

## Recent Developments Regarding Interest Rate Regulation

By Kathleen E. Keest, Jeffrey I. Langer and Scott A. Cammarn\*

This annual survey of developments concerning federal and state usury laws discusses a number of recent noteworthy cases and one regulatory interpretive letter regarding interest rate regulation of depository institutions and other lenders.

### **“INTEREST” UNDER SECTION 85 MAY INCLUDE UNAUTHORIZED INSURANCE PREMIUMS**

In *Kenty v. Bank One, Columbus, N.A.*<sup>1</sup> the Federal District Court for the Southern District of Ohio concluded that, in some situations, charges for excess insurance premiums may constitute “interest” for purposes of 12 U.S.C. § 85 (section 85), the federal statute regulating the rate of interest that may be imposed by national banks.<sup>2</sup> In *Kenty*, the plaintiff, Kenty,

\*Ms. Keest, a member of the Iowa bar, is a lawyer with the National Consumer Law Center (NCLC) in Boston. She is chair of the Subcommittee on Interest Rate Regulation. The views expressed are not necessarily those of the NCLC. No legal services funds were used in the preparation of this Article. Mr. Langer, a member of the Ohio and Illinois bars, is vice-chair of the Subcommittee on Interest Rate Regulation. Mr. Cammarn is a member of the Ohio bar. Messrs. Langer and Cammarn practice law with Jones, Day, Reavis & Pogue in Columbus, Ohio.

1. No. C2-90-709, 1992 WL 170605 (S.D. Ohio Apr. 23, 1992).
2. Section 85 provides in pertinent part:

Any association may take, receive, reserve, and charge on any loan or discount made, . . . interest at the rate allowed by the laws of the State, Territory, or District where the bank is located, or at a rate of 1 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal reserve bank in the Federal reserve district where the bank is located, whichever may be the greater, and no more, except that where by the laws of any State a different rate is limited for banks organized under State laws, the rate so limited shall be allowed for associations organized or existing in any such State under this chapter. When no rate is fixed by the laws of the State, or Territory, or District, the bank may take, receive, reserve, or charge a rate not exceeding 7 per centum, or 1 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal reserve bank in the Federal reserve district where the bank is located, whichever may be the greater. . . .

obtained a purchase money loan secured by an automobile from Bank One, Columbus, N.A. (Bank One), a national bank located in Ohio. The loan agreement obligated Kenty to maintain insurance on the automobile in the amount of the outstanding balance of the loan. The agreement authorized Bank One to obtain or "force-place" insurance covering Bank One's interest in the automobile if Kenty failed to maintain sufficient insurance herself and permitted Bank One to add the amount of the premiums to the balance of the loan. After Kenty failed to maintain sufficient insurance herself, Bank One procured insurance from Transamerica Premier Insurance Company (Transamerica), an unaffiliated insurance company, and added a charge for the premiums to the balance of the loan. The amount of the charge then accrued interest, along with the unpaid balance of principal, at the 11.5 annual percentage rate stated in the agreement.

Kenty then brought a class action on behalf of herself and all other similarly situated consumers, alleging several claims against Bank One and Transamerica, including a claim that Bank One had imposed excess charges for insurance and therefore had committed usury under section 85.<sup>3</sup> Kenty alleged that Bank One had committed usury because it received a rate of interest well in excess of the stated rate of 11.5%. In particular, Kenty contended that Bank One received excess interest in the form of (i) rebates received from Transamerica that were not credited to Kenty's account so that she was charged higher premiums than Bank One paid to Transamerica, (ii) premiums for insurance in excess of the insurance authorized by the agreement, and (iii) interest that accrued on the excess premiums.<sup>4</sup> In denying Bank One's motion to dismiss, the court examined whether the facts, as alleged, could support a claim for usury under section 85, and in particular, assuming the allegations were true, whether the charges caused the rate to be usurious.<sup>5</sup>

The court first declared that it did not need to determine the maximum rate of interest permitted by Ohio law and incorporated by section 85.<sup>6</sup> Rather, the court stated that "[t]he issue for purposes of this motion is whether the alleged unauthorized premium charges constitute 'interest,' so that the plaintiff might prove that the interest charged by Bank One exceeded the applicable statutory rate."<sup>7</sup> Thus, in the court's view, the

3. Kenty also raised claims under the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. §§ 1961-1968 (1988 & Supp. III 1991), and the Bank Tying Act, 12 U.S.C. §§ 1971-1978 (1988 & Supp. III 1991).

4. Kenty alleged that the insurance that Bank One obtained provided more than the typical coverage against damage to motor vehicle collateral. The insurance policies also provided coverage for conversion, embezzlement, mechanics' liens, premium deficiencies, repossession expense, repossessed vehicle storage expense, and repossessed vehicles. *Kenty*, 1992 WL 170605, at \*1-2.

5. *Id.* at \*2-4.

6. *Id.* at \*3.

7. *Id.*

sole issue for determination was whether the alleged excess insurance charges were "interest" for purposes of section 85.<sup>8</sup>

The court noted that neither section 85 nor the applicable Ohio statutes defined the term *interest*.<sup>9</sup> Without deciding whether the definition of *interest* is properly a question of federal law or Ohio law,<sup>10</sup> the court looked to several other authorities for a definition of *interest*.<sup>11</sup> The court concluded:

Charges that are unauthorized and unnecessary to protect the collateral must be considered compensation to the bank for the extension of credit. Thus, the court holds that any unauthorized charges for unauthorized insurance added to a loan balance must be considered "interest." To the extent that interest is charged on unauthorized premiums added to [sic] loan balance, that is also interest.<sup>12</sup>

The court further concluded that the rebates Transamerica paid to Bank One also constituted *interest* because the rebates caused the amount paid by Bank One to Transamerica to be less than the amount Transamerica charged Kenty.<sup>13</sup> The court stated: "[I]f the plaintiff can prove that Bank One received 'kickbacks' or 'rebates' on the premiums added to her loan balance, which funds were not discounted from her loan balance, that would also constitute interest."<sup>14</sup>

Although *Kenty* did not address whether the definition of *interest* is a matter of state or federal law, it suggested that any loan charge imposed by a national bank may be interest if not otherwise authorized by applicable

8. *Id.*

9. *Id.*

10. See *Greenwood Trust Co. v. Massachusetts*, 971 F.2d 818 (1st Cir. 1992) (concluding that late charges are "interest" under both federal law and Delaware law and therefore not deciding whether the definition of *interest* for purposes of section 85 is derived from state or federal law), *rev'g* 776 F. Supp. 21 (D. Mass. 1991), *cert. denied*, 61 U.S.L.W. 3478 (Jan. 11, 1993).

11. *Kenty*, 1992 WL 170605, at \*3. The court quoted the Black's Law Dictionary definition of *interest*—"the compensation allowed by law or fixed by the parties for the use or forbearance or detention of money." *Id.* With respect to Ohio case law, the court cited two Ohio trial court decisions. *Id.* (citing *Allshouse v. Bank & Trust Co.*, 30 Ohio N.P. (n.s.) 17 (C.P. 1932); *Russell v. Lumbermen's Mortgage Co.*, 27 Ohio Misc. 171 (C.P. 1966)). The cases addressed the definition of *interest* for purposes of Ohio's civil usury statute, now codified at OHIO REV. CODE ANN. §§ 1343.01-1343.05 (Anderson 1979 & Supp. 1991). Bank One, however, was imposing interest on the basis of Ohio's banking statutes, OHIO REV. CODE §§ 1107.26-1107.265 (Anderson 1988 & Supp. 1991). The court's approach seems to assume that the definition of *interest* is the same under both statutes.

12. *Kenty*, 1992 WL 17065, at \*4. Other courts have held that unauthorized charges may be *interest*. See, e.g., *Vander Weyst v. First State Bank of Benson*, 425 N.W.2d 803, 811 (Minn.) (holding "interest" includes "all charges . . . incident to the loan"), *cert. denied*, 488 U.S. 943 (1988); see generally NATIONAL CONSUMER LAW CENTER, USURY AND CONSUMER CREDIT REGULATION § 7.4.2 (1987 & Supp. 1991) (discussing excessive cost).

13. *Kenty*, 1992 WL 17065, at \*4.

14. *Id.*

law or the loan agreement. *Kenty* also suggested that if charges imposed on a borrower for services provided or procured by the lender exceed the lender's actual costs, such excess may constitute interest as well.

***MOST FAVORED LENDER DOCTRINE: REGULATIONS PROTECTING STATE-CHARTERED LENDERS' SAFETY AND SOUNDNESS MAY NOT BE "MATERIAL TO THE DETERMINATION" OF A NATIONAL BANK'S INTEREST RATE***

In a recent letter from Eugene A. Marsico, Jr., Senior Attorney for the Southwestern District of the Office for the Comptroller of the Currency (OCC) (Marsico Letter),<sup>15</sup> the OCC addressed the scope of the "most favored lender doctrine." Under that doctrine, first announced by the United States Supreme Court in *Tiffany v. National Bank of Missouri*<sup>16</sup> and now codified by the OCC in an interpretive ruling, a national bank is permitted to charge the rate of interest permitted to any competing state-chartered or licensed lending institution under the law of the state in which the national bank is located.<sup>17</sup> When a national bank uses the state interest rate, however, it must also comply with those provisions of state law that are "material to the determination of the interest rate."<sup>18</sup> The purpose of the most favored lender doctrine was to prevent state discrimination against national banks and to preserve competitive equality between state-chartered or licensed lenders and national banks located in that state.<sup>19</sup>

The Marsico Letter addressed whether certain provisions of Texas' credit union regulations were "material to the determination of the interest rate" and therefore applicable to a Texas-based national bank using the rate of interest authorized by the Texas credit union law under the most favored

15. Letter from Eugene A. Marsico, Jr., Senior Attorney, Southwestern District, Office of the Comptroller of the Currency, to Mark D. Morris (Feb. 18, 1992) (on file with *The Business Lawyer*, University of Maryland School of Law) [hereinafter *Marsico Letter*].

16. 85 U.S. (18 Wall.) 409 (1874).

17. 12 C.F.R. § 7.7310(a) (1992). Section 7.7310(a) provides:

A national bank may charge interest at the maximum rate permitted by State law to any competing State-chartered or licensed lending institution. If State law permits a higher interest rate on a specified class of loans, a national bank making such loans at such higher rate is subject only to the provisions of State law relating to such class of loans that are material to the determination of the interest rate. For example, a national bank may lawfully charge the highest rate permitted to be charged by a State-licensed small loan company or morris plan bank, without being licensed.

*Id.* For further discussion of the most favored lender doctrine, see Jeffrey I. Langer & Jeffrey B. Wood, *A Comparison of the Most Favored Lender and Exportation Rights of National Banks, FSLIC-Insured Savings Institutions, and FDIC-Insured State Banks*, 42 CONSUMER FIN. L.Q. REP. 4 (1988).

18. 12 C.F.R. § 7.7310(a) (1992); see *supra* note 17 (text of § 7.7310(a)).

19. See *Tiffany*, 85 U.S. (18 Wall.) at 412.

lender doctrine.<sup>20</sup> The OCC began by noting that provisions of state law setting forth the size or maturity of loans and the classes of borrowers to which a given category of loans may be made are “material to the determination of the rate” and thus would apply to the national bank.<sup>21</sup> The OCC also stated that state laws establishing the manner in which the numerical rate is calculated or affecting the ultimate yield on loan proceeds also are material and therefore applicable to a national bank.<sup>22</sup> With respect to the Texas credit union regulations at issue, the OCC reasoned that the regulations were not “material to the determination of the interest rate”—and therefore not binding on a national bank—because the *purpose* of the regulations was to protect the safety and soundness of Texas credit unions.<sup>23</sup>

The Marsico Letter evidences a novel approach by the OCC towards the most favored lender doctrine. State laws or regulations are not “material to the determination of the interest rate” and therefore are not binding upon a national bank if the objective of the state law or regulation is to protect the safety and soundness of the state-chartered or licensed lending institution, regardless of the law’s or regulation’s impact on the interest yield or the class of loan being made. In order for a national bank to determine whether it must comply with state laws, the national bank therefore must inquire whether the purpose of the provisions is to protect safety and soundness. State provisions that are otherwise material will apply

20. See TEX. ADMIN. CODE ANN. § 91.701 (West 1985). The Texas regulations govern secured and unsecured loans, commercial loans, personal loans, and “member business loans” made by a credit union, and impose limitations regarding security, terms, insurance, aggregate loan limits, and maturity. *Id.*

21. See *Marsico Letter*, *supra* note 15, at 3 (citing *Commissioner of Small Loans v. First Nat’l Bank of Md.*, 300 A.2d 685 (Md. 1973); *Northway Lanes v. Hackley Union Nat’l Bank & Trust Co.*, 464 F.2d 855 (6th Cir. 1972)).

22. See *id.* (citing *American Timber & Trading Co. v. First Nat’l Bank of Or.*, 511 F.2d 980 (9th Cir. 1973), *cert. denied*, 421 U.S. 921 (1975); *Evans v. National Bank of Savannah*, 251 U.S. 108 (1919); *Northway Lanes v. Hackley Union Nat’l Bank & Trust Co.*, 464 F.2d 855 (6th Cir. 1972)).

23. The OCC stated:

You describe the Texas Credit Union Commission’s regulation in question as imposing certain restrictions on state credit unions relating to the aggregate dollar amount of their long-term, fixed rate loans, the maximum permissible maturity of certain loans and a requirement that such loans be amortized at a rate sufficient to ensure repayment within specified maturity limits, and restrictions regarding loan-to-value ratios, insurance, and escrow relating to second-lien mortgage loans. Relying on this description and other information you obtained from the preamble to the regulation and conversations with the Commission’s staff concerning the objectives and purposes of those regulatory provisions, that is, that they are designed merely to address certain safety and soundness concerns regarding the institutions regulated by the Commission, I agree with your determination that those provisions would not be “material to the determination of the interest rate” . . . .

to a national bank only if it is shown that the provisions serve some purpose other than protecting safety and soundness, e.g., providing consumer protection. For example, the Marsico Letter illustrates that while provisions governing loan maturity typically are material and therefore applicable to national banks,<sup>24</sup> the Texas credit union regulations regarding loan maturity were intended to protect the safety and soundness of Texas credit unions and thus were not "material to the determination of the interest rate." The Marsico Letter, therefore, creates a competitive advantage for national banks because it renders inapplicable to national banks certain restrictive state laws and regulations that are binding upon the national banks' state-chartered or licensed competitors.

### **PREEMPTION OF STATE USURY RATES ON RESIDENTIAL FIRST MORTGAGE LOANS: INTERPLAY BETWEEN SECTION 85 AND SECTION 501**

In *Moore v. United National Bank*,<sup>25</sup> the Texas Court of Appeals was faced with a novel argument regarding the interplay of section 85, which provides that a national bank may charge the rate of interest of the state in which it is located,<sup>26</sup> and section 501 of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA),<sup>27</sup> which preempts state laws regulating the rate of interest that may be charged by qualified lenders on loans secured by a first lien on residential real estate.<sup>28</sup> United National Bank, a national bank located in Texas, granted a loan secured by a first mortgage on residential real estate to the appellants. The appellants later brought a usury claim against the bank, contending that the rate charged by the bank exceeded the rate permitted by section 85.

The appellants argued that because the loan was secured by a first mortgage on residential real estate, section 501 acted to preempt any Texas usury rate applicable to the loan. Because no Texas usury rate applied to

24. See, e.g., *Attorney Gen. of Md. v. Equitable Trust Co.*, 450 A.2d 1273, 1293-94 (Md. 1982) (maturity one of factors included as "material"); OCC Interpretive Letter No. 333, [1985-1987 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 85,503 (Mar. 20, 1985).

25. 821 S.W.2d 409 (Tex. Ct. App. 1991).

26. 12 U.S.C. § 85 (1988); see *supra* note 2 for text of § 85.

27. Pub. L. No. 96-221, 94 Stat. 132 (1980) (codified at scattered sections of 12 U.S.C.).

28. Section 501 of the DIDMCA provides in pertinent part:

The provisions of the constitution or the laws of any State expressly limiting the rate or amount of interest, discount points, finance charges, or other charges which may be charged, taken, received, or reserved shall not apply to any loan, mortgage, credit sale, or advance which is—

(A) secured by a first lien on residential real property, . . .

(B) made after March 31, 1980; and

(C) described in section 527(b) of the National Housing Act (12 U.S.C. 1735f-5(b) [a "federally related mortgage loan"]). . . .

12 U.S.C. § 1735f-7a(a)(1) (1988).

the loan, appellants contended that there was no "rate . . . fixed by state law" and that section 85 therefore mandated that the maximum lawful rate on the loan could not exceed the greater of seven percent or one percent over the discount rate.<sup>29</sup>

The court first noted that Texas law provides an unlimited ceiling on loans secured by residential real estate, and therefore, according to *Hiatt v. San Francisco National Bank*,<sup>30</sup> there is indeed a rate fixed by Texas law applicable to first mortgage loans.<sup>31</sup> Nonetheless, the court did not stop there. Instead, the court addressed the appellants' argument that section 501 preempted any applicable Texas law and therefore there was no rate fixed by state law for purposes of section 85.<sup>32</sup>

Acknowledging that the appellants presented "a compelling argument that a literal reading of section 85 would require" that the rate of interest on first mortgage loans be limited to the greater of seven percent or one percent over the discount rate,<sup>33</sup> the court nonetheless concluded that the appellants' argument was inconsistent with one of the purposes behind the DIDMCA (of which the court stated section 85 was a part).<sup>34</sup> The court stated that one of the DIDMCA's purposes "was to make sure federally insured institutions were not at a competitive disadvantage as a result of state usury laws."<sup>35</sup> If the appellants' argument were given effect, Texas-chartered lenders could charge a greater rate of interest on first mortgage loans than could Texas-based national banks because the rate charged by national banks would be limited to the greater of seven percent or one percent over the discount rate.<sup>36</sup> Accordingly, the court concluded that the appellants' construction of sections 85 and 501 was incorrect and that first mortgage loans made by national banks are not subject to the interest rate limitations of section 85.<sup>37</sup>

### **CREDIT CARD LATE FEES/OVERLIMIT FEES SUCCESSFULLY CHALLENGED**

In *Beasley v. Wells Fargo Bank, N.A.*,<sup>38</sup> Wells Fargo Bank lost a \$5 million argument<sup>39</sup> in the California courts that its credit card late fees and ov-

29. See 12 U.S.C. § 85 (1988); see *supra* note 2 for text of § 85.

30. 361 F.2d 504 (9th Cir.), *cert. denied*, 385 U.S. 948 (1966); see also *Daggs v. Phoenix Nat'l Bank*, 177 U.S. 549 (1900).

31. *Moore v. United Nat'l Bank*, 821 S.W.2d 409, 410-11 (Tex. Ct. App. 1991).

32. *Id.*

33. *Id.* at 411.

34. *Id.* at 410-11.

35. *Id.*

36. *Id.*

37. *Id.*

38. 1 Cal. Rptr. 2d 446 (Ct. App. 1991), *review denied*, 1992 Cal. LEXIS 1219 (Cal. Sup. Ct. Mar. 12, 1992).

39. Wells Fargo's total loss actually was closer to \$11 million, as the outcome of a companion case was riding on the outcome of this case, and the fee award was significant as well.

