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Discounting Held Usurious When Effective Rate of Interest Exceeds Legal Maximum–Fausett & Co. v. G & P Real Estate, Inc.

DISCOUNTING HELD USURIOUS WHEN EFFECTIVE RATE OF INTEREST EXCEEDS LEGAL MAXIMUM

Fausett & Co. v. G & P Real Estate, Inc.[1]

G & P Real Estate, Inc. obtained two one-year, 9%[2] construction loans from Fausett and Company to erect buildings on separate lots in Arkansas.[3] Fausett loaned \$42,800 on the first lot and \$41,600 on the second, deducted a 1% service charge from each loan at closing, and advanced the balances during the loan year.[4] Ultimately, Fausett advanced \$41,445, plus a \$428 service charge, on the first lot and \$41,600, including the 1% service charge, on the second lot.[5] After making one payment for interest, G & P sued to have the loans voided as usurious claiming the actual amount of interest charged exceeded the 10% legal rate.[6] The trial court found for G & P, and Fausett appealed to the Arkansas Supreme Court.

In affirming the trial court's decision, the Arkansas Supreme Court made two determinations. First, the court found that Fausett's 1% service charge constituted interest rather than a brokerage fee,[7] a finding in accord with Arkansas precedent.[8] Second, the court held that deducting the highest legal rate of interest from the principal before disbursing it, a practice known as

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1. 269 Ark. 481, 602 S.W.2d 669 (1980).

2. The maximum legal rate of interest in Arkansas is 10% per annum. ARK. CONST. art. 19, § 13; ARK. STAT. ANN. § 68-602 (1979).

3. 269 Ark. at 482, 602 S.W.2d at 670.

4. *Id.* at 483, 602 S.W.2d at 670.

5. For a table of calculations showing the interest charged on each disbursement and the interest that lawfully could be charged, see 269 Ark. at 485, 602 S.W.2d at 671. A thorough discussion of the complicated calculation problems in determining usurious interest is found in Comment, *Usury: Issues in Calculation*, 34 ARK. L. REV. 442 (1980).

6. The effective rate of interest charged was 10.723869% on the first loan and 10.6244% on the second. 269 Ark. at 485, 602 S.W.2d at 671 (table of calculations).

7. *Id.* at 484, 602 S.W.2d at 670-71.

8. *See* Arkansas Sav. & Loan Ass'n v. Mack Trucks, Inc., 263 Ark. 264, 566 S.W.2d 128 (1978); Strickler v. State Auto Fin. Co., 220 Ark. 565, 249 S.W.2d 307 (1952). *See also* notes 32-35 and accompanying text *infra.*

"discounting," constituted usury.[9] By disallowing discounting when the *effective* rate exceeds the legal maximum, the court's holding is contrary to the nearly unanimous body of English and American precedent.

Usury is the act of lending money at an excessive or unlawfully high rate of interest.[10] By prohibiting loans at excessive interest rates,[11] state legislatures seek to protect borrowers who, by adverse circumstances, must

9. 269 Ark. at 484, 602 S.W.2d at 671. *See also* Vahlberg v. Keaton, 51 Ark. 534, 538, 11 S.W. 878, 878 (1889) (discount is interest in advance); Cumberland Capital Corp. v. Patty, 556 S.W.2d 516, 520 (Tenn. 1977) (same).

Discounting also can refer to the sale of negotiable paper at less than face value. BLACK'S LAW DICTIONARY 418 (5th ed. 1979). A note for which value has once been given can be discounted at any rate, but the discount of paper for which no value has been given previously will be considered interest. *See* Baske v. Russell, 67 Wash. 2d 268, 407 P.2d 434 (1965).

10. BLACK'S LAW DICTIONARY 1385 (5th ed. 1979). Usury is purely a creation of statutes. The states have different usury statutes imposing a variety of penalties and allowing a variety of exemptions. In addition, many state statutes vary the maximum interest rate according to the type of loan or credit transaction involved. A consumer transaction is the most likely to be regulated by an interest ceiling. For a discussion of state usury laws, see Cooper, *A Study of Usury Laws in the United States to Consider Their Affect on Mortgage Credit and Home Construction Starts: A Proposal for Change,* 8 AM. BUS. L.J. 165, 174-80 (1970); Lowell, *A Current Analysis of the Usury Laws—A National View,* 8 SAN DIEGO L. REV. 193, 236-45 (1971).

Some states consider revolving charge accounts exempt from usury statutes while others do not. *See* Annot., 41 A.L.R.3d 682 (1972). *See also* cases cited in Whitaker v. Spiegel, Inc., 95 Wash. 2d 408, 417-18, 623 P.2d 1147, 1153 (1981). For further discussion of this point, see Comment, *Finance Charges or Time Price Differential in Installment Sales—Usury?,* 24 MO. L. REV. 225 (1959); *Usury—Consumer Credit—Revolving Charge Accounts Fall Under the Iowa Usury Laws,* 7 CREIGHTON L. REV. 419 (1974); *Consumer Credit—The Department Store Revolving Charge Account—Usury Resurrected,* 69 MICH. L. REV. 1368 (1971); *Consumer Law: Revolving Charge Account Rates Held to Violate State Usury Law,* 55 MINN. L. REV. 1244 (1971); *Sales—Usury—Revolving Charge Accounts: An Exemption from Usury?,* 45 TULANE L. REV. 1087 (1971); *Commercial Law—Usury and the Time-Price Differential,* 1975 WIS. L. REV. 246. For a general overview of Missouri usury laws, see Comment, *Usury—Effectiveness of the General Usury Statutes of Missouri—Sections 408.050 and 408.070,* 26 MO. L. REV. 217 (1961).

11. The first English statute regulating the rate of interest was passed during the reign of Henry VIII. *See* Bank of Newport v. Cook, 60 Ark. 288, 290-98, 30 S.W. 35, 36-38 (1895); Union Savings Bank & Trust Co. v. Dottenheim, 107 Ga. 606, 609, 34 S.E. 217, 219 (1899). For general discussions of the history of usury statutes, see Special Project, *Usury and the Monetary Control Act of 1980,* ARIZ. ST. L.J. 27, 61-110 (1981); Comment, *Usury—Effectiveness of the General Usury Statutes of Missouri—Sections 408.050 and 408.070,* 26 MO. L. REV. 217, 217-18 (1961); Note, *Usury Legislation—Its Effects on the Economy and a Proposal for Reform,* 33 VAND. L. REV. 199, 200-03 (1980).

borrow money at any cost.[12] The effect of usury laws is insignificant during periods of low or moderate interest rates because market rates never reach legal maximums.[13] When market interest rates exceed legal limits, however, usury limits can encourage lending institutions to divert funds from these markets to markets that allow a higher return on loans.[14] In addition, lenders may seek to lower loan costs by imposing more restrictive lending standards, such as increased down payments, stiffer credit criteria, higher minimum loan amounts, and increased loan fees or discounts.[15] For example, the Federal Housing Administration mortgage rate exceeded the maximum allowable rate in Missouri and Mississippi in the first quarter of 1974.[16] In those states, the number of new housing starts dropped 34% from the preceding year.[17] Although an economic recession contributed to the decline, the average drop nationally was 21%.[18] This suggests that usury laws intensify the effects of a recession and demonstrates that lending institutions will restrict loans rather than lend funds at an unprofitable rate. Potential borrowers, therefore, may be unable to obtain loans because of the legislatively imposed limits on interest rates.

The difficulty in determining if a transaction is usurious lies in calculating the borrower's payment for the use of the money.[19] In addition to the stated

12. *Cf.* Pease v. Taylor, 88 Nev. 287, 291-92, 496 P.2d 757, 760-61 (1972) (borrower's willingness to pay usurious rates irrelevant). *See also* Baske v. Russell, 67 Wash. 2d 268, 273, 407 P.2d 434, 437 (1965); Cooper, *supra* note 10, at 166-67.

13. *See generally* Cooper, *supra* note 10, at 168-69; Heath, *New Developments in Real Estate Financing*, 12 ST. MARY'S L.J. 811, 842-54 (1981); Nosari & Lewis, *How Usury Laws Affect Real Estate Development*, 9 REAL EST. L.J. 30, 34-35 (1980); Note, *supra* note 11, at 212-14. *See also* Special Project, *supra* note 11, at 35-60.

14. *See* articles cited note 13 *supra*.

15. *See* articles cited note 13 *supra*.

16. Giles, *The Effect of Usury Law on the Credit Marketplace*, 95 BANKING L.J. 527, 533 (1978).

17. *Id.*

18. *Id.*

19. *See generally* Comment, *supra* note 5. Generally, courts will look at the amount the borrower actually receives and not the face value of the note to determine if the interest rate is usurious. *See* Taylor v. Budd, 217 Cal. 262, 265, 18 P.2d 333, 334 (1933); Buck v. Dahlgren, 23 Cal. App. 3d 779, 784-85, 100 Cal. Rptr. 462, 466 (1972); Sones v. Spiegal, 179 Neb. 838, 839, 140 N.W.2d 799, 800 (1966); National Am. Life Ins. Co. v. Bayou Country Club, 16 Utah 2d 417, 422, 403 P.2d 26, 30 (1965).

Judicial decisions have identified four elements of usury: (1) a loan or forbearance of money or its equivalent, (2) borrower's absolute obligation to repay, (3) exaction or reservation of greater compensation than allowed by law, and (4) an intention to violate usury laws. *See* Fikes v. First Fed. Sav. & Loan Ass'n, 533 P.2d 251, 263 (Alaska 1975); Dixon v. Sharp, 276 So. 2d 817, 819 (Fla. 1973); State *ex rel.* Turner v. Younker Bros., 210 N.W.2d 550, 555 (Iowa 1973); Rathbun v. W. T. Grant Co., 300 Minn. 223, 230, 219 N.W.2d 641, 646 (1974); Beneficial interest rate, courts also examine other costs assessed by the lender in making the loan. Lending institutions commonly assess "front-end" charges in addition to interest. These are called service charges,[20] points,[21] origination fees,[22] commitment fees,[23] negotiation or brokerage fees,[24] or closing costs.[25] When the lender deducts a fee from the amount loaned, he reduces

Fin. Co. v. Kitson, 530 S.W.2d 497, 502 (Mo. App., St. L. 1975); Western Auto Supply Co. v. Vick, 303 N.C. 30, 37, 277 S.E.2d 360, 366 (1981); Rollinger v. J.C. Penney Co., 86 S.D. 154, 158, 192 N.W.2d 699, 701 (1971); Flannery v. Bishop, 81 Wash. 2d 696, 698, 504 P.2d 778, 779 (1972); Baske v. Russell, 67 Wash. 2d 268, 270, 407 P.2d,434, 435 (1965).

The intent required is not the conscious intent to violate the usury law, but rather the intent to receive compensation in excess of that permitted by law. *See* Fikes v. First Fed. Sav. & Loan Ass'n, 533 P.2d 251, 263 (Alaska 1975); Modern Pioneers Ins. Co. v. Nandin, 103 Ariz. 125, 130, 437 P.2d 658, 663 (1968); Superior Improvement Co. v. Mastic Corp., 270 Ark. 471, 475, 604 S.W.2d 950, 952 (1980); Cagle v. Boyle Mortgage Co., 261 Ark. 437, 440, 549 S.W.2d 474, 475 (1977); Abramowitz v. Barnett Bank, 394 So. 2d 1033, 1036 (Fla. Dist. Ct. App. 1981); State *ex rel.* Turner v. Younker Bros., 210 N.W.2d 550, 563 (Iowa 1973); Montana Nat'l Bank v. Kolokotrones, 167 Mont. 92, 98, 535 P.2d 1017, 1021 (1975); Western Auto Supply Co. v. Vick, 303 N.C. 30, 47, 277 S.E.2d 360, 371 (1981); Cochran v. American Sav. & Loan Ass'n, 586 S.W.2d 849, 850 (Tex. 1979).

20. *See* Fausett & Co. v. G & P Real Estate, Inc., 269 Ark. 481, 483, 602 S.W.2d 669, 670 (1980); Winston v. Personal Fin. Co., 220 Ark. 580, 582, 249 S.W.2d 315, 316 (1952); Cumberland Capital Corp. v. Patty, 556 S.W.2d 516, 535 (Tenn. 1977).

21. The word "point" as used in the home mortgage finance industry indicates a fee equal to 1% of the principal. It is collected once, at the inception of the loan. BLACK'S LAW DICTIONARY, *supra* note 10, at 1040. *See also* B.F. Saul Co. v. West End Park N., Inc., 250 Md. 707, 713, 246 A.2d 591, 595 (1968).

22. *See, e.g.*, Johnson v. Federal Nat'l Mortgage Ass'n, 271 Ark. 588, 589, 609 S.W.2d 60, 61 (1980); Turner v. West Memphis Fed. Sav. & Loan Ass'n, 266 Ark. 530, 534, 588 S.W.2d 691, 693 (1979).

23. A commitment fee, common in real estate transactions, is the amount paid by the borrower to the lender, in addition to interest, for a loan commitment. BLACK'S LAW DICTIONARY, *supra* note 10, at 248. *See also* Arkansas Sav. & Loan Ass'n, v. Mack Trucks of Ark., Inc., 263 Ark. 264, 267, 566 S.W.2d 128, 130 (1978); People v. Central Fed. Sav. & Loan Ass'n, 46 N.Y.2d 41, 43-44, 385 N.E.2d 555, 555, 412 N.Y.S.2d 815, 816 (1978); Stedman v. Georgetown Sav. & Loan Ass'n, 595 S.W.2d 486, 487 (Tex. 1979); Gonzales County Sav. & Loan Ass'n v. Freeman, 534 S.W.2d 903, 905 (Tex. 1976).

24. *See, e.g.*, Grady v. Price, 94 Ariz. 252, 255, 383 P.2d 173, 175 (1963); Habach v. Johnson, 132 Ark. 374, 376, 201 S.W. 286, 287 (1918); Speier v. Monnah Park Block Co., 84 So. 2d 697, 698 (Fla. 1955); United Mortgage Co. v. Hildreth, 93 Nev. 79, 81, 559 P.2d 1186, 1187 (1977); Miller v. York, 92 Nev. 226, 229, 548 P.2d 941, 943 (1976); Pease v. Taylor, 88 Nev. 287, 290, 496 P.2d 757, 759 (1972).

25. *See* United-Bilt Homes, Inc. v. Teague, 245 Ark. 132, 432 S.W.2d 1 (1968). For further discussion of the front-end charges assessed by lenders, see

the principal and increases the effective interest rate. To determine if a loan is usurious, the crucial factor is the effective rate of interest,[26] which hinges on the amount the borrower can use during the loan. For example, a lender might loan $1,000 at the 10% legal maximum for one year. If he deducts the $100 interest in advance, the borrower receives $900. The effective rate of interest, therefore, is 11.11%, not 10%, because the borrower is paying $100 for the use of $900 for one year. The effective rate of interest increases if front-end charges are found to be interest.[27]

Loiseaux, *Some Usury Problems in Commercial Lending*, 49 TEX. L. REV. 419, 422-24 (1971); Podell, *The Application of Usury Laws to Modern Real Estate Transactions*, 1 REAL EST. L.J. 136, 142-48 (1972).

26. In Arkansas, the term "rate" is construed to mean "effective yield." Davidson v. Commercial Credit Equip. Corp., 255 Ark. 127, 131, 499 S.W.2d 68, 70-71 (1973).

27. Courts have said often that they will look behind the form of a loan transaction to determine if charges are an attempt to circumvent the usury laws. *See* Modern Pioneers Ins. Co. v. Nandin, 103 Ariz. 125, 130, 437 P.2d 658, 663 (1968); Western Auto Supply Co. v. Vick, 303 N.C. 30, 37, 277 S.E.2d 360, 366 (1981); Russell v. Lumberman's Mortgage Co., 27 Ohio Misc. 171, 171, 273 N.E.2d 803, 804 (C.P. 1966); Gonzales County Sav. & Loan Ass'n v. Freeman, 534 S.W.2d 903, 906 (Tex. 1976); Brown v. Pilini, 128 Vt. 324, 329-30, 262 A.2d 479, 482 (1970).

Generally, courts will not consider the charges to be interest, provided they are for services actually performed in connection with the particular loan and the charges are reasonable. *See, e.g.*, Altherr v. Wilshire Mortgage Corp., 104 Ariz. 59, 62, 448 P.2d 859, 862 (1968) (charges for supplying required FHA supervision and processing FHA applications are not interest provided charges are reasonable); Johnson v. Federal Nat'l Mortgage Ass'n, 271 Ark. 588, 589, 609 S.W.2d 60, 61 (1980) (charges for photographs, appraisals, title insurance, credit reports, abstract, and attorney were legitimate); Harris v. Guaranty Fin. Corp., 244 Ark. 218, 224, 424 S.W.2d 355, 358 (1968) (charge for title work pursuant to contract was not interest); Klett v. Security Acceptance Co., 38 Cal. 2d 770, 788, 242 P.2d 873, 885 (1952) (legitimate charges for specific items of actual service and expense are not interest); Abramowitz v. Barnett Bank, 394 So. 2d 1033, 1035 (Fla. Dist. Ct. App. 1981) (borrower can be charged reasonable expenses of making particular loan); D & M Dev. Co. v. Sherwood & Roberts, Inc., 93 Idaho 200, 201, 457 P.2d 439, 440 (1969) (court found commitment fee or brokerage fee did not constitute interest); State *ex rel.* Turner v. Younker Bros., 210 N.W.2d 550, 560 (Iowa 1973) (lender could charge a reasonable fee for specific services such as title examination, recording fees, travel and commission expenses, and credit reports); People v. Central Fed. Sav. & Loan Ass'n, 46 N.Y.2d 41, 43-44, 385 N.E.2d 555, 555, 412 N.Y.S.2d 815, 816 (1978) (commitment fee paid in consideration of lender's keeping funds in reserve for future mortgage loans not considered interest for purpose of usury statute); Stedman v. Georgetown Sav. & Loan Ass'n, 595 S.W.2d 486, 488 (Tex. 1979) (lender may charge fee that commits it to make loan at future date); Gonzales County Sav. & Loan Ass'n v. Freeman, 534 S.W.2d 903, 906 (Tex. 1976) (same); Peoples Nat'l Bank v. National Bank of Commerce, 69 Wash. 2d 682, 690-91, 420 P.2d 208, 214 (1966) (10% service charge allowed for actual services performed, including plat-

The consequence of exceeding the legal limit is harsh in Arkansas.[28] While states impose a variety of penalties for violating usury statutes,[29] very few states exact forfeiture of the principal as does Arkansas.[30] A violation can occur even if the borrower pays no interest because usury occurs when the parties execute a usurious contract.[31] If the lender contracts for more

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ting area, blacktopping streets, installing drains, water supply, and fire hydrants).

When courts have considered the charges to be interest, the charges were for services not actually performed or were an unreasonable charge for the service that was performed. *See, e.g.*, Turner v. West Memphis Fed. Sav. & Loan Ass'n, 266 Ark. 530, 534, 588 S.W.2d 691, 693 (1979) (1% origination fee was interest because part of finance charge); Winston v. Personal Fin. Co., 220 Ark. 580, 587, 249 S.W.2d 315, 319 (1952) (service charge an attempt to conceal usury); Russell v. Lumberman's Mortgage Co., 27 Ohio Misc. 171, 172, 273 N.E.2d 803, 804 (1966) (lender performed no special services that justified discount or origination fee); Brown v. Pilini, 128 Vt. 324, 331, 262 A.2d 479, 483 (1970) (10% handling charge constituted interest).

Ordinarily, the charge is not retained by the lender, but is paid to third parties. *See, e.g.*, Johnson v. Federal Nat'l Mortgage Ass'n, 271 Ark. 588, 589, 609 S.W.2d 60, 61 (1980) (money charged for services was paid to third party and was legitimate); Abramowitz v. Barnett Bank, 394 So. 2d 1033, 1035 (Fla. Dist. Ct. App. 1981) (legitimate fees usually paid to third parties).

Courts tend to view an excessive charge for an otherwise legitimate service as a way of avoiding usury laws. Consequently, any amount above what is considered reasonable is regarded as interest. *See* Altherr v. Wilshire Mortgage Corp., 104 Ariz. 59, 63, 448 P.2d 859, 863 (1968); Abramowitz v. Barnett Bank, 394 So. 2d 1033, 1036 (Fla. Dist. Ct. App. 1981). *See also* D & M Dev. Co. v. Sherwood & Roberts, Inc., 93 Idaho 200, 207, 457 P.2d 439, 445 (1969) (commitment fee should comport with going rate in community); Cumberland Capital Corp. v. Patty, 556 S.W.2d 516, 535 (Tenn. 1977) (service charges must bear reasonable relation to expense and service of lender). In Stedman v. Georgetown Sav. & Loan Ass'n, 595 S.W.2d 486, 489 (Tex. 1980), the court held that a bona fide commitment fee is not interest. The court's holding disregards any inquiry into the reasonableness of the charge. *Id.* at 495 (Spears, J., dissenting). *Stedman* is notable because the lender repeatedly characterized the commitment fee as interest in its correspondence and its monthly billing to the borrower. *Id.* at 488. For criticism of *Stedman*, see *Usury—Commitment Fees—Consideration Paid for Loan Option Is Bona Fide Commitment Fee, Not Interest, Despite Label Attached and Amount Charged*, 12 ST. MARY'S L.J. 259 (1980); Stedman v. Georgetown Savings & Loan Association: *Reasonableness Is Not A Characteristic Of A Bona Fide Commitment Fee*, 21 SOUTH TEX. L.J. 127 (1980).

28. Both the interest and the principal are forfeited. The contract is void and cannot be enforced. *See* ARK. STAT. ANN. § 68-609 (1979).

29. The various penalties include forfeiture of the excess interest, forfeiture of double or triple the amount of interest involved, and forfeiture of both interest and principal. For a complete list of the state usury statutes and the penalties involved, see Cooper, *supra* note 10, at 174-80; Lowell, *supra* note 10, at 236-45.

30. Only two other states require that the principal be forfeited. *See* CONN. GEN. STAT. ANN. § 37-8 (West 1958); R.I. GEN. LAWS § 6-26-4 (1969).

31. Hayes v. First Nat'l Bank, 256 Ark. 328, 507 S.W.2d 701 (1974).

interest than the law allows, therefore, the Arkansas borrower can have the entire transaction declared void and retain the principal.

Contrary to the court's first determination, Fausett claimed the 1% service charge was a broker's fee for procuring the loans. After G & P executed the notes and mortgages, Fausett immediately assigned them to two separate banks.[32] The notes, however, listed Fausett as the payee and mortgagee on both loans.[33] In addition, G & P dealt only with Fausett during the transactions, and there was no evidence that G & P knew of the impending assignment.[34] Because the 1% service charge was not justified as a broker's fee, the Arkansas Supreme Court held that the charge constituted interest. The characterization of Fausett's 1% service charge as interest was crucial because if it were not interest, the total interest charged would have been less than 10%.[35]

In making its second determination, the *Fausett* court, without explanation, invalidated discounting when the effective interest rate exceeds the usury rate.[36] This invalidation conflicts with commercial custom sanctioned by a long line of cases and recognized in Arkansas when it adopted its present constitution.[37] For example, in *Bank of Newport v. Cook*,[38] which was overruled by *Fausett*, the court allowed a lender to deduct in advance the highest legal rate of interest on a twelve month note. *Cook* was reaffirmed in *Simp-*

32. 269 Ark. at 483, 602 S.W.2d at 670.

33. *Id.*

34. *Id.* A broker's fee is almost universally considered interest if it is exacted by the lender or an agent of the lender. *See* Clarke v. Horany, 212 Cal. App. 2d 307, 27 Cal. Rptr. 901 (1963); Speier v. Monnah Park Block Co., 84 So. 2d 697 (Fla. 1955); United Mortgage Co. v. Hildreth, 93 Nev. 79, 559 P.2d 1186 (1977); Miller v. York, 92 Nev. 226, 548 P.2d 941 (1976); National Am. Life Ins. Co. v. Bayou Country Club, 16 Utah 2d 417, 403 P.2d 26 (1965). *See also* Modern Pioneers Ins. Co. v. Nandin, 103 Ariz. 125, 437 P.2d 658 (1968) (50% of broker's stock owned by lender; broker's fee is interest).

35. *See* 269 Ark. at 485, 602 S.W.2d at 671 (table of calculations).

36. *Id.* The concurring judges agreed, without explanation, that the loans were usurious. *Id.* at 486, 602 S.W.2d at 672 (Stroud, J., concurring). They strongly disapproved, however, of the majority's invalidation of the discounting rule, noting that the custom clearly was recognized in Arkansas at the time their present constitution was adopted. *Id.* (Stroud, J., concurring).

37. *Id.* at 487, 602 S.W.2d at 672 (Stroud, J., concurring). *Cf.* Houchard v. Berman, 79 Ariz. 381, 290 P.2d 735 (1955) (agreement to pay maximum rate of interest in advance not usurious); Cobe v. Guyer, 237 Ill. 516, 86 N.E. 1071 (1909) (same); Johnson v. Groce, 175 S.C. 312, 179 S.E. 39 (1935) (same); Roller v. Hamilton, 13 Tenn. App. 241 (1931) (same). *But cf.* Buck v. Dahlgren, 23 Cal. App. 3d 779, 100 Cal. Rptr. 462 (1972) (no interest may lawfully be collected in advance if lender charges maximum amount of interest allowed).

38. 60 Ark. 288, 30 S.W. 35 (1895) (overruled by Fausett & Co. v. G & P Real Estate, Inc., 269 Ark. at 484, 602 S.W.2d at 671).

son v. Smith Savings Society,[39] which again upheld discounting.[40]

Courts that have allowed discounting have done so because it is a traditional financial practice of the commercial community. The strength of this custom is sufficient to allow courts to approve an admittedly usurious transaction.[41] Courts, however, are in a difficult position because the custom is usurious in a strict mathematical sense. An unequivocal legislative expression, either allowing or disallowing discounting, would enable courts to reach a decision on a challenged transaction that is both legally *and* mathematically correct.[42]

Because discounting can produce a loan that is mathematically usurious, courts have been reluctant to allow discounting on long-term obligations.[43] For example, in *Miller v. First State Bank*,[44] the lender retained two years' interest in advance on a three-year loan. The court rejected the bank's contention that this prepayment of interest did not violate the usury statute, although it recognized that the rule allowing interest in advance at the highest rate for a year or less was "too firmly established to be departed from."[45]

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39. 178 Ark. 921, 12 S.W.2d 890 (1929).

40. *Accord*, Hickingbotham v. Industrial Fin. Corp., 192 Ark. 429, 91 S.W.2d 1023 (1936).

41. *E.g.*, Shropshire v. Commerce Farm Credit Co., 120 Tex. 400, 30 S.W.2d 282 (1930), *cert. denied*, 284 U.S. 675 (1931). The *Shropshire* court stated:

> [T]hough logically it is usury to deduct in advance the highest legal rate of interest on the principal of a loan for any part of the term for which the principal is borrowed, . . . [this practice has] been validated by the decisions in Texas, as elsewhere in the United States, too long for this court to now adjudge . . . [it] to be usurious.

120 Tex. at 412, 30 S.W.2d at 286.

42. Georgia's usury statute provides that the lawful rate of interest may not be exceeded by reserving or discounting the interest, regardless of the type of loan. GA. CODE ANN. § 57-101 (Cum. Supp. 1981). *See also* Kent v. Hibernia Sav., Bldg. & Loan Ass'n, 190 Ga. 764, 10 S.E.2d 759 (1940) (deducting interest in advance at highest legal rate is usurious, regardless of term of loan). Conversely, Alaska has a statute that expressly allows money lenders to collect the maximum interest in advance. *See* ALASKA STAT. § 45.45.30 (1980).

43. *See* First Nat'l Bank v. Nowlin, 509 F.2d 872, 876 (8th Cir. 1975) (discounting of short-term single payment notes is long-standing mercantile practice). *See also* 45 AM. JUR. 2d *Interest and Usury* § 171 (1969); 91 C.J.S. *Usury* § 34 (1955); Annot., 57 A.L.R.2d 630 (1958).

44. 551 S.W.2d 89 (Tex. Civ. App. 1977), *modified*, 563 S.W.2d 572 (Tex. 1978).

45. 551 S.W.2d at 97. *See also* Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 783 (Tex. 1977) (not usurious to collect one year's interest at highest lawful rate in advance). In Bothwell v. Farmers' & Merchants' State Bank & Trust Co., 120 Tex. 1, 30 S.W.2d 289 (1930), the court recognized the rule, but pointed out "how devoid of logic . . . it was to sanction the collection in advance of interest at the highest conventional statutory rate, on even short-term loans, under statutes against

While also recognizing the validity of discounting on one-year obligations, the court in *First National Bank v. Davis*[46] stated:

> [W]e regard the toleration of taking interest in advance at the highest rate allowed by law, as an artificial rule, resting upon long usage and authority, unsupported by any sound reasoning, and can not consent to take that artificial rule as the basis of a philosophy by which a like rule may be extended to cases not within the artificial rule.[47]

The majority in *Fausett* seems to say that custom cannot legalize a usurious loan. The court's decision is logically consistent if the *effective* interest rate determines whether a loan is usurious. It follows that if a 1% deduction of interest in advance in combination with the interest rate charged causes the effective yield to exceed the legal maximum, then a deduction of the entire maximum legal rate in advance that has the same effect is also usurious. Lending institutions, however, have long relied on the permissibility of front-end charges and discounting, which are justified by commercial custom that acknowledges both the desirability and convenience of these practices to borrowers and lenders. Arkansas usury laws have been observed repeatedly to be strict.[48] *Fausett* exemplifies this strictness and is important to any lender that makes loans in Arkansas. Since almost all other jurisdictions have long permitted discounting,[49] however, it is unlikely that *Fausett* will acquire a following.

J. BRUCE FARMER

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usury." *Id.* at 5, 30 S.W.2d at 290. Refusing to extend the rule further, the court stated:

> But the question which now confronts the court is whether a rule difficult to sustain in reason . . . which sanctions the advance deduction of interest at the highest conventional rate on short-term loans . . . shall be extended. . . . Common sense counsels against extension of a rule not entirely defensible on principle.

Id. at 7, 30 S.W.2d at 291.

46. 108 Ill. 633 (1884).

47. *Id.* at 638.

48. *See* notes 28-30 and accompanying text *supra. See also* authorities cited in note 49 *infra.*

49. *See* notes 10 & 42 *supra. See also* 6 MICHIE ON BANKS AND BANKING Ch. 11, § 33 (1975). Arkansas usury laws have been subject to considerable comment over the years. For further reading, see Anderson, *Usury—Constitutional Interdiction Applies to Sale of Merchandise on Credit*, 12 ARK. L. REV. 202 (1958); Collins & Ham, *The Usury Law of Arkansas: A Study in Evasion*, 8 ARK. L. REV. 399 (1954); Jack, *Usury—Recent Arkansas Developments Analyzed*, 21 ARK. L. REV. 224 (1967); Penick, *The Impact of Usury Law on Banks in Arkansas*, 8 ARK. L. REV. 420 (1954); Putnam, *Act 330 Discounting of Commercial Papers*, 7 ARK. L. REV. 341 (1953).