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RECENT MINNESOTA CASES

Commercial Law—USURY DEFENSE UNAVAILABLE TO GUARANTORS OF CORPORATE LOANS—*Charmoll Fashions, Inc. v. Otto*, ___ Minn. ___, 248 N.W.2d 717 (1976).

In *Charmoll Fashions, Inc. v. Otto*,¹ the Minnesota Supreme Court held that the defense of usury was unavailable to persons signing a corporate note as guarantors. This decision reflects current limitations on the usury defense in Minnesota and suggests questions concerning its future use.

The ancient prohibition against usury² has changed significantly through the ages.³ Today, usury in Minnesota is a purely statutory defense⁴ which, if successfully interposed, will void a contract.⁵ In recent years, the scope of the defense has been narrowed by statutes⁶ which, for example, provide for different rates of interest in consumer transactions,⁷ and by case law which defines the elements of the defense.⁸ The

1. ___ Minn. ___, 248 N.W.2d 717 (1976).

2. The Mosaic law forbade Israelites from charging interest to a fellow Israelite. See *Exodus 22:25*; *Deuteronomy 23:19*. But to a non-Israelite, interest could be charged. See *Deuteronomy 23:20*. See also *Ezekiel 18:5-13* (the penalty for exacting usury was death). See generally Horack, *A Survey of the General Usury Laws*, 8 LAW & CONTEMP. PROB. 36, 36-39 (1941) (showing development of the law of usury).

3. See *Blindman v. Industrial Loan & Thrift Corp.*, 197 Minn. 93, 101, 266 N.W. 455, 458-59 (1936) (Loring, J., dissenting) (describing history of law of usury); Berstein, *Background of a Gray Area in Law: The Checkered Career of Usury*, 51 A.B.A.J. 846 (1965).

4. See MINN. STAT. § 334.03 (1976) (declaring that usurious contracts are void); *id.* § 334.01 (fixing the legal rate of interest at 6% and prohibiting charging more than 8%); *id.* § 334.01(2) (exempting loans of \$100,000 or more from the 8% ceiling but only until July 1, 1978).

5. See MINN. STAT. § 334.03 (1976).

6. See, e.g., MINN. STAT. § 48.153 (1976) (12% annual interest may be charged on installment loans of less than \$25,000); *id.* § 52.14 (1% monthly interest may be charged by credit unions); *id.* § 56.13 (1.25% to 2.75% interest per month may be charged by small loan companies).

7. See MINN. STAT. § 334.16 (1976) (finance charge for open end credit sales limited to 1% per month). Technically, however, the interest charged on the sale of goods cannot be labelled usurious for usury applies only to a loan of money. See *Schauman v. Solmica Midwest, Inc.*, 283 Minn. 437, 439, 168 N.W.2d 667, 669-70 (1969); *Dunn v. Midland Loan Fin. Corp.*, 206 Minn. 550, 553-55, 289 N.W. 411, 413-14 (1939).

8. Usury in Minnesota is defined as "taking or receiving more interest or profit on a loan than the law permits." *Schauman v. Solmica Midwest, Inc.*, 283 Minn. 437, 439, 168 N.W.2d 667, 669 (1969). To conclude that a transaction is usurious, the court must find:

- (a) a loan of money or forbearance of a debt;
- (b) an agreement between the parties that the principal shall be payable absolutely;
- (c) the exaction of a greater amount of interest or profit than is allowed by law; and
- (d) the presence of an intention to evade the law at the inception of the transaction.

Id. at 439, 168 N.W.2d at 669-70. Thus, in *Schauman*, the fact that the transaction

Charmoll court continued the narrowing of the defense by drawing a fine line between comakers and guarantors of corporate obligations.

In *Charmoll*, a loan was made for the purchase of equipment by a corporation formed by the defendants. The plaintiffs had sold the equipment to the corporation, taking its note with ten percent interest. The defendants had signed this note on behalf of the corporation, but also signed a separate agreement, designated a "guarantee" clause, which read in part:⁹

The undersigned shall jointly and severally be bound upon this guarantee to the holder . . . as if the obligation of the [corporate] maker . . . were the primary obligation of the [defendants] and the [plaintiff] shall not be required to proceed against the maker . . . prior to proceeding to collect under this guarantee, but may proceed directly against the [defendants]

Upon default by the corporation, the plaintiffs sought to hold the defendants liable on the guaranty. The defendants asserted the usury defense, claiming the corporate-loan exception to the eight-percent usury law¹⁰ was inapplicable because the term "primary obligation" in the guarantee clause rendered them comakers of the corporate loan. The defense would void the contract.¹¹ The plaintiffs, however, claimed the defendants were guarantors of the note, precluding them from interposing the defense because in Minnesota, the defense may not be used if the guarantors are obligated under a corporate note.¹² The loan would then be valid and the defendants obligated to pay.

The trial court concluded that the defendants were primarily obligated under the note, and thus not guarantors but comakers. The supreme court disagreed, relying heavily upon its decision in *Dahmes v. Industrial Credit Co.*¹³ In *Dahmes*, the situation was not dissimilar to the situation in *Charmoll*; a corporation made a note which was guaranteed by persons interested in the corporation. However, the interested

involved a sale of property on credit did not make the transaction illegal because a seller may charge one price for cash and another for credit, although the difference between the prices would, if charged as interest, be usurious. *Id.* at 443-44, 168 N.W.2d at 672. *But cf.* MINN. STAT. § 334.16 (1976) (open-end credit finance charge may not exceed 1% per month).

9. — Minn. at —, 248 N.W.2d at 718.

10. *See* MINN. STAT. §§ 334.01(1), .021 (1976).

11. *See* *Seebold v. Eustermann*, 216 Minn. 566, 574, 13 N.W.2d 739, 744 (1944); MINN. STAT. § 334.03 (1976). The usury defense will not be available, however, if the loan is for more than \$100,000, *see id.* § 334.01(2) (expires July 1, 1978); if the transaction is disguised as a corporate debt in order to avoid the usury law, *see, e.g.,* *Gelber v. Kugel's Tavern, Inc.*, 10 N.J. 191, 196, 89 A.2d 654, 656 (1952); or if the borrower has prior knowledge of the usurious character of the loan. *See* *Nelson v. Dorr*, 239 Minn. 423, 433, 58 N.W.2d 876, 882 (1953).

12. *See* *Dahmes v. Industrial Credit Co.*, 261 Minn. 26, 31, 110 N.W.2d 484, 488 (1961).

13. 261 Minn. 26, 110 N.W.2d 484 (1961), *noted in* 47 MINN. L. REV. 266 (1962).

persons, the plaintiffs in *Dahmes*, had given personal notes and mortgages on their homestead to secure the corporate obligation which provided for twenty percent interest. When the corporation defaulted, the lender sought to foreclose on the mortgages and to collect the notes. The plaintiffs, successfully interposing the defense at the trial level, were held liable on appeal. The “direct and unconditional” obligation which the personal notes and mortgages provided for, the court said, did not refer to the obligation on the corporate note.¹⁴ Rather, it referred to the type of guaranty the plaintiffs had undertaken. The “direct and unconditional” liability meant only that the guaranty was absolute. Thus, the plaintiffs, having guaranteed the corporate obligation, could not use the defense of usury because “if an excessive interest rate does not render the principal obligation illegal, it should likewise not affect the undertaking of the guarantor”¹⁵

The *Charmoll* court noted that although the corporate note and the guaranty were in one document, the two agreements were separately stated with signatures affixed to each.¹⁶ The fact that the two were simultaneously executed did not change the effect of the agreements.¹⁷ Use of the term “primary obligation” in the guaranty clause referred to the fact that after default by the corporation, the holder of the note could sue the guarantor without first having to sue the principal obligor.¹⁸ According to the court, this clause defined a guaranty which was absolute rather than conditional.¹⁹ The *Dahmes* court distinguished the two types of guaranties by stating:²⁰

A contract of guaranty may be either conditional or absolute. If the guaranty is absolute, the obligor becomes liable merely upon the failure of performance by the debtor. A conditional guarantor, on the other hand, is liable only upon the happening of the stated contingency, such as, for example, suit against the principal debtor, exhaustion of security, or the like.

In Minnesota, in the absence of language to the contrary, a guaranty is considered absolute.²¹ Because the *Charmoll* guaranty contained no limiting language, it was construed to be absolute.

14. 261 Minn. at 33-34, 110 N.W.2d at 488-89.

15. *Id.* at 31-32, 110 N.W.2d at 488.

16. ___ Minn. at ___, 248 N.W.2d at 719.

17. *Id.* (by implication).

18. *Id.* at ___, 248 N.W.2d at 720.

19. *Id.*

20. 261 Minn. at 33, 110 N.W.2d at 488-89 (footnotes omitted). See *Holbert v. Wermerskirchen*, 210 Minn. 119, 121, 297 N.W. 327, 328 (1941); cf. MINN. STAT. § 336.3-416 (1976) (defining contract of guarantor on a negotiable instrument). For examples of the two types of guaranties, compare *Northwestern Nat'l Bank v. Foster*, 196 Minn. 96, 264 N.W. 570 (1936) with *State Bank v. Lauterbach*, 198 Minn. 98, 268 N.W. 918 (1936).

21. See *Dahmes v. Industrial Credit Co.*, 261 Minn. 26, 33, 110 N.W.2d 484, 489 (1961); *Holbert v. Wermerskirchen*, 210 Minn. 119, 121, 297 N.W. 327, 328 (1941).

The defendants also argued that an acceleration clause in the note made them comakers because it made the loan payable in full upon the death or incapacity of one of the defendants, which suggested that the loan was made personally to her. According to some authority,²² the transaction might not be enforced if it is a personal transaction disguised as a corporate one to avoid the usury law. The court found no evidence to support this argument, however, saying that the acceleration clause merely suggested that the defendant was a key figure whose death or disability would affect the success of the corporation to such a degree that the holder would deem itself insecure if she were unable to direct the business. No liability on the guaranty, however, would be created by the acceleration clause until the corporation defaulted on the note.²³

The decision raises a question which should, perhaps, be answered by the legislature: Should comakers as well as guarantors of a corporate loan be denied the defense of usury? The denial of the usury defense to corporations stems from statutes which "in effect [repeal] usury laws insofar as loans to corporations are concerned."²⁴ These statutes, which are in force in many states,²⁵ have been held constitutional.²⁶ The rationale behind the policy includes an assumed equality in bargaining power between corporations and lenders,²⁷ the limited liability of corporate

22. See, e.g., *Gelber v. Kugel's Tavern, Inc.*, 10 N.J. 191, 196, 89 A.2d 654, 656 (1952); *Walnut Discount Co. v. Weiss*, 205 Pa. Super. Ct. 161, 165, 208 A.2d 26, 27 (1965). See generally Note, *Incorporation to Avoid the Usury Laws*, 68 COLUM. L. REV. 1390 (1968).

23. — Minn. at —, 248 N.W.2d at 721. However, the court indicated that this defense is available only to the party who was the subject of the provision; it may not be asserted by a fellow guarantor.

The court noted that the plaintiff may have engaged in conduct which may have supported a claim of tortious interference with business. See generally *Johnson v. Gustafson*, 201 Minn. 629, 277 N.W. 252 (1938). This claim, which was not asserted by the defendants on appeal, was founded on the fact that when defendants negotiated for the sale of the corporation, plaintiff insisted that it would hold one of the defendants personally liable on the note should the negotiations result in a sale. This assertion, the court indicated, was not justified by the terms of the note. However, the court expressed no opinion on the merits of the claim, saying "such activities do not change our usury law or the language in the note . . ." — Minn. at —, 248 N.W.2d at 722.

24. *Bichel Optical Labs., Inc. v. Marquette Nat'l Bank*, 336 F. Supp. 1368, 1370 (D. Minn. 1971), *aff'd*, 487 F.2d 906 (8th Cir. 1973).

25. See, e.g., DEL. CODE ANN. tit. 6, § 2306 (1975); N.Y. GEN. OBLIG. LAW § 5-521(1) (McKinney 1964).

26. See, e.g., *759 Riverside Ave., Inc. v. Marvin*, 109 Fla. 473, 475, 147 So. 848, 849-50 (1933); *Tennant v. Joerns*, 329 Ill. 34, 40, 160 N.E. 160, 162 (1928) (per curiam); *Country Motors, Inc. v. Friendly Fin. Corp.*, 13 Wis. 2d 475, 478, 109 N.W.2d 137, 142 (1961).

27. See, e.g., *Country Motors, Inc. v. Friendly Fin. Corp.*, 13 Wis. 2d 475, 478, 109 N.W.2d 137, 142 (1961); Krause, *The Treatment of Usury in Bankruptcy Proceedings*, 29 N.Y.U.L. REV. 1082, 1096 (1954); Note, *Usury in the Conflict of Law: The Doctrine of the Lex Debitoris*, 55 CAL. L. REV. 123, 206 (1967). But see N.Y. GEN. OBLIG. LAW § 5-521(2) (McKinney 1964) (corporations whose principal assets are one- or two-family dwellings

stockholders,²⁸ and the promotion of commercial interests.²⁹ It has also been suggested that high-risk corporate loans for new ventures would be commercially impractical to finance at the low interest rates required by the usury statutes.³⁰

Guarantors of corporate loans are, like the corporation, precluded from asserting the usury defense.³¹ The guarantor's obligation is measured by that of the corporation, the principal obligor.³² If a defense is unavailable to the principal obligor, it is also unavailable to the guarantor.³³ This is analogous to situations in which the assignee of a contract stands "in the shoes of the assignor," and cannot assert any defense which the assignor could not.³⁴ A comaker, as distinguished from a guarantor, may assert the usury defense.³⁵ The distinction is drawn on the basis of the comaker's obligation.³⁶ Because the comaker has assumed an independent obligation, the argument goes, his rights should not be limited to those of the corporate maker.³⁷

This distinction, however, may be improperly drawn. Because both a comaker and a guarantor have assumed a personal obligation to pay the debts of the corporation, both should be fully informed about corporate finances.³⁸ Indeed, in theory, the comaker, who may find his liability discharged by a successful assertion of the usury defense, has assumed a greater obligation than the guarantor. A comaker is primarily liable on the loan,³⁹ but a guarantor is secondarily liable because his liability

may assert usury defense if corporation was organized within six months prior to execution of note and if note is secured by mortgage on the dwellings).

28. See Krause, *supra* note 27, at 1096 n.64; Note, *supra* note 27, at 209.

29. See Krause, *supra* note 27, at 1096-97; Note, *Usury Laws and the Corporate Exception*, 23 MD. L. REV. 51, 55 (1963).

30. See Krause, *supra* note 27, at 1097 n.67.

31. See, e.g., *Charmoll Fashions, Inc. v. Otto*, ___ Minn. ___, ___, 248 N.W.2d 717, 719 (1976); *Dahmes v. Industrial Credit Co.*, 261 Minn. 26, 31, 110 N.W.2d 484, 488 (1961).

32. See *Dahmes v. Industrial Credit Co.*, 261 Minn. 26, 34, 110 N.W.2d 484, 489 (1961).

33. See *id.*

34. See *Sorenson v. Greysolon Co.*, 170 Minn. 259, 263, 212 N.W. 457, 458 (1927); *Frye v. Metropolitan Music Co.*, 96 Minn. 535, 104 N.W. 1149 (1905) (per curiam). See generally J. CALAMARI & J. PERILLO, *THE LAW OF CONTRACTS* § 269 (1970).

35. See *Twin City Co-op Credit Union v. Bartlett*, 266 Minn. 366, 369, 123 N.W.2d 675, 677 (1963); *Dahmes v. Industrial Credit Co.*, 261 Minn. 26, 36, 110 N.W.2d 484, 490 (1961) (Gallagher, J., dissenting).

36. See *Twin City Co-op Credit Union v. Bartlett*, 266 Minn. 366, 369, 123 N.W.2d 675, 677 (1963) (by implication); *Dahmes v. Industrial Credit Co.*, 261 Minn. 26, 34, 110 N.W.2d 484, 489 (1961).

37. See *Dahmes v. Industrial Credit Co.*, 261 Minn. 26, 36, 110 N.W.2d 484, 490 (1961) (Gallagher, J., dissenting).

38. See Note, *supra* note 27, at 214.

39. See, e.g., *Twin City Co-op Credit Union v. Bartlett*, 266 Minn. 366, 369, 123 N.W.2d 675, 677 (1963); *Dahmes v. Industrial Credit Co.*, 261 Minn. 26, 36-37, 110 N.W.2d 484, 490-91 (1961) (Gallagher, J., dissenting).

does not arise until after the corporation has defaulted.⁴⁰ As a practical matter, it is not until after default that either a guarantor or a comaker will be called upon to pay.⁴¹ It follows from this that if a lender is looking for security from an individual when a loan is made for corporate purposes, all the lender has to do is require the individual to guarantee the loan before advancing any money. Only when the loan is made at less than usurious rates of interest would a lender consider having the individual sign as a comaker.

Allowing a comaker to assert the defense in an action to enforce a corporate loan would only serve to thwart the underlying purpose of the usury statute: to protect individuals from overreaching by lenders.⁴² The proper place to draw the line between permitting the usury defense and requiring payment at usurious interest is not at a stage where the lender can control the result. Rather, the purpose of the loan should determine the applicability of the usury defense.⁴³ People organizing a business or involved in business have access to advice which will aid them in their decision whether or not to take the loan.⁴⁴ People arranging for a personal loan ordinarily do not seek out legal or financial advice and rely instead on the advice of the lender.⁴⁵ It is for the protection of the latter group of people that the usury defense was enacted.⁴⁶ Thus, the defense of usury should be reserved for the benefit of individual borrowers only when the loan is made for personal, not commercial, purposes.

In *Charmoll*, it was the nature of the defendants' obligation which dictated the result, not the nature of the loan. The tenuous distinction between a guarantor and a comaker was the basis of the decision to deny the benefit of the usury defense to the defendants. A more coherent public policy, drawing the distinction between business and personal loans, is called for in order that the usury defense be permitted only to effectuate its underlying purpose. Because legislation concerning usury has so far been fluid and responsive to social change, perhaps further legislative action is needed to reflect this more coherent policy.

40. See *Dahmes v. Industrial Credit Co.*, 261 Minn. 26, 34, 110 N.W.2d 484, 489 (1961).

41. Cf. U.C.C. § 3-416, Comment (if an indorser guarantees payment of a negotiable instrument, his liability "becomes indistinguishable from that of a co-maker"). Compare *Twin City Co-op Credit Union v. Bartlett*, 266 Minn. 366, 123 N.W.2d 675 (1963) with *Charmoll Fashions, Inc. v. Otto*, ___ Minn. ___, 248 N.W.2d 717 (1976).

42. See Note, *supra* note 27, at 136-37. But see *Shanks, Practical Problems in the Application of Archaic Usury Statutes*, 53 VA. L. REV. 327, 329-30 (1967).

43. See Note, *supra* note 22, at 1408-10. See also *Shanks, supra* note 42, at 347-50.

44. See Note, *supra* note 27, at 214.

45. See generally *Nugent, The Loan-Shark Problem*, 8 LAW & CONTEMP. PROB. 3 (1941). See also Note, *supra* note 27, at 136-37, 206.

46. See *Adjustment Serv. Bureau, Inc. v. Buelow*, 196 Minn. 563, 567, 265 N.W. 659, 661 (1936).