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Gauging One's Interest: Part One

By **S. Christopher Provenzano**

Winning the case and getting the judgment are (rightfully) foremost in the mind of litigators seeking to enforce instruments for the payment of money. But questions of interest—what is permissible in a loan (or other) agreement, penalty interest, and how pre- and postjudgment interest are calculated—can have a large impact on the amount recovered. Litigants can end up leaving quite a bit of money on the table inadvertently and, particularly in a low interest rate environment, strategic choices can have large effects.

In two articles we will explore some of the issues that arise with respect to interest in New York. Part One looks at usury in New York and how it affects the drafting and enforceability of interest clauses in loan agreements. Part Two will look at how interest is calculated from breach through judgment to recovery, and how specific drafting choices in the loan agreement and strategic litigation choices can impact the recovery. Part Two will also offer some practical drafting and strategic advice.

Usury and Penalty Interest

Is a loan usurious? This is a more complex question than you might expect. New York distinguishes between civil and criminal usury, and the distinction can have important consequences. The maximum permissible

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interest rate for "civil" usury is 16% per annum and a usurious loan is unenforceable. Banking Law §14-a (1). At 25% it becomes criminal usury and you can in theory get thrown in jail for loan sharking. Penal Law §§190.40-190.42. Simple, right? Well, that depends on how you calculate interest, who you are lending to, and how much you are lending.

Under the Banking Law, "any and all amounts paid or payable, directly or indirectly, by any person, to or for the account of the lender in consideration for the making of a loan or forbearance as defined by the superintendent pursuant to subdivision three of this section" are included as interest. Banking Law §14-a (2). For ordinary commercial loans the regulation interpreting this section just refers back to New York common law at the time of the statute's adoption, so that guidance is not very helpful.

When interpreting these rules, courts have generally interpreted the language broadly to include just about any fees or charges associated with the making of the loan. "Origination" or "extension" fees, or "points," for example, are included in determining the rate of interest. In general, any money retained by the lender from the amount to be advanced should probably be included as interest and used to compute the effective rate. See, e.g., *Oliveto Holdings v. Rattenni*, 110 A.D.3d 969, 972 (2d Dept. 2013). It is therefore important to consider what the "real" interest rate is.

Apart from determining the "real" interest rate, whether the recipient of the loan is a natural person or a corporation also matters. In general, corporations may not interpose a defense of civil usury, Gen. Oblig. L. §5-521(1), but *may* interpose a defense of criminal usury. Gen. Oblig. L. §5-521(3). In most commercial settings the borrower will be a corporation so only the 25% criminal usury threshold will be relevant. And we haven't gotten to the special rules for larger loans yet.

What happens if a corporation borrows at a rate that would be usurious as to an individual and defaults but the obligation is *guaranteed* by an individual? Does the loan suddenly *become* usurious when demand is made on the individual guarantor? Commercial loans to closely-held companies are often guaranteed by officers, owners or members, so this is not a remote hypothetical. Fortunately, however, this question has been settled for a long time:

> Inasmuch as the company is a corporation, the undertaking of the written agreement was not void, as being usurious. Frazee was a guarantor of a lawful contract, and therefore liable within the obligations of his guaranty.

Union Estates Co. v. Adlon Const. Co., 221 N.Y. 183, 186 (1917); see

also *Rosa v. Butterfield*, 33 N.Y. 665, 675 (1865). The "Frazee" in this case was the Harry Frazee who sold Babe Ruth to the Yankees in 1920 so his judgment is suspect not just for personally guaranteeing a high-interest corporate loan. The lesson so far is: If you are lending to a corporation, keep it under 25% *including* all fees or charges withheld from the amount advanced, and don't worry if there is a natural person guaranteeing the loan.

But when it comes to usury, size does, in fact, matter. Loans of $250,000 or more are generally exempt from the civil usury statute regardless of the borrower. Gen. Oblig. L. §5-501(6)(a). Loans of $2.5 million or more are generally exempt from the civil *and* criminal usury statutes. Gen. Oblig. L. §5-501(6)(b). This certainly makes things a bit simpler for larger lenders, but large loans often have a more complex structure than small loans that can make the analysis tricky. Fortunately, the statute clarifies two common situations.

First, many large loans are designed to be funded in tranches. In loans over $250,000 that are made available in installments by written agreement, you look to the total value of the loan, not any particular advance or drawdown. Gen. Oblig. L. §5-501(6)(a).

Second, many large loans are funded not by individual lenders but by syndicates. For loans of $2.5 million or greater made "pursuant to a written agreement by one or more lenders" the value is deemed to be the total amount of the loan. Therefore, the fact that an individual lender in a syndicate advances less than $2.5 million does not matter as long as the total amount of the loan reaches the $2.5 million threshold. Gen. Oblig. L. §5-501(6)(b).

Read together, the two provisions leave in interesting gap: The provision relating to loans over $250,000 refers to "a lender." The provision relating to loans over $2.5 million refers to "one or more lenders." Although this may be a legislative oversight, the result appears to be that a syndicate of lenders cannot take advantage of the safe harbor for loans that aggregate less than $2.5 million. Lenders who syndicate smaller loans should be attentive to this distinction.

The statutes leave open a couple of other questions that often arise. They address loans *made* in installments, but do not expressly address loans *paid back* in installments. Almost any amortized loan will eventually have a principal balance below either the $250,000 or $2.5 million threshold. Does such a loan retroactively *become* usurious when the principal balance falls below the relevant threshold? No reported case appears to have decided this issue expressly, but the answer seems obvious: a loan that was legal when made should not become usurious because you pay it down according to the loan terms. The alternative would absurdly transform a proper loan into a usurious one as it is paid off in the ordinary course, making the exemption applicable to loans paid off in a lump sum but not amortized loans. This is contrary to the legislative purpose of the statute and the reasoning of the many decisions that emphasize that the relevant legal issue is the propriety of the loan when made. There are probably no reported cases on this simply because it is so obvious. Be careful, though, if the payment terms change because of a modification to the loan agreement. That situation is discussed below.

What about penalty interest upon default? Nothing in the General Obligations Law seems to exempt loans in default from the general rules. However, a line of New York cases holds that an increase in interest upon default is *not* subject to a defense of usury. There are decisions to this effect in three of the four Departments of the Appellate Division. See, e.g., *Flynn v. Dick*, 13 A.D.2d 756, 756 (1st Dept. 1961); *Rebeil Consulting v. Kappa Realty*, 244 A.D.2d 540, 540 (2d Dept. 1997); *Klapper v. Integrated Agr. Mgt.*

Co., 149 A.D.2d 765, 767 (3d Dept. 1989).

Nonetheless, several *federal* cases have called this conclusion into question. *Madden v. Midland Funding*, concluded that "the New York Court of Appeals, were it to face this situation, would hold that the criminal usury cap limits interest charged on debts to 25% annually, even for defaulted debts." 237 F. Supp. 3d 130, 144 (S.D.N.Y. 2017); see also *Union Capital v. Vape Holdings*, 2017 WL 1406278, at *8 (S.D.N.Y. March 31, 2017) ("[A]s Judge Seibel convincingly determined after a lengthy analysis of state and federal cases considering the applicability of the criminal usury statute to default interest rates, the best reading of the cases urges an interpretation that the state criminal usury cap does apply to default interest.") (citing *Madden*).

On the other hand, a different District Judge disagreed, holding that the better view of New York law is that "default interest provisions do not render a note usurious." *Blue Citi v. 5Barz Intl.*, 338 F. Supp. 3d 326, 337 (S.D.N.Y. 2018).

The latter view is certainly more consistent with the state of the law in the Appellate Division, but given the ambiguity in the law (at least in the federal courts) it is probably safest to keep penalty interest provisions to under 25% unless the $2.5 million safe harbor applies, or at least provide that the rate of interest shall be 25% in the event that the higher rate is deemed unlawful.

If the usury cap were to apply to defaulted debts there is another issue: what if the original loan was large enough to qualify for a safe harbor, but the outstanding principal at the time of default does not? For example, a company borrows $3 million, pays off $1 million before defaulting and then default interest brings the interest rate on the outstanding $2 million to 26%. Is this usurious? Again, no case directly addresses this issue but two main factors provide lenders with comfort. First, the New York cases typically look to the propriety of the loan at the time it was made. Second, the line of cases discussed above seems to exempt penalty interest altogether from the usury statute. As noted, though, the Court of Appeals has not addressed this and some federal courts have expressed unease with exempting penalty interest from the criminal usury statute.

Finally, it is very common in a default situation for the parties to renegotiate their loan agreement. Special caution is warranted here—a new agreement will not necessarily enjoy the same exemption as the original agreement. However, as always courts are loath to endorse a forfeiture. The New York courts have held that even if the new agreement can be avoided on the basis of usury this will not necessarily void the prior agreement:

> It is well settled that an obligation valid when created, is not rendered unenforceable by any subsequent usurious agreements between the parties. *It is only the subsequent usurious transactions that are deemed void.*

> In this two-part article, the author explores some of the issues that arise with respect to interest in New York. Part One, here, looks at usury in New York and how it affects the drafting and enforceability of interest clauses in loan agreements.

Dichter v. Viking Off. Products, 119 A.D.2d 794, 795 (2d Dept. 1986) (emphasis added). Thus, even if a subsequent modification is void, this does not extinguish the borrower's obligations under the original agreement, *Eikenberry v. Adirondack Spring Water Co.*, 65 N.Y.2d 125, 129, though any payments under the new (void) agreement would have be credited to the borrower's account. *Dichter*, 119 A.D.2d at 795. A lender would therefore not lose the benefit of the original agreement.

An offhand comment in an 1864 case from which many subsequent cases ultimately derive suggests an additional concern: it observes that "*so long as the latter* [that is, the initial agreement] *remains in force*, usury cannot be imparted to it by the subsequent agreement." *Lesley v. Johnson*, 41 Barb. 359, 362 (N.Y. Gen'l Term 1864) (emphasis added). Any new forbearance or renegotiated loan agreement should refrain from extinguishing the original agreement, expressly or by implication. The cases identify no specific magic words to use, but two things seem advisable: First, to frame the modification as a modification or amendment rather than a new agreement; second, to reflect that the borrower acknowledges its obligation under the original agreement and that it is not impaired should any portion of the new agreement be deemed unenforceable.

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Gauging One's Interest: Part Two

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In the first article of this pair, we looked at the law of usury in New York, and the statutes and case law that affect the drafting and enforceability of interest clauses in loan agreements. This part will look at how interest is calculated after breach, and then on the judgment. We examine how the specific language of the loan agreement will impact what interest rate will apply, and how the forum can have a large impact on the ultimate amount. We also offer some practical drafting and strategic advice.

Pre- and Postjudgment Interest

In order to understand what the ultimate judgment amount will be—and the strategic decisions that will maximize recovery—we must consider under what circumstances courts will make awards of interest, what the rate will be and the time periods to which interest may apply.

New York's statutory pre- and postjudgment interest rate is 9% simple interest, CPLR 5004, and the circumstances under which it is applied are largely governed by statute, at least in principle. The CPLR creates three separate timeframes: from breach until verdict, from verdict to entry of judgment, and interest on the judgment until collection. CPLR 5001-5003. Since the statutory rate of interest does not change, and the time from verdict to judgment should (ideally) be brief, the distinction is often—but not always—academic. Practically, the important timeframes are from breach to judgment, and from judgment to satisfaction. The most significant issues arise when there is a conflict between the statutory interest rate and the contract interest rate, as we discuss below.

Under CPLR 5001(a), prejudgment interest "shall be recovered" in contract actions and in cases arising from "an act or omission depriving or otherwise interfering with title to, or possession or enjoyment of, property." Interest from verdict to judgment (CPLR 5002) and postjudgment interest (CPLR 5003) are awarded regardless of the cause of action upon which the action is founded. In equitable actions both the rate of interest and the date from which it is computed are within the Court's discretion, id., so the Court could potentially set different rates for the various time periods.

Under New York law, the date at which interest begins running is "the earliest ascertainable date the cause of action existed" unless the damages accrue as a result of subsequent events, in which case it runs from *that* date; where a series of events cause damage, interest may be computed from each of the events or from "a single reasonable intermediate date." CPLR 5001(b). The last issue typically arises in mortgages and other loans paid back by installment. In a typical commercial lending case with an acceleration clause, the damages therefore will typically be upon the full amount of the loan from the first date of default triggering the clause. Where acceleration is optional, the option must however be validly exercised. See, e.g., *Wells Fargo Bank, N.A. v. Burke*, 94 A.D.3d 980, 982 (2d Dept. 2012). In the absence of a validly exercised acceleration clause each missed payment will be a new breach.

In contrast, federal law makes no specific provision for prejudgment interest, and the issue is left to the discretion of the trial courts. 28

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U.S.C. §1961; *Waterside Ocean Navigation Co. v. International Navigation, Ltd.*, 737 F.2d 150, 153 (2d Cir. 1984).

Despite the seemingly mandatory language of the New York statute, there can be complications. For example, does language providing that something is a party's "sole remedy" preclude an award of interest? The Court of Appeals concluded that it does in a case where the agreement provided that the return of a deposit would be a party's "sole remedy" in the event of breach. The majority emphasized the right of the parties to a contract to decide for themselves how damages are to be computed in the event of a breach. The dissent observed that "shall" ought to mean "shall," but that was a dissent, so be careful with "sole remedy" language or anything else that could be construed to limit a right to interest. See *J. D'Addario & Co. v. Embassy Indus.*, 20 N.Y.3d 113 (2012).

What about arbitral awards? Typically, if a judgment debtor doesn't pay an arbitral award it will be converted into a judgment—or "confirmed"—to begin enforcement proceedings. In New York state courts this is governed by CPLR 7510; in federal courts by 9 U.S.C. §9. The result is a state or federal judgment reflecting the terms of the arbitral award. What rate of interest will apply? Note that this creates a new time period to consider—from award to judgment.

Under New York law, whether and at what rate to award interest from breach to award is solely for the arbitrators to determine, but the court will apply the statutory interest rate from award to judgment. *Gruberg v. Cortell Group*, 143 A.D.2d 39, 39 (1st Dept. 1988). In the federal courts, like other prejudgment interest questions, this is left to the trial court's discretion. *Waterside Ocean Navigation*, 737 F.2d at 154. Keep in mind that arbitrators have enormous discretion and modifying or reversing arbitral awards is nearly impossible, so it is important to be clear about what you want and ask that it be reflected in the award.

Strategic Choices and Practical Consequences

Imagine you have a corporation that had defaulted on a $2.6 million loan, thanks to a penalty interest clause the interest is running at a whopping 30%, *and* there are assets against which to execute a judgment. The amount of the loan makes usury a nonissue even with the very high interest rate, notwithstanding the split of authority between state and federal courts on whether penalty interest is exempt. Let's go to court! But which court? This choice could have significant consequences. First, though, let's look at the drafting pitfalls that can cost lenders money.

By statute, New York's rate of both pre- and postjudgment interest is 9%. Let's look at the first important time period—from breach to judgment. What interest rate applies: the contract rate of 30% or the statutory rate of 9%?

Whether the contract rate or the statutory rate applies from the date of breach depends on how the parties have framed their agreement. As the Court of Appeals has explained:

New York courts have long held that when an agreement involving an indebtedness provides that the interest shall be at a specified rate until the principal shall be paid, then the contract rate governs until payment of the principal, or until the contract is merged in a judgment. Said another way, when the principal on a loan is due on a date certain and the debtor fails

to make payment, the interest rate in the contract will be used to calculate interest on unpaid principal from the date of maturity of the loan to the entry of judgment. Thus, inclusion of a clause directing that interest accrues at a particular rate "until the principal is paid" (or words to that effect) alters the general rule that interest on principal is calculated pursuant to New York's statutory interest rate after the loan matures or the debtor defaults.

NML Capital v. Republic of Argentina, 17 N.Y.3d 250, 258-59 (2011) (citations, quotations omitted).

Put more simply, in New York, if the parties have agreed to a specified rate of interest "until the principal is paid" (or something similar), that rate will apply until judgment is entered. If the parties have been silent on this issue, the statutory rate of 9% will apply. The necessity of making an express statement to this effect seems a bit odd (when else does interest apply except until payment of principal is complete?) but this is what the Court of Appeals has said.

Whom this benefits depends on the base rate of interest until default. If the original loan was running at 4% interest, imposing the statutory rate functions as de facto penalty interest, adding 5%. If, as in our hypothetical above, it was running at 30% interest (and if the required language was not present), the debtor could obtain a huge discount by deliberately defaulting. How the parties address this in their agreement will depend on the prevailing interest rates at the time and the perceived risk of default, but it is something that should be expressly considered. As a practical matter most well-drafted loan agreements will include the language the Court of Appeals describes.

What about the period from entry of judgment to satisfaction of the judgment? In general, the rule in New York is that the cause of action "merges" into the judgment; the underlying cause of action is extinguished and the plaintiff—now the judgment creditor—may recover only upon the judgment.

In this two-part article, the author explores some of the issues that arise with respect to interest in New York. Part Two, here, looks at how interest is calculated after breach, and then on the judgment. He examines how the specific language of the loan agreement will impact what interest rate will apply, and how the forum can have a large impact on the ultimate amount. He also offers some practical drafting and strategic advice.

The consequence of this is that the statutory rate, not the contract rate, applies upon entry of judgment. *Metro-Gem Leasing & Funding v. Dancy Auto Group*, 183 A.D.3d 611 (2d Dept. 2020). As before whether this is a good thing or a bad thing depends on the interest rate in the agreement.

In the above hypothetical with a large debt carrying a very high penalty rate of interest, the debtor could hurry the case along by making no defense or even offering entry of judgment. Once judgment is entered, the debtor will have obtained a 21% discount by *losing* its case. If the debtor couldn't pay before this might not matter much, but if it has assets to execute the judgment against, or there are other parties against whom to enforce the judgment, this represents a significant discount from the agreement. How this may be avoided is discussed below.

What about federal court, assuming it has jurisdiction? The situation (from a lender's perspective) would be even worse. The federal interest rate is pegged to the "weekly average 1-year constant maturity Treasury yield." 28 U.S.C. 1961. On the date of this article, that rate is 0.11%. In our hypothetical, the borrower of $2.6 million could cut its interest rate from 30% to 0.11% by defaulting and getting judgment entered as quickly as possible. This is the difference between $780,000 and $2,860 a year in interest.

But what about state law claims in federal court based on diversity jurisdiction? Shouldn't the state rate prevail? The general rule is that state law governs the award of prejudgment interest, but that once the underlying debt is merged into a judgment the federal rate prevails. *FCS Advisors v. Fair Fin. Co.*, 605 F.3d 144 (2d Cir. 2010). A creditor (in the absence of "until the principal is paid" language) would be entitled to the contract

rate until default, 9% from default to judgment, and the federal rate once judgment is entered.

Barring a major change in the interest rate environment, a lender has a strong incentive to proceed in state court (especially with the availability of CPLR 3213—a motion for summary judgment in lieu of complaint), while a defaulting defendant has a strong incentive to remove to federal court if at all possible. Can a defendant's right to remove be limited by a forum selection clause? The answer appears to be yes, provided the language doing so is "clear and unequivocal." *JP Morgan Chase Bank, N.A. v. Reijtenbagh*, 611 F. Supp. 2d 389, 390 (S.D.N.Y. 2009) (citation, quotation omitted). A clause giving *exclusive* jurisdiction (this is important—it must not be merely consensual but mandatory) *requiring* any actions to be brought in New York State court located in a particular county irrespective of any purported right to remove should do the trick. (Personally, I like to include a provision that the party will seek assignment to the Commercial Division if the rules permit it.)

Given these facts, a smart lawyer might well advise a distressed client with a high interest rate loan to *deliberately* default just to lower its interest rate and, if at all possible, get into federal court. Can this be avoided? Yes, but only with careful drafting of the underlying agreement. There is a line of authority that the parties to an agreement may "clearly and unequivocally" agree that a higher rate shall apply until judgment is actually *satisfied*. See, e.g., *Marine Management v. Seco Management*, 176 A.D.2d 252, 253 (2d Dept. 1991), aff'd 80 N.Y.2d 886 (1992) (applying rule, finding language insufficiently clear and unequivocal); *Retirement Accounts v. Pacst Realty*, 49 A.D.3d 846, 847 (2d Dept. 2008) (finding parties "clearly, unambiguously, and unequivocally expressed that … the agreed-upon rate of interest, 24%, was to govern over the statutory rate of interest from that time through the entry of judgment up until actual satisfaction"). To satisfy this standard the agreement should be *very* clear that the interest rate survives judgment and applies until the debt is fully repaid.

From the rules we have discussed, a few basic drafting and strategic guidelines emerge for any lending agreement:

- If the agreement does not clearly come within a usury safe harbor be sure to include all the various costs and fees in calculating the effective interest rate.
- The agreement should be explicit that the interest rate—if it is higher than the statutory 9%—applies through payment in full of the principal. In fact, it should be clear that the rate survives judgment *and* applies until satisfaction of judgment.
- Forum selection clause with care. If you want to restrict the right of the borrower to remove to federal court make that very clear, but remember it binds you too.
- Think carefully about the choice of venue. Different states may have very different rates and rules. The choice of state or federal court can make a big difference.
- When entering into a forbearance or modification agreement, be sensitive to the question of whether it will be deemed a new agreement that extinguishes the prior agreement. If so, you may need to reconsider the usury calculus.
- If you are proceeding in arbitration, be sure to argue to the arbitrators—and request that they reflect in their award—what the appropriate rates of interest should be. If the parties have selected New York law the tribunal should apply the principles above, but if it fails to do so there will be no practical way to remedy that failure.
- Finally, keep in mind that these often-neglected issues can have a material financial impact on the ultimate recovery. When drafting lending agreements you should always consider your recovery strategy should things go sideways.

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