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LEGAL AND HISTORICAL BACKGROUND OF MISSOURI SMALL LOAN PROBLEM

George L. Gisler*

I. Introduction

The contest between the efforts of lawmakers and agencies of law enforcement on the one hand, and the ingenuity and rapacity of the loan shark on the other hand, has been a close one through the years, with the latter enjoying the fruits of victory currently in Missouri. As Dr. Kelso has so ably shown, the need of the small borrower, unfulfilled through legitimate channels under ordinary usury laws, left the borrower with no choice but the illegal high rate lender. Under these circumstances natural economic laws have proved themselves more powerful than prohibitory laws or the efforts of social workers and legal aid societies. The presence of the loan shark problem again in Missouri properly leads us to review the history of Missouri laws and the effectiveness, or lack of effectiveness, of those laws for such assistance in the solution of the problem as can be drawn from our experience.

II. Missouri Laws and Cases to 1927

Because the loan shark is a by product of the industrial era, we are not surprised to find that the problem he created first received the attention of courts and legislatures in the latter part of the last century.[1] Even before Missouri statehood, laws effective in Missouri limited interest charges to customary rates.[2] The progressive enactment, in a trial and error method, of various laws relating to the problem, however, is convincing evidence in itself that somehow the earlier laws were not an effective force in dealing with the problem. The dates when the laws were enacted and a brief characterization of each are as follows:

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1. For a comprehensive statement of the fundamental background of the problem see: Gallert, Hillborn and May, Small Loan Legislation (Russell Sage Foundation, 1932); Robinson and Nugent, Regulation of Small Loan Business (Russell Sage Foundation, 1935); 8 Law & Contemp. Prob. pp. 1-108 (1941).

2. La. Terr. Laws 1808, November 5, 1808. In the absence of contract 6% was the rate. Ten percent was permitted by contract. Usury could be pleaded as a defense. This law remained virtually unchanged until 1891 when the contract maximum was reduced from 10% to 8%, Laws 1891, page 169. The general usury law has remained substantially unchanged to this date. See §§ 408.020 and 408.030, Mo. Rev. Stat. (1949).

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1891 (Laws 1891, page 170) Declared invalid any chattel mortgage given to secure a usurious loan. *Mo. Rev. Stat.* § 408.070 (1949).

1897 (Laws 1897, page 202) Made it a crime to charge more than 1 per cent per month on loans of $500 and less secured by chattel mortgage on household goods.

1899 (Laws 1899, page 166) Made it a crime to sell or transfer a note or contract known to be usurious without notifying the transferee. *Mo. Rev. Stat.* § 561.430 (1949).

1899 (Laws 1899, page 167) Made it a crime to charge more than 2% per month; *Mo. Rev. Stat.* § 563.900 (1949).

1905 (Laws 1905, page 172) Authorized action for recovery of usurious interest; *Mo Rev. Stat.* § 408.050 (1949).

1911 (Laws 1911, Page 143) Declared assignments of unearned wages to be void; *Mo. Rev. Stat.* § 432.030 (1949).

1913 (Laws 1913, page 545) An act regulating chattel loan business (provisions to be explained in detail later).

1919 (Laws 1919, page 239) Loan and Investment Companies Act, *Mo. Rev. Stat.* c. 368 (1949).

1927 (Laws 1927, page 252) Small Loan Act. *Mo. Rev. Stat.* Art. 7, c. 39 (1939).

1927 (Laws 1927, page 164) Credit Union Act, *Mo. Rev. Stat.* c. 370 (1949).

1929 (Laws 1929, page 201) Amendment to Small Loan Laws reducing rate to 2½% and enacting Section 16.

1933 (Laws 1933, page 199) Amendment to Loan and Investment Company Act changing investigation fee and adding $20 "extra hazard" fee.

1939 (Laws 1939, page 772) Amendment to Small Loan Laws permitting 3% per month on loans of $100 and less and reenacting regulatory section on salary buying.

1941 (Laws 1941, page 331) Minor changes in Credit Union Act.

1943 (Laws 1943, page 502) Major changes in Loan and Investment Company Act; regulation, supervision, reports, regulation of investigation fee and of "extra hazard" fee.

The existence of a racket in small chattel mortgages is attested by a number of early cases which demonstrate the occasion for the 1891 law. These cases involve loans made after that law, for there would have been no relief for the borrowers involved in those loans without the 1891 law. In *Fidelity Loan Guarantee Company v. Baker*,[3] the loan was made in 1891 for

3. 54 Mo. App. 79 (1893).

a period of six months in the approximate amount of $140 on boarding house furniture. This was a renewal of a prior obligation and the borrower signed one note for $151.25 and five notes of $7.50 each, making a total interest charge of approximately $47.25. The 1891 law was used as a defense to the lenders suit for possession of the furniture.[4] A charge of $70 interest and $106 storage charges was made on a chattel loan of $44.50 made in 1892 in *Johnson v. Vette.*[5] The action was in replevin under the 1891 statute.

The effectiveness of the 1891 Act was impaired by the holding in several cases that the mortgage would not be void if in the hands of a purchaser in good faith for value. The borrower then had the additional burden of proving that the mortgage was not purchased in good faith because most lenders began using straw parties. In *Smith v. Mohr,*[6] the defendant paid $50 for a $125 chattel loan for 10 months and the evidence showed the alleged bona fide purchaser was really a straw party for plaintiff. A similar type of transaction was presented in *Johnson v. Simmons,*[7] where plaintiff finally recovered his furniture after two changes of venue, trials in a justice of the peace court and the circuit court, and the appeal to the St. Louis Court of Appeals. The 1891 law was held constitutional in *Kreibohm v. Yancey,*[8] where the borrower paid $77 for the use of $175 for one year.

From the number of these cases which reached appellate courts even though the amount involved was small, we can safely assume that the high rate chattel loan business was of considerable volume. The 1897 law was another attempt to aid the borrower. It sought to overcome the effect of *Smith v. Mohr, supra,* by making the mortgage void even though purchased in good faith for value. The purchaser was given a remedy against the transferor. Significantly the 1897 law recognized that the evil was confined to loans of $500 and less, and, by making it a crime to charge more than 1%

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4. Plaintiff apparently contended he was a broker to evade the effect of the 1891 law, see *id.* at 82:

> "The plaintiff itself seems nearly as much of a myth as Teutsch. The business methods of both of these parties appear from the evidence to have been strangely devious and complex. It is made to appear that Teutsch, a Chicago capitalist, was in the habit of loaning his money at the modest rate of eight per cent in Kansas City on Chattel mortgages covering such personal property as old and well-worn boarding-house furniture when guaranteed by the plaintiff corporation, whose capital as far as the evidence discloses is invisible. It appears that the plaintiff is the only party that realized any profit or advantage from the Teutsch transactions."

5. 77 Mo. App. 563 (1898).
6. 64 Mo. App. 39 (1895).
7. 61 Mo. App. 395 (1895).
8. 154 Mo. 67, 55 S.W. 260 (1900).

per month on chattel loans, gave tacit approval to that rate. The 1899 Act (p. 167), which is still in effect, makes it a crime to charge more than 2% per month.[9]

Whether because the 1897 and 1899 Acts were effective or because of change in other circumstances, illegal lenders next turned to wage assignments as security for loans. These transactions were so complicated that borrowers and even the courts had difficulty understanding what had occurred. From the lenders' standpoint the transactions were simpler to handle and the wage assignment was a far more effective security than chattel mortgages. A number of cases demonstrate the presence of groups of high rate lenders in various parts of the state, some of them undoubtedly parts of a chain of lenders. In *Bell v. Mulholland*,[10] the borrower had paid $170 on a loan of $115 in three years and the entire principal was claimed to be due. Eighty one dollars was charged as interest on eighty three dollars for four months in *D. H. Tolman v. Union Casualty and Surety Company*.[11] Apparently the same lender was involved in *Henderson v. D. H. Tolman*.[12] Two cases arising under the 1905 law indicate a prevailing charge of 10% per month on wage assignment loans. The same lender was operating in several towns.[13]

In these cases the borrowers signed an array of complex instruments of assignment and agency. Copies of these instruments or receipts for payments were never given to borrowers, who were confused as to their rights. It was practices of this character which led to the inclusion of Section 8163, *Missouri Revised Statutes* (1939) in the Small Loan Laws, requiring the lender to give the borrower a clear concise statement of all the important aspects of the loan as well as receipts for all payments. The wage assignment was such an effective means for evading the usury statutes that it was later regulated as a loan.[14]

These cases, as well as the emergency clause of the 1913 Act, are witness to the fact that illegal high rate lending continued in Missouri despite

9. See *Ex parte* Berger, 193 Mo. 16, 90 S.W. 759 (1905), which held this act to be constitutional. In a well written opinion our supreme court upheld the power of the legislature to regulate interest rates and to classify loans. The case was important in the validity of the Credit Union Laws and Small Loan Laws, both of 1927, and it has been widely cited in other jurisdictions.

10. 90 Mo. App. 612 (1901).

11. 90 Mo. App. 274 (1901).

12. 130 Mo. App. 498, 109 S.W. 76 (1908).

13. Snyder v. L. F. Crutcher, 137 Mo. App. 121, 118 S.W. 489 (1909); L .F. Crutcher v. Sims, 184 Mo. App. 488, 170 S.W. 430 (1914).

14. See §§ 8165 and 8166, Mo. REV. STAT. (1939).

all previous efforts to stop it.[15] The 1913 Act was limited to cities of 30,000 population or more and provided for licensing, bonding, supervision and regulation of those persons who engaged in the chattel loan business. There were severe civil and criminal penalties and the lenders were required to give the borrowers receipts for payments. The Act recognized that legitimate capital would not enter the business unless more than the ordinary contract rates of interest were permitted. Hence, the act allowed licensees to charge 2 per cent per month, together with certain fees.

III. The Small Loan Laws

The principal shortcomings of the 1913 Act were that it dealt only with one part of the small loan business[16]—the chattel loan business—and that the permitted rate of 2% per month plus certain charges was inadequate. The last is proved by the fact that only one person ever obtained a license under the act.[17] Hence, the Act had virtually no impact on lending. The Act, however, was characteristic of the more enlightened approach to the loan shark problem at that time. Since 1907 the Russell Sage Foundation, a philanthropic foundation of New York City had sponsored a series of pioneer studies of the problem.[18] These studies gradually led to an understanding of the fundamental complexities underlying a solution. Legislatures were not slow in adopting the results of these studies. In time, men began to realize that loan shark rackets could be stopped only by encouraging legitimate business to destroy the loan sharks by competition with more reasonable charges and that legitimate capital could be attracted to the busi-

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15. The emergency clause, Laws 1913, page 545 was as follows:
"That the wide spread and evil effects upon many people in the cities described in Section 1 of the foregoing Act consequent upon the charge of oppressive and usurious rates of interest by persons and corporations (commonly called loan sharks) engaged in the chattel loan business in said cities creates an emergency within the meaning of the Constitution; and therefore, this Act shall take effect and be enforced from and after its passage and approval."

16. By 1913 the wage assignment lending racket was considerable. Perhaps it was believed that the 1911 Act, declaring assignments of unearned wages to be void, had solved this problem. The 1911 Act, however, proved no obstacle to extensive operations in later years. Salary buyers made a substantial portion of their loans to railroad workers whose wages are normally "held back" two weeks. Furthermore, most borrowers did not know about the 1911 Act. See Gisler and Birkhead, *Salary Buying in Kansas City, Missouri* (Conference on Personal Finance Law, New York, 1938).

17. This was the Welfare Loan Agency of Kansas City operated as a charity with funds largely furnished by the philanthropist, William Volker.

18. Two of the most important early studies were: Wassam, the Salary Loan Business in New York City (Russell Sage Foundation, 1908); Ham, the Chattel Loan Business (Russell Sage Foundation, 1909).

ness only if the law permitted charges which recognize the increased risk and the greater cost of doing business in proportion to the size of the loans.

While the 1913 Act recognized these principles, it failed mainly because the charges permitted—2% per month—were insufficient to induce legitimate businessmen to invest their capital in such a business.[19] By 1927 a number of states had adopted the Russell Sage Model Act,[20] and in the light of experience, various improvements had been made in it.[21] In 1927 most of the Act as recommended by the Russell Sage Foundation was adopted in Missouri. The principal provisions of this Act were:

1. Licensing, supervision and regulation. All persons, partnerships and corporations engaging in the business of lending sums of $300.00 and less and charging more than 8% per year were required to obtain a license from the State Finance Commissioner, submit annual reports and to be subject to supervision and regulation.

2. Licensees were permitted, in lieu of all other charges and fees, to charge interest at 3½% per month on declining unpaid balances of loans.

3. Severe civil penalties for violation of the act, including stringent definitions to prevent evasion. These penalties included revocation of the license and forfeiture of all principal and interest in any individual transaction.[22]

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19. With the number of chattel mortgage lenders in business in 1913 it is inconceivable that they would not have sought licenses had the 2% rate been attractive. In 1929 there were 141 lenders who had obtained licenses in two years under the Small Loan Act which then offered a 3½% per month rate.

20. These states and the dates of enactment were: 1911, Massachusetts; 1914, New Jersey; 1915, New York, Ohio and Pennsylvania. These laws were enacted before the Russell Sage Model Act of 1916. States which followed were: 1917, Illinois, Indiana, Maine, New Hampshire and Utah; 1918, Maryland and Virginia; 1919, Arizona, Colorado and Connecticut; 1920, Georgia; 1921, Iowa and Michigan; 1923, Rhode Island; 1925, Florida, Michigan (revision), Tennessee and West Virginia.

21. For a complete discussion of the development of the small loan laws and an analysis of the basis for each section see: Hubachek, *The Development of Regulatory Small Loan Laws*, 8 LAW & CONTEMP. PROB. 108 (1941). Also: GALLERT, AND MAY, SMALL LOAN LEGISLATION (Russell Sage Foundation, 1932); ROBINSON AND NUGENT, REGULATION OF SMALL LOAN BUSINESS (Russell Sage Foundation, 1935).

22. The effectiveness of the penalty clauses of the Small Loan Laws is demonstrated by the two following cases: Vaughn v. Graham, 234 Mo. App. 781, 121 S.W. 2d 222 (1938) and Vining v. Probst, 239 Mo. App. 157, 186 S.W. 2d 611 (1945).

In the Vaughn case it was held that a licensee could not compound interest by adding interest to the principal in a renewal note. The entire transaction was held void under § 8168, Mo. REV. STAT. (1939).

Vining was a "hip pocket" lender in Kansas City. When confronted with § 8168 and the fact that he was not licensed under the Small Loan Laws he adopted

By 1929 there were 141 licenses issued under this Act and illegal loan operations had been materially reduced. An important omission in the 1927 Act had been the failure to include that part of Section 16 of the Uniform Act which defined an assignment of wages of $300 and less to be a loan and defined as interest and difference between the amount of cash received and the amount required to be repaid. The 1929 amendment enacted this provision and also reduced the maximum charge from 3½% to 2½% per month. The number of licenses declined from 141 in 1929 to 87 in 1932, and there was a lack of interest in making loans of $100 and less by licensees. Since this was the traditional field for operation of the salary buying racketeers, they began boldly plying their trade and challenged the constitutionality of the 1929 salary buying amendment. They succeeded in obtaining a holding that the part of the amendment relating to salary buying was unconstitutional because of a technical defect in the title of the bill.[23]

The salary buying racket quickly assumed such proportions that free legal aid committees of St. Louis and Kansas City lawyers were devoting a major portion of their time to the problem.[24] It is interesting to review the legal remedies employed by these committees. A number of criminal prosecutions were instituted under what is now Section 563.800, *Missouri Revised Statutes* (1949). Attorney General Roy McKittrick began several injunction suits both in Kansas City and St. Louis based on the theory that the

the ingenious but ineffective theory that he could abandon the usurious note and sue on the loan of money with interest at only 6% per annum. The court entertained no difficulty in holding the entire transaction to be void under § 8186, which rendered unenforceable any transactions in violation of the Small Loan Laws. Vining soon ceased business.

23. Sherrill v. Brantley, 334 Mo. 497, 66 S.W. 2d 529 (1933). The timing of this case is of more than passing interest. The bill incorporating Section 16 into the small loan laws became effective on August 29, 1929. The wage assignment involved in the case was executed on November 2, 1929 and the commissions became due on November 9th. Sherrill (the lender) sued Brantley (the employer) on November 13, 1929 for refusal to pay the commissions and the case was decided by the St. Louis Circuit Court on March 21, 1930, holding the bill unconstitutional. For a more complete report on both the 1927 and 1929 legislative sessions see Gisler, *Organization of Public Opinion Against Loan Sharks*, 8 LAW & CONTEMP. PROB. 187-189 (1941).

24. The author is personally acquainted with the Bar Association activities and the history of this problem from 1936 to 1943 having been chairman of the Loan Shark Committee of the Lawyers Association of Kansas City and of the Small Loans Committee of the Missouri Bar Association. Work of the Kansas City Committee is briefly summarized in Gisler and Birkhead, *Salary Buying in Kansas City, Missouri, supra* n. 16. See also the following committee reports of the Missouri Bar Association: 8 Mo. BAR J. 189 (1937); 9 Mo. BAR J. 194 (1938) (this report lists all the cases filed by the Attorney General); 10 Mo. BAR J. 174 (1939); 11 Mo. BAR J. 105 (1940); 12 Mo. BAR J. 205 (1941); 13 Mo. BAR J. 179 197 (1942). The last three reports dealt primarily with the abuses under the Loan and Investment Act.

loan shark business is a public nuisance.[25] After delaying trials for some time, the persons sought to be enjoined sold out to other persons who continued the business. While the omission of the section regulating salary buying made it necessary to prove in each case that the salary buying transactions were in fact usurious loans, the legal aid committees advised borrowers to cease paying, under Section 8168, *Missouri Revised Statutes* (1939).[26] A number of cases were filed in St. Louis by salary buyers to enforce collection, but these were vigorously defended by the legal aid committees. Despite the fact that some three thousand borrowers were advised to cease paying in Kansas City, no such suits were filed there. A substantial number of cases were filed by the legal aid committees under what is now Section 408.050, *Missouri Revised Statutes* (1949), to recover usurious interest. Dilatory tactics, including an application to the supreme court for a writ of prohibition required a Kansas City committee to expend over one thousand hours of time on a case in which final judgment for $285.00 was ultimately obtained. Despite all these efforts the loan shark racket continued unabated.[27] Hence, the legal aid committees turned to a legislative solution, the one which was achieved in 1939. That solution, first proposed by the State Finance Commissioner[28] was for a re-enactment of the section to outlaw salary buying and an increase in rates to 3% per month on loans of $100 and less to stimulate competition by the licensees in the field in which the salary buyer operated. The bill was supported by nearly every

25. The legal theory and the cases supporting actions of this character are discussed in 8 LAW & CONTEMP. PROB. 100 (1941).

26. Following the case of Household Finance Company v. Shaffner, 356 Mo. 808, 203 S.W. 2d 734 (1947), which declared the Small Loan Laws to be unconstitutional under the 1945 Constitution, a revision bill in the legislature repealed these laws. Hence the references to Small Loan Laws throughout this article necessarily are to the 1939 revision.

27. There is not space in this article to demonstrate the difference between the existence of a remedy at law and the effectiveness of that remedy in actual practice with reference to the problem being discussed. The disparity between the loan shark who had a lucrative business at stake and the borrower who had only a few dollars involved and no funds with which to hire attorneys was one factor. In the years from 1936 to 1939 the problem of attorneys to represent borrowers was solved by the unremitting work of the legal aid committees. Most borrowers, however, were afraid to assert their rights for the reason they were afraid they would thereby terminate the availability of their only source of credit. Some idea of the practical and legal difficulties facing the legal aid committees may be obtained from: Collins, *Evasion and Avoidance of Usury Laws*, 8 LAW & CONTEMP. PROB. 54 (1941); Birkhead, *Collection Tactics of Illegal Lenders, id* at 78; Kelley, *Legal Techniques for Combating Loan Sharks, id* at 88.

28. See Recommendations of Missouri State Finance Commissioner in *Summary of Annual Reports of Personal Finance Companies* in the years 1931, 1933, 1934, 1935, 1936 and 1938. These reports of the state supervising official were addressed to the Governor and the members of the Legislature.

segment of the population[29] and on the day it became effective, every known salary buyer had closed his office.

As a result of charges of improper lobbying activities in connection with bills in the 1941 and 1943 sessions of the legislature a committee of the House of Representatives headed by W. E. Bailey (formerly Judge of the Springfield Court of Appeals and now Circuit Judge in Jasper County), was appointed to investigate lending institutions.[30] When the committee opened its hearings on the lobbying charges those who had made the charges presented no evidence as to any such activities. The committee went on, however, to hold hearings on the need for amendments to the small loan laws, the loan and investment act and the banking laws. This was the first complete investigation into the small loans problem by the legislature and the report is therefore worthy of study. The final report recommended no changes in the Small Loan Laws, stated there was no evidence of any violation of these laws by licensees, and found that the demand for small loans was being adequately served.[31]

IV. The Credit Union Laws

A solution to the loan shark problem widely proposed in the latter part of the 19th Century was the philanthropic Remedial Loan Society. In nearly all the principal cities one or more of these Societies were organized

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29. The story of the legislative campaigns in Missouri is reviewed in Gisler, *Organization of Public Opinion Against Loan Sharks*, 8 Law & Contemp. Prob. 187-194 (1941). For a more detailed report on the legislative program in 1939 see Gisler, *What Bar Associations Did in Missouri to Combat the Loan Shark Evil* (Program and Papers, Conference on Personal Finance Law, 1939).

30. Other members of this committee were J. J. Endres, William B. Weakley and Raymond J. Lahey. On April 1, 1943, by resolution of the House of Representatives Mr. Lahey was removed form the committee and was replaced by Morris Osburn. Journal of the House, 62nd General Assembly, August 23, 1943, page 2209.

31. Journal of the House, 62nd General Assembly, August 23, 1943, page 2214:

> "Not one scintilla of evidence was offered to this Committee showing or tending to show that any of the licensed small loan companies were violating the Small Loan Law or any other law of this State. The evidence before this Committee showed that those who are operating under the Small Loan Law consisted of individuals, partnerships and corporations and that all of them had assumed the responsibility for carrying out the purposes of the Small Loan Law and that they furnished a complete and adequate loan service in all amounts from $5 or $10 to $300."

On the rate question the report concluded at page 2217:

> "In view of these circumstances it is quite likely that to reduce the current rate would be to jeopardize the entire small loan industry in this state, and to threaten small loan borrowers with the necessity of once again becoming victims of the illegal high rate lenders who have reappeared in every state where the small loan rate has been reduced below a figure at which licensed lenders could render an adequate service."

and since they operated without profit and often with a loss, they aided in ameliorating conditions. The present size of consumer installment lending operations alone proves that even in a country as open handed as the United States, it would be impossible to find enough capital on a philanthropic basis to satisfy the need and the demand. An equally interesting and far more practical approach to the problem is an application of the cooperative idea.

A credit union—a cooperative savings and loan association for small loans—is a group of persons united by some common interest (ordinarily employment in the same business establishment) who pool their savings in order to have a fund from which to make loans to members of the group in time of need. A great deal of research and study was given to the problem of developing the legal and economic framework on which a credit union could operate successfully. Philanthropists such as Edward A. Filine made notable contributions to the overall development of the movement.

The credit Union Act was enacted in Missouri in 1927, the same year as the enactment of the Small Loan Laws, (Laws 1927, p. 164). Under this act, a credit union is a corporation organized with a special charter authorizing it to accept deposits from its member stockholders and to make loans to such members. The making of loans is regulated and supervised and an overall charge for loan services not to exceed a flat interest charge of 1% per month on declining balances is allowed. The only change in this law of consequence to this study was the amendment of 1941 which permitted a minimum interest charge of 25c per month regardless of the size of the loan and which authorized the Treasurer (without reference of the application to the loan committee) to make loans not to exceed $25 for a period of not more than 30 days (Laws 1941, page 331).[32]

The credit union movement in Missouri is one of interest and significance. The number of credit unions and total amount of loans outstanding, as well as the stability of the companies, has enabled them to participate effectively in the solution of the small loan problem. In dollar volume in comparison with the commercial lending agencies, the participation until recent years, however has not been large. Several factors contribute to this result:

1. The amount of capital available to a credit union for lending is obviously limited by factors other than the success or profitability of its operations, *i.e.* the savings of its members.

32. The Credit Union Act is now Chapter 370, Mo. Rev. Stat. (1949).

2. There is a natural reluctance on the part of an employee to air his financial problems to his fellow workers. Hence, many victims of loan sharks are persons who could borrow from credit unions.[33]

V. Loan & Investment Company Laws

The Loan and Investment Companies Act of 1919 (Laws 1919, p. 239) gave legislative sanction to the Morris Plan type of lending. The sum is borrowed at the legal rates and the note is due in a lump sum at the end of the loan period. The return to the lender is virtually doubled by requiring the borrower to purchase, in installments, a certificate of indebtedness (or investment certificate) the last installment of which comes due on the date the borrower's note becomes due. The Missouri Act also permitted a charge of $1.00 for each $50 loaned "for expenses" in investigation of the borrower. In *Discount Corporation v. Mitchell*,[34] it was held that the investigation fee could be charged only if there were, and only in the amount of, the actual expenses. A provision in the original law limiting the period of loans to one year had proved to be a bonanza to certain less reputable lenders who had incorporated under the Act and who were enabled thereby to pyramid not only the discounted interest but investigation charges on successive renewals.

The *Mitchell* case was a disappointment to the latter type of lenders, who obtained a change in the law in 1933. This amendment (Laws 1933, page 199) not only obviated the need for any correlation between actual expenses and charging the investigation fee, but added a new fee of $20.00 which became known as the "extra hazard" fee. The basis for this fee was a clause in the note providing that the borrower could surrender his automobile at any time regardless of condition in full satisfaction of the obligation. The fee was permitted because of the "extra hazard" in this type of automobile loan.

By 1940 some of the business which developed under this act was denominated by Bar Association Committees as a "racket."[35] Borrowers who

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33. See Gisler and Birkhead, *op. cit., supra* n. 16. In Appendix B, 300 loans are detailed. Of these borrowers 25% were employed by companies with credit unions to which they presumably could have applied for their loans. The same condition obtained in the study of the Junior Bar Conference of the American Bar Association on loan shark conditions in Kansas. The latter report was based primarily on records seized by the prosecutor in a loan shark office in Kansas City, Kansas. Unfortunately this report is now out of print.

34. 216 Mo. App. 100, 261 S.W. 743 (1924).

35. See particularly the reports of the Small Loans Committee in the years 1940 to 1943 referred to *supra* n. 24.

had no automobiles were given titles to jalopies in junk yards so the extra hazard fee could be charged. Fantastic charges were realized by repeated forced renewals, with duplications of discounts, insurance charges, investigation fees and extra hazard fees. It was not uncommon to find loans in this category where the charges aggregated 1000% per year on the amount of cash advanced; 520% and 240% per year were very common charges. Strangely enough, there was no public clamor to stop such practices. Since it required arithmetic calculations and some knowledge of the law to determine what the charges were in terms of interest, the public accepted at face value the representation that only 8% interest was being charged. Criticism in the legislature was directed primarily at the "36% per year" small loan companies.[36] It was the Bar Association committees which first demonstrated the unwholesome practices under this act and the investigation and report of the Bailey committee which led to the corrective legislation in 1943.[37]

The 1949 revision of the statutes eliminated from the Loan and Investment Act the requirements of licensing, regulation and supervision which had been enacted in 1943.[38] Even in 1943 the act stood on shaky ground as a special law fixing interest rates and granting certain corporations special rights, privileges and immunities.[39] To examine fully the difficult constitutional question in the light of the intricate wording of the Loan and Investment Act would require more space than is possible in this article. The constitutional prohibitions would appear to be violated, however, if the Act allows loan and investment companies to make charges not allowed to individuals and to other corporations and unless the loan and investment type of loan constitutes a proper classification. Because there are no restrictions on these loans as to size, security, method of repayment etc., there would seem to be no reason that individuals and other corporations should not be permitted to operate in the same manner and to make the same changes.

The use of the investment certificate is a device which virtually doubles the amount which a loan and investment company can earn from a loan,

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36. This strange phenomenon was noted in the Bailey Committee report, Journal of the House, 62nd General Assembly, August 23, 1943, page 2212.

37. See the complete report and recommendations *op. cit. supra.* n 36, pages 2218-2222. Virtually all the recommendations of the committee were adopted.

38. Mo. Rev. Stat. c. 368 (1949).

39. The present constitutional limitations are the same as the old ones: Article III, Section 40, subsections (26) and (28).

as opposed to the maximums allowed other individuals and corporations. Similarly the investigation fee and the extra hazard fee also increase the rate of return, an increase which is not available to individuals or to other corporations. The investigation fee is justifiable only if it represents actual expenses.[40] The 1933 amendment eliminated this justification. Several lower court decisions have held the certificate plan of operation to be usurious.[41] Two New York cases have held that payments on the investment certificate are actually payments on the loan; a holding which, if applied to the Missouri law, means that a greater interest rate is allowed loan and investment companies on loans than is allowed to other corporations or individuals. In *People's Loan & Investment Company v. Singer*,[42] the court said:

> "One finds it difficult to appreciate how an investment company can issue an evidence of indebtedness for moneys which it does not owe and how a so-called installment certificate, which has 'no value other than the agreement of the borrower to pay the amount of his loan,' can be considered additional security for the loan."

A more recent case has held that the extra hazard charge is in fact interest. The court said:

> "We are convinced that the extra hazard charges which constituted such a large percentage of the corporation's total income for the taxable years were received for the use of money loaned. The fact that in order to be permitted to retain for itself any part of the extra charges exacted, the Missouri law required the corporation to agree to accept the security in full settlement of the indebtedness and that the corporation complied with that law does not alter this conclusion. The extra charge is authorized "on account of the extra hazards involved in such loans.' In other words, the charge is authorized because of the extra hazard to the lender in making such loans. The Missouri statute does not authorize the extra charge in consideration of the option. It authorizes it in recognition of insufficiency of an 8% interest rate and protects the borrower to the

40. See Stewart v. Boone County Trust Company, 230 Mo. App. 120, 87 S.W. 2d 223 (1935), where the court said, at 226:

> ". . . where a contract for a loan, which requires in terms, or from necessary implication, the rendition of services by the lender for the benefit of the borrower, a fair and reasonable charge, for the services over and above the highest legal rate of interest on the money loaned, does not render the contract usurious."

41. These cases are cited and referred to in Collins, *Evasion and Avoidance of Usury Laws*, 8 LAW & CONTEMP. PROB. 66. (1941).

42. 140 Misc. 383, 250 N. Y. Supp. 613 (Sup. Ct. 1931). See also Morris Plan of New York v. Osnato, 123 Misc. 152, 204 N. Y. Supp. 829 (Supp. Ct. 1924).

> extent that, having paid the additional charge he will not subsequently be subject to a deficiency judgment in case of foreclosure of the security.
>
> The corporation's business is that of a money lender, not an insurer."[43]

Up to 1945 a few Missouri cases had sustained loans made under the Loan and Investment Act. The constitutionality of the Act, however, was not raised in these cases.[44]

VI. Banking Laws

Until recent years banks made few small loans. Certainly the maximum interest rate of 8% per annum did not encourage banks to make such loans. Such loans were also regarded as being too hazardous for the investment of depositor's funds. Gradually, however, and particularly in the larger cities, banks have entered the consumer credit field through the discount of commercial paper and even more recently, by direct loans. These loans are made under the general usury laws which permit a maximum interest rate of 8% per annum. Under the banking act this charge can be discounted in advance.[45] In all other respects as to penalties, etc., banks are subject to the general usury laws.

The small loan laws in effect in Missouri from 1927 to 1946 specifically exempted banks from the application of those laws. Neither could a bank be a credit union, nor exercise the corporate powers peculiar to a loan and investment company. While the exclusion of banks from the small loan laws denied them the benefits of higher maxmium charges, it also enabled them to escape the additional regulation and supervision as well as the severe penalties for usury which were a part of those laws.

In legislative sessions in 1941 and 1943 bills were introduced to create small loan laws for banks. The availability of depositor's funds and the fact that such small loan operations might be handled by existing facilities and personnel led to the belief that banks might supply the demand for certain types of small loans at lower rates than other lending institutions. The bills introduced provided for maximum charges approximating 15% to 19% per annum simple interest. The desirability of such laws to enable banks

43. Bond Auto Loan Corporation v. Commissioner of Internal Revenue, 153 F. 2d 50, 51 (8th Cir. 1946).

44. Auto Money Corp. v. Clark, 236 Mo. App. 862, 153 S.W. 2d 113 (1941); Van Doeren v. Pelt, 184 S.W. 2d 744 (Mo. App. 1945); Huddleston v. Ozark Acceptance Corp., 125 S.W. 2d 81 (Mo. App. 1939).

45. Mo. Rev. Stat. § 362.105 (1949).

to increase their services in the field of small loans in the larger cities was scarcely questioned.[46] Rural legislators, however, most of whom had no small loans problems of any kind in their districts, were afraid to endorse such legislation for fear it might result in farmers and small businessmen paying higher interest rates in rural areas. Furthermore the bankers did not present reliable data as to the cost of engaging in such business,[47] and the bankers were unable to agree among themselves on such matters as regulation, supervision, civil penalties and rebate clauses.

The disagreement among bankers on the latter points arose, among other things, from legal problems. National banks are entitled to the benefit of any increase in the maximum rate of interest allowed to banks generally but are not subject to state laws relating to penalties, regulation, supervision, etc.[48] Since a rebate clause is essential in any small loan law where interest may be discounted or added to the face of the note, the possibility of discrimination against state banks and in favor of national banks on the matter of rebates as well as on the matter of the additional trouble and expense of supervision and regulation is apparent. The fact that the legislature in 1941 and 1943 was unable to find and to agree on a solution to all these

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46. Bailey committee recommended such a law, *op. cit. supra* n. 36, page 2223.

47. The Bailey committee report commented, *op. cit. supra* n. 36, page 2223, on the lack of definite statistics and on the lack of agreement among bankers as to the necessary rate of interest. In fairness to the bankers it must be noted: (1) Banks' cost accounting practices probably did not make such figures available and, if not, it would have required considerable effort to have produced such figures. (2) Different banks contemplated making various different types of loans. Hence the differences of opinion as to the necessary rate of interest. From the standpoint of the bankers these differences of opinions were logical. However the bankers should not have been surprised when the confused and uncertain legislative front which they presented produced uncertainty and confusion in the minds of the legislators.

48. This is the holding of one of the very few Missouri cases involving a small loan made by a bank. First National Bank of Steele v. Hopkins, 59 S.W. 2d 773 (Mo. App. 1933). The bank loaned Hopkins $400 on March 27, 1930 and he signed a note for $432 due October 15, 1930. After foreclosing a chattel mortgage given for security the bank sued for a deficiency. Hopkins counterclaimed for damages for the wrongful foreclosure of the mortgage which he contended was void under Sec. 408.070, Mo. REV. STAT. (1949), on account of the usury—better than 15% per year. The court reversed a judgment for defendant on the counterclaim holding that a national bank is authorized to charge the highest amount of interest allowed by Missouri law, but is subject only to the penalties of the National Banking Act (a separate action to recover twice the amount of usurious interest actually paid). See the leading cases of Farmers and Mechanics National Bank v. Dearing, 91 U. S. 29 (1875) and Central National Bank v. Haseltine, 73 Mo. App. 60 (1898), *affd.* 155 Mo. 58, 55 S.W. 1015 (1900) *affd.* 183 U. S. 132 (1901). More recent cases are: Rushton v. Schram, 143 F. 2d 554 (6th Cir. 1944) and National City Bank of N. Y. v. Levine, 155 Misc. 132, 277 N. Y. Supp. 664 (Mun. Ct. 1933).

problems should not necessarily be taken as evidence of unwillingness to see the banks enter the small loans field.

VII. Pawnbroker Laws

Laws relating to pawnbrokers antedate those of any other lender in the small loans field. Strangely enough less has been accomplished toward effectively regulatory laws for pawnbrokers. In 1941 Rolf Nugent, then of the Russell Sage Foundation, advised the author that he knew of no state laws or in fact any model laws which he could wholeheartedly recommend. The pawnbroker holds the pledged article and should be permitted to charge for this service. Reports to and regulations by the police are necessary to aid in recovery of stolen goods. Many loans are in small amounts and of short duration. Redemption or sale of pledged articles involve a myriad of problems. These are only a few of the reasons for the difficulty in drafting satisfactory legislation.

An 1879 law of Missouri (Laws, p. 162) allowed pawnbrokers to charge 5% interest per month on loans under $20.00 and 3% per month on loans of $20.00 and over. In 1889 the law which has remained virtually unchanged to date was enacted.[49] As to interest, this equivocal law[50] states that it shall be unlawful for a pawnbroker to charge more than 2% per month. Pawnbrokers act on the theory that the law authorizes 2% per month, a construction which seems to strain the language.[51] The provisions for redemption and sale[52] are far from satisfactory and the author is unable to express an opinion as to the efficacy of those police regulations aimed at aiding in the tracing of stolen property.

There was some interest in rewriting the pawnbroker laws in 1941, interest which created confusion in the minds of most persons and led to no tangible results. Because of the antiquity of the business, the author ventures the suggestion that the pawnbroker business is regulated more by custom than it is by law. In Kansas City, 10% per month seems to be a fairly common charge. This apparent flouting of the law cannot be condoned. On the other hand a charge of $2.50 for a $25.00 loan for one month

49. Mo. Rev. Stat. § 7208 (1889). See Mo. Rev. Stat. c. 367 (1949).
50. Mo. Rev. Stat. § 367.010 (1949).
51. This section does not seem to have been construed, a situation not too surprising in view of the small size of most loans and the cost of litigation. There are a few cases on rights of redemption and holding that a usurious charge voids the pledge agreement giving rise to a right to replevin or action for a wrongful sale. Such rights are based on Sec. 408.070, Mo. Rev. Stat. (1949).
52. *Id.* § 367.020.

may not result in a large profit, if any, to a pawnbroker who has to open books on the transaction, report to the police and assume liability for the safe storage of the pledged article. The solution would seems to lie here, as it does in other phases of the small loans problem, in segregating from interest charges, the expense to the lender of those services which are actually performed for the benefit of the borrower and which have no relation to the forebearance of money.

VIII. The Missouri Constitution of 1945

Section 44 of Article III of the Missouri Constitution of 1945 has no counterpart in other state constitutions. It is as follows:

> "No law shall be valid fixing rates of interest or return for the loan or use of money, or the service or other charges made or imposed in connection therewith, for any particular group or class engaged in lending money. The rates of interest fixed by law shall be applicable generally and to all lenders without regard to the type or classification of their business."

The previous Missouri constitution had contained no limitation on the power of the legislature to regulate interest rates beyond a requirement that there be no special law fixing interest rates.[53] This latter provision is common to many state constitutions.[54] A few state constitutions prescribe a maximum interest rate[55] but this practice is now not generally regarded as sound. Other states have apparently been able to solve their small loans problem in a satisfactory manner without a constitutional provision such as Section 44.[56] Hence the reasons which led to its adoption and the policy it enunciates is a matter of interest.

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53. Mo. Const. Art. IV, § 53 (20) (1875): "The General Assembly shall not pass any local or special law fixing the rate of interest. This same prohibition is also included in the Constitution of 1945, Article III, Sec. 40(26).

54. See Constitutions of the following states: Arizona, Art. IV, Sec. 19; Alabama, Art. IV, Sec. 104; Illinois, Art. IV, Sec. 22; Indiana, Art. IV, Sec. 22; Kentucky, Sec. 59, Louisiana, Art. IV, Sec. 4; New York, Art. III, Sec. 18; Pennsylvania, Art. III, Sec. 7; Utah, Article VI, Sec. 26; Washington, Art. II, Sec. 28; West Virginia, Art. VI, Sec. 39; Wyoming, Art. III, Sec. 27.

55. There are at least five such states. See Constitutions of Arkansas, Art. XIX; California, Art. XX, Sec. 22; Oklahoma, Art. XIV, Sec. 2; Tennessee, Art. II, Sec. 7; and Texas, Art. XVI, Sec. 11.

56. Nebraska, for instance, has separate small loan laws relating to pawnbrokers, credit unions, loan and investment companies, small loan licensees, and banks. The chief difficulty with the Nebraska small loan law relating to banks is that national banks claim immunity from the penalty provisions and from regulation and supervision. Section 44 of our constitution has not solved this problem. In fact it has made this problem a stumbling block to *any* small loans legislation.

Previous laws in the small loans field had classified lenders according to the type of loan which they made. These laws permitted to all within the class charges commensurate with the expense of making loans of the type involved. Historical accident, as we have seen, has played a considerable part in determining the place of pawnbrokers, credit unions, loan and investment companies, small loan companies, banks and other credit institutions in the consumer credit field. As the demand for small loans arose, credit institutions which were already present tried to make their methods of operation conform in such manner as would satisfy that demand. Through the efforts of lenders and of the public, legislation evolved which authorized these methods of operation and which permitted the satisfaction of the demand for small loans under the supervision of state officials.

The Credit Union Act and the Loan and Investment Company Act, therefore, applied only to certain kinds of corporations. The Pawnbroker laws applied only to a certain class of lenders. Those laws are now unconstitutional under Section 44, at least insofar as they authorize interest or other charges in excess of 8% per annum. It is at least arguable that the portion of Section 362.105, *Missouri Revised Statutes* (1949), which authorizes banks to "receive or retain in advance" the highest rate allowed by law may be unconstitutional for the same reasons. The small loan laws were available to any person, partnership or corporation which applied for a license but by their terms they excluded banks, loan and investment companies, credit unions and pawnbrokers. It was this exclusion clause which rendered all the small loan laws unconstitutional under Section 44 in 1947, in the case of *Household Finance Corporation v. Shaffner*.[57]

With the exception of banks, the other lenders excluded from the operation of the small loan laws were apparently satisfied with their own operations and the laws under which they were operating. At least there is no record of any desire on their part to be included within the terms of the small loan laws or of their advocacy of Section 44. Accordingly it seems to follow that the pressure for adoption of Section 44 originated with banks and with those who desired to see the banks authorized to operate under small loan laws.[58]

57. 356 Mo. 808, 203 S.W. 2d 734 (1947).

58. See the resolution adopted by the Council of Administration of the Missouri Bankers Association May 17, 1944 (shortly after Section 44 was introduced in the Convention) urging the Constitutional Convention to approve Section 44. The author of Section 44 stated on the floor of the Convention that he was a director of three banks and held stock in others. Transcript of the Convention, p. 899. He had also been active in urging small loans legislation for banks in prior sessions of the legislature.

Some members of the Convention had the impression that the small loan laws were monopolistic in character or at least that there was a lack of competition in the field. While small loan licensees had no monopoly on their commodity (money) or on the services rendered (the loaning of money), it is true that only a licensee under the Small Loan Laws could charge the rates permitted by those laws. Although the shareholders of a loan and investment company, a bank, etc., as individuals, partners or as shareholders in another corporation could obtain a small loan license and operate under the small loan laws, the Convention did not believe this would have the same effect as permitting banks, loan and investment companies, etc., as such to operate under small loans laws. In any event the Convention (from the tenor of the debates) was interested in lowering interest rates. Without discussion of the difficulties of including banks in small loans legislation, the Convention apparently assumed that the legislature would not include banks in small loans legislation unless forced to do so, and that including banks would necessarily result in a lowering of interest rates. Scant attention was given in the Convention to the possibility that forcing the legislature to include banks might result in raising the charges which previously had been allowed banks on small loans.[59]

The failure to consider the history and the legal and economic background of the small loans problem in Missouri, was inevitable from the manner in which Section 44 originated. The committee of the Convention which made recommendations on that portion of the constitution relating to interest originally proposed that interest rates be limited to a maximum of 18% per year. Section 44 was proposed from the floor of the Convention as a substitute and was debated by the entire Convention without the benefit of committee hearings. Whether deliberately or by accident an atmosphere was created in the Convention wherein anyone who opposed Section 44, regardless of his reasons, thereby labelled himself as one who favored high interest rates. The atmosphere therefore was not conducive to sober consideration of the intricacies of the problem. Furthermore some members of the convention believed that other provisions of the constitution were of far greater importance to the state as a whole. While these persons entertained misgivings as to the advisability of including Section 44 they were constrained to vote for it in order to marshall support for other portions of

59. The author has read and reread the transcript of the debates in the Convention on Section 44 as well as newspapers of the time. Limitations of space however prevent documentation of much of this comment on the Convention.

the constitution. It is therefore of interest that the vote on Section 44 in the Convention was close.

While this discussion of the background of Section 44 is pertinent because of the grave doubt in the minds of many attorneys that any feasible solution of the small loans problem is possible under that section, we can turn now to a consideration of what the policy of the section is. Succinctly stated, that policy is that all lenders must be treated alike in the matter of charges for or in connection with the loan of money. The contention also possible under Section 44 that all borrowers must likewise be treated alike would seem to be negated by the language of our supreme court in the case of *Household Finance Corporation v. Shaffner, supra,* to the effect that loans may be classified. It is manifestly impractical to attempt to license, regulate and supervise every individual who may occasionally make a loan of money. It is also doubtful whether it is possible under Section 44 to classify for the purposes of licensing, supervision and regulation only those lenders who regularly engage in the business of loaning money. Hence there is a distinct possibility that the small loan business in Missouri in the future may be one without these provisions which have generally been regarded as desirable in any small loans legislation. This possibility has been recognized by the legislature in that all attempts to write a small loan law since 1946 have been in the form of two bills, one fixing the interest rate and penalties for violation of it and the other bill establishing licensing, regulation and supervision for those persons who regularly engage in the business of lending money.

The old distinctions between small loan companies, loan and investment companies, banks, etc., will very likely be obliterated in the future in Missouri. Since the constitution requires all lenders to be treated alike, all lenders will have equal powers and every lending institution will be legally clothed with the power to make any kind of loan regardless of size, character, security or any other such factor. Should lending institutions find it sound to operate in this manner, they should be able to spread overhead over a wider field of activity. In turn this should result in increased competition and lower costs to the borrower. It will thus be seen that the state of Missouri is about to embark on an experiment in the small loans field which will be watched with great interest throughout the nation.[60]

60. For an authoritative discussion of the overall implications of Section 44, see Hubachek. *The Drift Toward a Consumer Credit Code,* 16 U. of Chi. L. Rev. 609, 627 (1949), where the author says:

> "The new Missouri constitution is a dramatic illustration of an effort to force codification. Missouri is now under a constitutional necessity to

IX. Conclusions

No attempt to analyze the proposals which have been made in the last two sessions of the legislature is made here as they will be discussed elsewhere in this issue.[61] A consideration of those bills, of the debates in the legislature on those bills and of all the past history of the small loan problem in Missouri does, however, lead to definite conclusions. Certain characteristics of small loan legislation are so generally recognized to be essential that they are no longer an issue in Missouri. They are as follows:

1. Licensing, supervision and regulation by state officials. The desirability of these requirements was not even discussed in the Constitutional Convention and the merits of bills incorporating such provisions have not seriously been questioned in the legislature for more than twenty years. In fact, the trend has been to tighten supervision and regulation. The bringing of loan and investment companies under regulation and supervision in Missouri in the last decade and the noteworthy results in eliminating abuses which existed under the law is a case in point. Since the effective date of the Constitution, proposed small loan legislation has included licensing, supervision and regulation.

While a few individuals contend that making it a felony to exact usury will, in itself, solve the small loan problem, this view is so unrealistic as to call for little discussion. Prosecuting attorneys and lawyers in private practice who have actually been confronted with instituting criminal prosecutions against loan sharks do not endorse this theory. The evasive tactics of loan sharks are too numerous and too devious. As shown elsewhere in this issue criminal prosecutions are no permanent solution to the problem.[62]

2. Severe civil and criminal penalties coupled with adequate definitions of evasive tactics so as to bring the person who violates the law within the purview of the law. Here again and for many years these requirements have not been questioned by the legislature or by persons informed on the small

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codify its interest laws and treat all classes of lenders substantially the same for the purpose of statutes fixing maximum interest rates. The effect of the new constitution was to destroy all existing legislation authorizing rates of interest in excess of the general maximum, 8 per cent a year, fixed by the usury law. Missouri has been without a small loan law or any other regulatory interest law based on lender classification since July 1, 1946, when the new constitution became effective. The Missouri legislature has been unable to solve this problem despite a steady succession of bills in regular and special legislative sessions beginning in 1945."

61. See McReynolds *infra* p. 292.

62. See Birkhead, Murray and Lochmoeller, *Illegal Lending in Missouri*, *infra* p. 251.

loans problem. Prior to the Constitution, the definition of evasive tactics, and the penalties provided, were so effective that there was seldom occasion to resort to the courts, but when the necessity did arise the laws then in effect were found to be adequate.[63] The chief deterrent to illegal practices from the civil point of view is revocation of the license. The lender is not likely to risk his entire business for the sake of usurious charges on a few loans. Among lenders who are operating in violation of the law and/or without a license, the most effective provision is that of the Small Loan Laws [Section 8168, *Missouri Revised Statutes* (1939)] which renders void any usurious loan and denies to the lender the recovery of either principal or interest. Section 408.070, *Missouri Revised Statutes* (1949), voids any security given for such a loan.

3. Adequate charges for loans. The charges must be something in excess of the ordinary contract rate of interest of 8%. Even in the Constitutional Convention where the thinking on charges for loans seemed to depend more upon emotion than upon economic factors, it was recognized that something more than 8% per annum would have to be allowed lenders in the small loan field to interest them in engaging in the business. In current legislative discussions, few proposals have suggested an annual charge, inclusive of fees for services, below 18% or above 36% per year, depending on the size of loans, the security, etc.

Hence we can conclude that the two important problems remaining to be solved in Missouri are:

1. A determination of what a fair charge is for small loans which will be high enough but no higher than that necessary to induce legitimate capital to engage in the business.

2. A solution of the peculiar problems created by the unusual provisions of Section 44 of Article III of the Constitution of 1945.

Of these problems the first in importance is that of charges. Nothing is to be gained by considering the constitutional questions unless we can reasonably anticipate that some lenders will be operating under the law. Experience with the Missouri 1913 Act and in Georgia, Tennessee, Alabama, and the District of Columbia establishes this beyond question. As Dr. Upton points out, the maximum amount of charges to be allowed relates directly to the type of loans which the legislature desires to encourage. After the legislature has decided the questions of policy, the rate structure is largely a matter of the analysis and compilation of economic data. We leave these

63. See footnote 22, *supra*.

questions to the economist. However, when the amount of charges has been determined, the lawyer may interest himself in the manner of stating the maximum amount of charge allowed by law.

The small loan laws are virtually alone, in the field of lending, in requiring that all charges in connection with the loan, whether for services rendered or for forbearance of money, be denominated as interest. Other lending institutions charge the ordinary contract rate of interest, and charge separately for services in connection with the loan. In a real estate loan the borrower pays the costs of appraisal of the property, of the survey, of a legal opinion on the title, of recording fees, etc. A bank may require an expensive audit and cumbersome and expensive controls of inventory or of accounts receivable in connection with the loan. All such expenses are borne by the borrower and are part of the cost of the loan, but neither the borrower nor the courts consider them to be interest on the money borrowed. Similarly, the small loan licensee may expend money for a credit investigation and pay its employees to visit the borrower's home for the purpose of appraising and listing on a chattel mortgage the borrower's household goods. These expenses must be born by the licensee and recouped from his interest charges.

Under these circumstances it is obvious that what is denominated to be the maximum interest rate allowed a small loan licensee must be larger than that allowed other lenders who are not required to classify as interest their charges for services rendered. This, we submit, constituted much of the basis for the misunderstanding in the Constitutional Convention and in many recent sessions of the legislature. It confuses the borrower and the public. Is it necessary to take on the emotional and intellectual hazards of attempting to justify an *interest* charge of 3% per month or 36% per year, for instance, when such charge is composed principally of items which are not interest at all? Is it not time to revise our nomenclature, allow the small loan licensee 8% per year as interest and permit, in addition, such charges for investigation of credit, appraisal of property, drawing of instruments, cost of collection, etc., as will reasonably reimburse the lender for his expenses? Such a proposal would force a realistic appraisal of the fundamental economic factors involved in the matter of fair charges for small loans.

The suggestion has the further merit of being a more satisfactory solution to the peculiar problems created by Section 44 of the new Constitution. Any law fixing interest rates or service charges must now apply to all lenders alike. Most lenders traditionally have segregated their service charges from their interest charges. That method has worked successfully in practice for many years as to larger loans without regulation or supervision of any kind. If, as suggested by the *Shaffner* case, it is possible to classify loans under the new Constitution, then the need for regulating service charges in the case of small loans is at once apparent. The disparity in bargaining power between the borrower and the lender, the greater familiarity of the latter with lending transactions and the opportunities for abuse, guarantee the constitutional propriety of regulation of such service charges.

The reasons which led the Russell Sage Foundation to recommend the all inclusive "interest" rate in 1916 were sound in the light of conditions as they then existed. In the intervening 35 years, however, the consumer credit business has matured and along with it the borrowing public has grown in intellectual stature. The difficulties in supervising an interest plus service charges statute which were then encountered have proved remarkably absent in states such as Oklahoma, Colorado and Arkansas which have such small loan laws. Furthermore each succeeding legislature does not need to be briefed on the intricacies of an all inclusive interest rate. There is no argument about the ordinary contract rate of interest and the service charges can be discussed without emotion.

The peculiar problems created by Section 44 are practical as well as legal. The legal problems, which involve the question as to whether or not licensing, supervision and regulation and classification of loans are possible, will be considered in Senator McReynolds' article. The practical problems include the matter of evolving a rate structure and forms of licensing, supervision and regulation which will be fair to the public and feasible for all types of lenders. What the legislature knows but what the Constitutional Convention failed to consider is that various kinds of lenders came into being as a result of the demand for the peculiar services which they have trained their personnel to furnish. Every loan office under Section 44 is legally capable of making any kind of loan regardless of size, risk or security. The lender, however, may question whether his personnel, trained in handling applicants for loans of $300.00 and under, can evaluate applicants for loans of $1,000.00 or $5,000.00 or more. Moreover it is doubtful that the busy executive desiring a $5,000.00 loan will line up with the man in overalls who is applying for a $100.00 loan. It is no accident that banks have begun to segregate their consumer loan departments from their banking offices and that especially trained personnel have been placed in charge. The practical benefits if any, of Section 44 therefore remain to be seen.

X. The Small Loan Laws of 1951

On May 8, 1951 and after this article was virtually complete, Governor Smith signed Senate Bills 78 and 79 which will be effective ninety days after the adjournment or recess of this session of the legislature. The bills were written with an eye to the possible constitutional difficulties in the path of licensing, regulation and supervision. Hence we find the interest code provisions in Senate Bill No. 79 and licensing, supervisory and regulatory provisions in Senate Bill No. 78. In general it may be said that these bills together contain the elements of what experience has shown to be the requirements of sound, feasible small loans legislation. The bills recognize the higher cost of engaging in the small loan business and surround the doing of business with licensing, regulation, supervision and civil and criminal penalties which have in the past been regarded as adequate. There are several aspects of these bills however which seem to call for particular comment:

1. Senate Bill 79 provides, as to loans of $400.00 and less and in lieu of all other charges, an interest rate of 2.218% per month or 26.596% per year, or stated dollar wise, $15.00 per each $100.00 of principal to be repaid in equal monthly installments in one year. Upon its face this appears to be a reduction under the maximum rate allowed by the previous small loan laws of 3% per month on loans of $100.00 and less and 2½% per month on loans of $100.00 to $300.00. Section 8 of Senate Bill 78, however, provides that insurance premiums shall not be considered as interest, service charges or fees in connection with any loan, and permits the Commissioner of Finance of Missouri to issue regulations providing and governing the types and limits of insurance and the issuance of policies which may be sold in connection with consumer credit loans. Whether there will be, in fact, any reduction in charges to the borrower therefore will depend upon the fairness, thoroughness and carefulness with which insurance regulations are framed and enforced.

2. Section 408.032 of Senate Bill 79 provides for certain penalties in the event of violation of the law and contains a detailed provision (subparagraph f) for rebate of interest if the loan is prepaid in full by cash, renewal or financing one month or more before the final installment date. We have seen previously that neither the penalty nor the rebate provisions of this section will apply to national banks.[64] Since interest may be added to

64. See footnote 48, *supra*.

the principal of the loan, the matter of rebate has an important bearing on the return to the lender, particularly in the case of a prepayment by renewal. Accordingly if national banks are especially favored by this Act by not being subject to the rebate clause, then this factor may render the bill unconstitutional under Section 44. On the other hand, general usury statutes do not normally carry with them any right to a rebate. The fact that a lender is not required to rebate is not ordinarily understood to affect the interest rate for the reason that a rebate clause is inoperative if the contract is complied with according to its terms. In the field of small loans, however, pre-payment especially by renewal which may involve the lending of additional money is relatively common and a rebate clause is essential in order to avoid the offering of a loophole for avoidance of rate limitation.

3. By the terms of Senate Bill 78 both national and state banks are relieved of the requirements of licensing, supervision and regulation. Because these institutions are supervised under other laws this exemption would not invalidate Senate Bill 78 as a special law. However, one of the serious problems faced by a legislature writing small loans legislation involving banks has been the absence of the type of complete and authentic information as to the cost of small loans which is required to be furnished by Section 6 of Senate Bill 78 from which the banks are exempt. It is to be hoped that the banks will voluntarily maintain such records and submit such information to the Finance Commissioner so that this knowledge may be available to subsequent sessions of the legislature.

4. The preliminary report of the Bailey committee commented on the fact that the State Finance Commissioner has been inadequately supplied with money and personnel wherewith to conduct annual audits of the operations of licensed lenders. The annual reports required by Section 6 of Senate Bill 78 are required to be under oath as were the reports of licensees under the old small loan laws. While it is true that this requirement is, or should be, a guarantee of the accuracy of these reports, nevertheless, it is the opinion of the writer, as apparently it was of the Bailey committee, that much of the argument concerning the cost of engaging in the small loan business would be eliminated if the figures upon which these statements of cost are based were audited by state officials. Section 7 of Senate Bill 78 gives the commissioner adequate power to make these audits and it is therefore the responsibility of the legislature to supply the commissioner with the funds with which to do so.

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5. From the standpoint of stimulating competition it is probably a step forward to have the maximum rate of interest stated dollar wise as well as percentage wise. The author, however, still adheres to the views previously expressed in the conclusion of this article, that it would have been more realistic had the legislature left the interest rate alone and established a system of fees and charges which would reasonably compensate the lender for those services rendered by him in addition to the actual forebearance of money.

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