearance,[5] among others, although there are scores of items generally not includable in computing the interest rate: reasonable charges for appraisals, surveys, title insurance, standby fees,[6] prepayment penalties,[7] late charges,[8] legal fees,[9] but a few in a list too lengthy to delineate here.

MORTGAGE FORECLOSURE

BY BRUCE J. BERGMAN

What is or is not includable, though, can become less of a factor, or can be rendered irrelevant, is many situations—part of the confusing nature of usury. That the "legal" rate of interest in New York is 16 percent is a ready concept, one which suggests that if a mortgage loan were to be made at an interest rate in excess of 16 percent, it would not only be illegal, but usurious. That would be true if an ordinary individual extended a mortgage loan to another individual at such an excessive rate. It would not be true, however, if the borrower were a corporation, in which event civil usury would generally not apply.[10] (Criminal usury would still apply, though.)[11] Moreover, persons or entities in the category of "qualified lenders" can benefit from federal preemption of all state usury laws if the loan is a first lien upon residential real estate.[12] And Banking Law Article 12-D licensed lenders can charge at least up to 25 percent for a second or more junior mortgage upon residential property.[13] Moreover, any loan of $250,000 or more is not subject to civil usury proscriptions, unless the loan is secured primarily by a one or two family residence.[14] But there are neither civil nor criminal usury consequences for loans of $2,500,000 or more.[15] Still further, usury cannot attach to a true purchase money mortgage.[16]

In the mortgage arena, contemplating the labyrinthine subject of usury necessitates at the outset the asking and answering of a series of questions: (1) who is the lender; (2) who is the borrower; (3) what is the priority of the mortgage; (4) what type of mortgage is it (as in purchase money mortgage); and (5) what is the amount of the mortgage? Resolution of those issues should reveal if usury is even possible, and if so, at what interest rate level. If usury could taint the transaction, the analysis then shifts to what fees or charges will be included in the formula, with the computation then presumably disclosing whether a usury threshold has been crossed.

Yet, all this is not enough, because then the realm of nuance and permutation must be parsed and banished. So, for example, although a corporate borrower cannot generally interpose a civil usury defense (even

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where a borrower forms a dummy corporation to avoid usury laws, so long as the proceeds go to a corporate purpose)[17] the defense is viable where the corporate borrower's principal asset is a one or two family dwelling and either the corporation was organized, or the controlling interest acquired, within six months prior to execution by the corporation of the note evidencing the indebtedness.[18] However, even if a loan is made to a corporation, if the proceeds are actually advanced to an individual guarantor to discharge his personal obligations, then the usury defense becomes available to the guarantor.[19]

What if a usurious interest rate was actually set by the borrower? That still does not remove the loan from the penalties of usury,[20] on the theory that the protection afforded borrowers by usury statutes could too easily undermined by lenders' inducing borrowers to set the interest rate.[21] But there is an exception to this too, where the borrower, by virtue of a fiduciary or similar relationship of trust with the lender, has a duty to speak, yet refrains from revealing the illegality of the interest rate he has suggested. In the presence of rightful reliance by the lender, that borrower is estopped from asserting a usury defense.[22] Because all this goes on at extraordinary length, the evaluation of usury's applicability to any particular mortgage loan becomes markedly perplexing.

So, confronted with what amount almost to imponderables, lenders err on the side of caution and intend to save the day—if it ever needs saving— via the ubiquitous usury avoidance provisions. Unfortunately for lenders, they don't achieve the desired end.[23]

One case formulation holds that language purporting to reduce interest to a legal rate upon a usury finding does not render the agreement non-usurious.[24] Another states that a usury avoidnace clause does not save an otherwise usurious loan because if the loan is usurious it is therefore void. [25]

A basic source of the underlying theory is the maxim that a usurious transaction is void from its inception so that a return of any excess interest cannot preserve for a lender the sums advanced or the interest due upon those monies. [26] One related analysis assessed the efficacy in an agreement of an arbitration provision to be triggered in the event a usury issue arose.[27] In finding that arbitration could not be permitted, the point was made that if the primary purpose of a transaction is illegal, then any subsidiary agreements become invalid by the very invalidity of the main agreement[28]. If a usurious agreement could be made enforceable through the mere imposition of an arbitration provision, then the judiciary would surrender public policy control in a manner which was never intended. Then too, anyone seeking to construct an unassailable usurious contract would only have to elicit from desperate borrowers a consent to arbitration perhaps with named arbitrators sympathetic to the lending community.[29] In the end, artful draftsmanship would serve to bypass legislative intent.[30]

A more recent view, and one specifically addressing usury avoidance language, observes the basic foundation of usury statutes as dedicated to protection of unsuspecting, vulnerable people.[31] If a lender could sidestep usury proscriptions through the use of a usury avoidance provision, the bedrock policy would be undermined.[32] If unassaulted, the contract affords the lender a usurious return. If challenged, only the excess interest would be in peril and the usury statutes clearly envision more than that by way of protection for borrowers.[33] In sum, the usury avoidance provision will not empower foreclosure of a usurious mortgage.

Lenders and borrowers have no doubt always believed it wise to rely upon the efficacy of usury avoidance provisions. The intent and the goal are both appropriate, even laudable, but it would seem not the proper substitute for the effort needed to divine in advance whether or not the loan is usurious.

(1) This writer will hardly, pretend to have all the answers in this frequently perplexing realm, but much of the helpful arcana can be found at 1 *Bergman on New York Mortgage Foreclosures,* Chap. 6, Matthew Bender & Co., Inc. (rev. 2000).

(2) *Band Realty Company v. North Brewster, Inc.,* 37 N.Y.2d 460, 373 N.Y.S.2d 97, 335 N.E.2d 316 (1975). See also *Karas v. Schur,* 189 A.D.2d 856, 592 N.Y.S.2d 779 (2d Dept. 1993), and for a further discussion of the subject, I *Bergman on New York Mortgage Foreclosures,* §6.02[4], Matthew Bender & Co., Inc. (rev. 2000).

(3) *Fareri v. Rains Int'l. Ltd.,* 187 A.D.2d 481, 589 N.Y.S.2d 579 (2d Dept. 1992); See also *Hilal v. Lipton,* 227 A.D.2d 378, 379 (2d Dept. 1996).

(4) See *Ludlum Corp. Pension Plan Trust v. Matty's Superservice, Inc,* 156 A.D.2d 339, 548 N.Y.S.2d 292 (2d Dept. 1989).

(5) 3 N.Y.C.R.R. §4.2.

(6) *Boston Road Shopping Center, Inc. v. Teachers Ins. and Annuity Ass'n.,* 13 A.D.2d 106, 213 N.Y.S.2d 522 (1st Dept. 1961), aff'd mem. 11 N.Y.2d 831, 227 N.Y.S.2d 444, 182 N.E.2d 116 (1962).

(7) 3 N.YC.R.R. §4.2(g)(1); *Feldman v. Kings Highway Sav. Bank,* 278 A.D. 589, 102 N.Y.S.2d 306 (2d Dept.), aff'd. 303 N.Y. 675, 102 N.E.2d 835 (1951).

(8) 3 N.Y.C.R.R. §4.3(g)(2).

(9) See, inter alia, *In re American Motors Products Corp.,* 98 F.2d 774 (2d Cir. 1938).

(10) See, inter alia, G.O.L. §5-521(1); *Intima-Eighteen, Inc. v. A.H. Schreiber Co., Inc.,* 172 A.D.2d 456, 568 N.Y.S.2d 802 (1st Dept. 1991).

(11) G.O.L. §5-521(3).

(12) Depository Institutions Deregulation and Monetary Control Act of 1980, 12 U.S.C. §1735F-7.

(13) Banking Law §590(1)(a), §590(1)(b) and §590-a(1).

(14) G.O.L. §5-501(6)(a).

(15) G.O.L. §5-501(6)(b); *Tides Edge Corp. v. Central Fed. Sav. Bank,* 151 A.D.2d 741, 542 N.Y.S.2d 763 (2d Dept. 1989).

(16) *Szerdahelyi v. Harris,* 67 N.Y.2d 42, 499 N.Y.S.2d 650, 490 N.E.2d 517 (1986); *Mandelino v. Fribourg,* 23 N.Y.2d 145, 295 N.Y.S.2d 654, 242 N.E.2d 823 (1968). For a further review of this subject see 1 *Bergman on New York Mortgage Foreclosures,* §6.03[1] [b] and [i], Matthew Bender & Co., Inc. (rev. 2000).

(17) See, inter alia, *Millerton Properties Assocs., v. Brescia Enters., Inc.,* 184 A.D.2d 845, 584 N.Y.S.2d 660 (3d Dept. 1992); *Leader v. Dinkler Management Corp.,* 20 N.Y.2d 393, 283 N,Y.S.2d 281, 230 N.E.2d 190 (1967).

(18) G.O.L. §5-521(2).

(19) See, inter alia, *A.S.A.P Funding Corp. v. Fariello,* 164 A.D.2d 973, 559 N.Y.S.2d 417 (4th Dept. 1990); *First Nat'l. Bank of Amenia v. Mountain Food Enters., Inc.,* 159 A.D.2d 900, 553 N.Y.S.2d 233 (3d Dept. 1990).

(20) *Matter of Dane,* 55 A.D.2d 224, 390 N.Y.S.2d 249 (3d Dept. 1976).

(21) Id.

(22) *Pemper. v. Reiter*__.A.D.2d__, 695 N.Y.S.2d 555 (1st Dept. 1999), citing *Abramovitz v. Kew Realty Equities, Inc,* 180 A.D.2d 568, 580 N.Y.S.2d 269, lv. denied 80 N.Y.2d 753; 587 N.Y.S.2d 905, 600 N.E.2d 632.

(23) *Simsbury Fund, Inc. v. New St. Louis Associates,* 204 A.D.2d 182, 611 N.Y.S.2d 557 (1st Dept. 1994); *Federal Home Loan Mort. Corporation v. 333 Neptune Avenue Limited,* 1999 WL 390837 (E.D.N.Y); see also *Durst v. Abrash,* 22 A.D.2d 39, 253 N.Y.S.2d 351, affd. 17 N.Y.2d 445, 266 N.Y.S.2d 806, 213 N.E.2d 887.

(24) *Simsbury Fund, Inc. v. New St. Louis Associates,* 204 A.D.2d 182, 611 N.Y.S.2d 557 (1st Dept. 1994), citing *Durst v. Abrash,* 22 A.D.2d 39, 42, 253 N.Y.S.2d 351, affd. 17 N.Y.2d 445, 266 N.Y.S.2d 806, 213 N.E. 2d 887.

(25) *Federal Home Loan Mort. Corporation v. 333 Neptune Avenue Limited,* 1999 WL 390837 (E.D.N.Y.).

(26) *Federal Home Loan Mort. Corporation v. 333 Neptune Avenue Limited,* 1999 WL 390837 (E.D.N.Y.), citing *Szerdahelyi v. Harris,* 67 N.Y.2d 42 (1986).

(27) *Durst v. Abrash,* 22 A.D.2d 39, 253 N.Y.S.2d 351, affd. 17 N.Y.2d 445, 266 N.Y.S.2d, 806, 213 N.E.2d 887.

(28) *Durst v. Abrash,* 22 A.D.2d 39, 253 N.Y.S.2d 351, affd. 17 N.Y.2d 445, 266 N.Y.S.2d 806, 213 N.E.2d 887, citing *Manson v. Curtiss,* 223 N.Y. 313, 324, 119 N.E. 559, 562.

(29) *Durst v. Abrash,* 22 A.D.2d 39, 253 N.Y.S.2d 351, affd. 17 N.Y.2d 445, 266 N.Y.S.2d 806, 213 N.E.2d 887, citing *Mtr Of Astoria Med. Group [Health Ins.],* 11 N.Y.2d 128, 227 N.Y.S.2d 401, 182 N.E.2d 85.

(30) *Durst v. Abrash,* 22 A.D.2d 39, 253 N.Y.S.2d 351, affd. 17 N.Y.2d 445, 266 N.Y.S.2d 806, 213 N.E.2d 887.

(31) *Federal Home Loan Mort. Corporation v. 333 Neptune Avenue Limited,* 1999 WL 390837 (E.D.N.Y.).

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