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California's Usury Law May Pose Hidden Risks for Investors in California Loans

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December 2011

California's highly technical usury law poses risks even for passive investors in loans, as demonstrated by *Creative Ventures, LLC v. Jim Ward & Associates*, a California Court of Appeal decision issued earlier this year. In *Creative Ventures*, a real estate loan arranged by a licensed California real estate broker was held to be usurious on a technicality, and investors in that loan were held liable for usury even though they had no reason to know the loan was usurious and did not receive any interest at a rate that was usurious. The beneficiary of this result was no hapless or disadvantaged borrower, but rather a sophisticated real estate developer who cashed in on the lender's mistake with a court-ordered, interest-free loan.

The California Constitution sets the maximum legal rate of interest at "the higher of 10 percent or 5 percent plus the Federal Reserve Bank of San Francisco's rate on the 25th day of the month preceding the date the [loan] agreement was contracted." For the past decade, this has meant a maximum legal rate of interest in California of 10%. The interest rate for purposes of California's usury law generally includes origination fees, and not just the stated rate of interest. The usury law has many exceptions, including one for loans secured by real estate and made or arranged by any person licensed as a real estate broker.

In *Creative Ventures*, two real estate developers borrowed several million dollars from Jim Ward & Associates (JWA), a California corporation. Jim Ward, a licensed California real estate broker, formed JWA to make real estate loans, was an officer of the corporation, and arranged the loans. The loans had interest rates of 8% and 10% , but also included real estate broker fees of 4% and 6% , making the interest rates on the loans for purposes of California's usury law exceed the maximum non-usurious interest rate of 10% when the loans were made. JWA sold interests in the loans to 54 individual investors, and assigned them fractional interests in the loans. The loan documents recited, and all parties believed, that JWA was a licensed real estate broker.

As it turned out, Mr. Ward's lawyer mistakenly licensed a defunct, older corporation with the same name as JWA, rather than the newly formed JWA. This mistake proved fatal to the usury exemption for the transaction. California's Department of Real Estate discovered the mistake and began investigating JWA. The borrowers, who had repaid the loans in full with interest, learned that JWA was unlicensed and filed suit against JWA and the investors to recover all of the interest they paid plus treble damages. The result? The court ruled that JWA and the investors were liable for usury, because the JWA licensing glitch meant the loan was not made or arranged by a licensed real estate broker.

The court rejected several plausible defenses:

- It did not matter that Mr. Ward himself was a licensed real estate broker and had arranged the loan, because he had done so on behalf of the unlicensed JWA
- It did not matter that the investors did not know about the real estate broker fees or JWA's unlicensed status, or that the loans were usurious; this is because they were not holders-in-due course, but rather were assignees subject to all claims on the notes against JWA, the assignor
- It did not matter that the investors never received any usurious interest, because on a usurious loan they should never have received *any* interest.

Conclusion. This case is a cautionary tale for investors in California loans. It is also an exercise in form over substance, and provides a remedy when there was no wrong in any harmful way, resulting in a windfall for the savvy plaintiff developers. More than anything else, the case suggests that California's antiquated and exception-riddled usury law has outlived any usefulness it may once have had in commercial transactions between sophisticated parties.