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Inflation and Indexing--Usury in Commercial Loans: Aztec Properties, Inc. v. Union Planters National Bank

Mildred B. Dodson

INFLATION AND INDEXING— USURY IN COMMERCIAL LOANS: *AZTEC PROPERTIES, INC. v. UNION PLANTERS NATIONAL BANK*

Aztec Properties, Inc. negotiated a $50,000 loan from Union Planters National Bank at the Tennessee statutory maximum 10 percent interest rate.[1] The promissory note called for the loan principal to be adjusted for inflation (deflation) according to a formula based on the consumer price index.[2] A written waiver of the defense of usury was executed at the signing of the note by the promisor corporation. On maturity of the note Aztec Properties repaid the $50,000 plus interest but refused to pay the "indexed principal" of $500, claiming a usury defense. The bank sued for the $500 plus interest from maturity and chancery court granted summary judgment for the bank. On appeal, the Tennesee Supreme Court reversed the lower court releasing Aztec Properties from any obligation to pay the "indexed principal." The court held that the indexing device was usurious interest exceeding the constitutional rate and that, apart from the usury question, indexing the principal of a debt is improper for contravention of the national currency policy.[3]

Because of the novelty of this attempt at circumvention of the usury law, there was no case law directly on point. The plaintiff bank argued that the indexed principal was the difference in value between the principal lent and returned rather than being extra compensation. The court concluded that an intentional increase in the face value of the loan was usurious interest because interest includes *all* compensation for the use of money. "Any payment to the lender in addition to the rate of

1. TENN. CONST. art. 11, § 7; TENN. CODE ANN. § 47-14-104 (Supp. 1975).

2. The text of the indexing clause read:

"Amount of principal due shall equal the amount of original principal multiplied by the consumer price index adjustment factor. This adjustment factor shall be computed by dividing the consumer price index at maturity by the consumer price index on date of borrowing. Said consumer price index numbers shall be for the most recent month available preceding borrowing and maturity dates. This consumer price index shall be the index not seasonably adjusted for all items as reported by the United States Department of Labor."

Aztec Properties, Inc. v. Union Planters Nat'l Bank, 530 S.W.2d 756, 757 (Tenn. 1975).

3. *Id.* at 760-61.

interest legally permissible, whether called . . . *by any other name*, is usurious."[4] The lender has traditionally borne the risk of inflation and interest compensates him for this risk, the court explained.[5]

Waiver of the defense was immaterial to the court since consent of the one paying the usurious interest is irrelevant in Tennesee.[6] Nor did the fact of incorporation deprive the appellant of the defense, as is the case in other states.[7] Answering the bank's assertion that corporations have the power granted legislatively "to borrow money at such rates of interest as the corporation may determine,"[8] the court held that the legislature has no power to grant any rate but a uniform and equal rate applicable to all and not exceeding 10 percent because of constitutional mandate.[9]

Indexing is a legitimate business concept which the court approved for such uses as lease agreements, employment contracts and collective bargaining.[10] Relying heavily on the United States Joint Congressional "Gold Clause" Resolution of 1933,[11] however, the court concluded that indexing the principal of a loan violates the national policy of debt repayment "dollar for dollar" in legal tender.[12] Quoting the United States Supreme Court in *Guaranty Trust Co. v. Henwood*,[13] the court found

> "illegality upon both outstanding and future contractual provisions designed to require payment by debtors in a frozen money value rather than in a dollar of legal tender current at date of payment . . . ."[14]

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4. 2 RESTATEMENT OF CONTRACTS § 526 (1932), *as quoted in* Aztec Properties, Inc. v. Union Planters Nat'l Bank, 530 S.W.2d 756, 757 (Tenn. 1975) (emphasis added by court).

5. 530 S.W.2d at 759.

6. Providence A.M.E. Church v. Sauer, 45 Tenn. App. 287, 323 S.W.2d 6 (1958), *cited in* Aztec Properties, Inc. v. Union Planters Nat'l Bank, 530 S.W.2d 756, 760 (Tenn. 1975).

7. *See* Shanks, *Practical Problems in the Application of Archaic Usury Statutes*, 53 VA. L. REV. 327, 346 *et seq.* (1967), *cited in* Aztec Properties, Inc. v. Union Planters Nat'l Bank, 530 S.W.2d 756, 760 (Tenn. 1975).

8. TENN. CODE ANN. § 48-402(g) (Supp. 1975).

9. TENN. CONST. art. 11, § 7; McKinney v. Memphis Overton Hotel Co., 59 Tenn. 104 (1873), *cited in* Aztec Properties, Inc. v. Union Planters Nat'l Bank, 530 S.W.2d 756, 760 (Tenn. 1975).

10. 530 S.W.2d at 761.

11. H.R.J. Res. 192, ch. 48, 48 Stat. 112 (1933). *See* 31 U.S.C. § 463 (1970).

12. 31 U.S.C. § 463(a) (1970), *quoted in* Aztec Properties, Inc. v. Union Planters Nat'l Bank, 530 S.W.2d 756, 760 (Tenn. 1975).

13. 307 U.S. 247 (1938).

14. 530 S.W.2d at 760, *quoting from* Guaranty Trust Co. v. Henwood, 307 U.S. 247, 252-53 (1938).

Thus, indexing the principal of a loan so that the number of dollars to be repaid varies from the number of dollars loaned was held to violate federal law.

MONEY MARKET PRICE IGNORES USURY RATE

Aztec Properties portrays the dichotomy between the moral and economic aspects of usury laws.[15] The framers of the Tennessee constitution felt it was, perhaps, immoral to charge a borrower more than 10 percent interest.[16] The court speaks of "protection" regarding the usury statute. Legal scholars, on the other hand, urge legislatures to view usury in its economic setting so that the mischief it does can be perceived correctly.[17] Ryan, in his treatise *Usury and Usury Laws*, illustrates that moral usury (exacting of unreasonably high interest by taking advantage of the borrower) cannot be prevented by statutory maximum usury laws.[18] Usury laws "were enacted in ignorance of the economic laws of interest and without taking the trouble to study lenders' costs."[19]

"There is a marked difference between the making of a large commercial or investment loan and a small loan to an industrial worker," Ryan points out.[20] The price of money in commercial transactions is fixed nationally. There is less need for protection of commercial borrowers because they tend to be more sophisticated,[21] and commercial borrowers can often avoid personal liability when individuals cannot.[22] These differences are not reflected in the Tennessee constitution and cases interpreting it; the interest rate is required to be equal for all.[23] Ironically, an industrial worker in Tennessee may pay 18 percent annual

15. *See* F. RYAN, USURY AND USURY LAWS 8-20 (1924); Benfield, *Money, Mortgages and Migraine—The Usury Headache*, 19 CASE W. RES. L. REV. 819, 831-33 (1968); Shanks, *Practical Problems in the Application of Archaic Usury Statutes*, 53 VA. L. REV. 327, 328-29 (1967); Note, *Usury—An Analysis of Usury Legislation and the Mississippi Corporate Exception Statute*, 38 MISS. L.J. 347, 351-52 (1967).

16. Shanks, *Practical Problems in the Application of Archaic Usury Statutes*, 53 VA. L. REV. 327, 328 (1967). Shanks traces the religious history of the American usury statutes: "They were based on the assumption that there was a fair and just price for the use of money and on the belief that this price could be fixed once and for all time—essentially a theological task." *Id.* at 328.

17. *See* note 15 *supra*.

18. F. RYAN, USURY AND USURY LAWS (1924).

19. *Id.* at 10.

20. *Id.* at 8.

21. Loiseaux, *Some Usury Problems in Commercial Lending*, 49 TEX. L. REV. 419, 443 (1971).

22. *See* Shanks, *Practical Problems in the Application of Archaic Usury Statutes*, 53 VA. L. REV. 327, 348-49 (1967).

23. TENN. CONST. art. 11, § 7; McKinney v. Memphis Overton Hotel Co., 59 Tenn. 104 (1873); Hazen v. Union Bank, 33 Tenn. 115 (1853).

interest on his credit purchase,[24] but Aztec Properties may not pay over 10 percent for a $50,000 loan.

States surrounding Tennessee recognize the differing needs and ability to pay of business borrowers. These states offer a higher interest rate to lenders than does Tennessee and thus siphon away Tennessee funds.[25] Business borrowers with credit outside the state find a source of capital there when the market rate is above Tennessee's 10 percent limit.[26] Those without outside credit may be forced to participate in one of the many subterfuges to avoid the usury law such as fees, penalties, compensating balances, etc.[27] to compensate the lender for his alternative use costs.[28] These devices have the twofold result of promoting disrespect for the law and raising the cost of money to the borrower.[29] The borrower who needs funds will find them and will pay at least the market price, regardless of the usury ceiling.

A committee of the Tennessee General Assembly in 1859 that the state usury law was then "defeating its own object" by driving money out of the state where it could earn more money.[30] In 1974 Congress recognized the severity of the restriction on commerce caused by usury laws in the states of Tennessee, Arkansas and Montana.[31] Passage of a three-year increase in the interest rate ceiling followed testimony by bankers that loans "are becoming unavailable, liquidity of financial institutions is adversely affected, small borrowers are disadvantaged with competing with national corporations and there is an outflow of funds from the states."[32] This legislation took effect after the

24. Dennis v. Sears, Roebuck & Co., 223 Tenn. 415, 446 S.W.2d 260 (Tenn. 1969). This exception applies to the time-price differential, applicable to sales but not to consumer loans.

25. Alabama, Georgia, Kentucky, Mississippi, Missouri and North Carolina all offer a higher rate to corporate lenders than does Tennessee and all either prohibit the corporate usury defense or make it subject to the corporate rate. 1 CCH CONSUMER CREDIT GUIDE ¶ 510 (1976).

26. *See* Shanks, *Practical Problems in the Application of Archaic Usury Statutes*, 53 VA. L. REV. 327, 329 (1967).

27. *See generally* Benfield, *Money, Mortgages and Migraine—The Usury Headache*, 19 CASE W. RES. L. REV. 819 (1968); Loiseaux, *Some Usury Problems in Commercial Lending*, 49 TEX. L. REV. 419 (1971); Shanks, *Practical Problems in the Application of Archaic Usury Statutes*, 53 VA. L. REV. 327 (1967).

28. Alternative use costs compensate the lender for the profit he could make investing his funds elsewhere. *See generally* McManus, *Variable Mortgage Note: Route to Increased Housing*, 55 A.B.A.J. 557 (1969).

29. Shanks, *Practical Problems in the Application of Archaic Usury Statutes*, 53 VA. L. REV. 327, 330 (1967).

30. F. RYAN, USURY AND USURY LAWS, Append. D (1924).

31. Act of Oct. 29, 1974, Pub. L. No. 93-501, 88 Stat. 1557, *as cited in* 1 U.S. CODE CONG. & AD. NEWS 1793 (1974).

32. 3 U.S. CODE CONG. & AD. NEWS 6259, 6261-62 (1974).

note in Aztec Properties was signed and may be superseded by state law at any time at the state's option.[33]

LEGISLATIVE ALTERNATIVES

The Tennessee Supreme Court, by terming the indexed principal additional interest, refused to give relief to the lender who was trapped between the usury ceiling and a higher market rate. It reaffirmed the rigidity of the Tennessee constitution. Now, the only possible relief is a constitutional amendment such as Oklahoma passed in 1968.[34] If an amendment were passed, supplemental laws would be necessary in Tennessee to distinguish between classes of borrowers and amounts borrowed. Four distinct alternatives exist.

The first alternative is to except corporations from the defense of usury as twenty-six states have done,[35] but the better view is to include noncorporate partnerships and associations as well as businesses in general so as to broaden the opportunities of all commercial borrowers.[36] A variation of the corporate exception is to raise the corporate ceiling above the legal and contract rate, as nine states have done, and allow a corporate usury defense subject to this rate.[37] The advantage of the corporate exception is to open sources of capital to the commercial borrower while continuing to regulate loans to individuals. The major disadvantage of this method is that some persons can be forced to incorporate to get the higher rate.[38]

A second alternative is the enactment of the Uniform Consumer Credit Code (UCCC).[39] The UCCC produces uniformity and protection of borrowers of amounts up to $25,000. Above $25,000 there is

33. *Id.* at 6261.

34. OKLA. CONST. art. 14, § 2 provides for classification of loans and lenders and gives the legislature the authority to fix maximum rates of interest by specific legislation, but in the absence of specific legislation 10 percent is the maximum contract rate.

35. 1 CCH CONSUMER CREDIT GUIDE ¶ 510 (1976). The states, including Puerto Rico and the District of Columbia are Delaware, Georgia, Hawaii, Illinois, Iowa, Kansas, Kentucky, Louisiana, Maryland, Michigan, Minnesota, Missouri, New Jersey, New Mexico, New York, Ohio, Oklahoma, Pennsylvania, South Carolina, South Dakota, Virginia, Washington, West Virginia and Wisconsin.

36. 1 CCH CONSUMER CREDIT GUIDE ¶ 510 (1976). Maryland, Michigan, Missouri, North Dakota and Vermont embrace "businesses" as well as corporations within the exception.

37. 1 CCH CONSUMER CREDIT GUDIE ¶ 510 (1976). Alabama, Arizona, Connecticut, Florida, Idaho, Mississippi, North Carolina, Oregon and Texas use this variation.

38. Note, *Stemming Abuses of Corporate Exemptions from the Usury Laws: A Legislative and Judicial Analysis*, 59 IOWA L. REV. 91, 93 (1973).

39. *See* Benfield, *Money, Mortgages and Migraine—The Usury Headache*, 19 CASE W. RES. L. REV. 819 (1968).

no ceiling on loans and all borrowers are free of restrictions.[40] The United States District Court for the Western District of Oklahoma, in *Stricklin v. Investors Syndicate Life Insurance & Annuity Co.*, held that the UCCC cannot be invoked by the large-scale commercial borrower since the Code applies only to consumer credit transactions up to $25,000.[41] Presumably then, in view of *Stricklin* the UCCC must be supplemented by other specific legislation to remove the ceiling in large commercial loans. Oklahoma has provided for such specific supplemental legislation.[42]

A third alternative is the English system whereby a loan with interest in excess of 48 percent is presumed excessive unless proved otherwise.[43] The English courts have the power to reopen any loan transaction in order to reduce the rate if the charge is found to be harsh and unconscionable. This system has the advantage of allowing the market rate and judgment of the parties to control yet sanctioning the overreaching party.[44] English courts are free to assess attorneys' fees as well as costs. Therefore, the borrower's threat of suit carries weight.[45] The English system assures that high-risk capital is available from licensed, regulated lenders so that loan sharking is unnecessary.[46] It has the further advantages of avoiding (1) a hodgepodge of classification laws, (2) a plethora of judicial exceptions and (3) private circumvention.[47] A variant, adding more certainty to loan transactions, is the enactment of a reasonable interest ceiling with the provision that violations are only prima facie usurious and that equity will determine if there has been overreaching.[48] The English system and the other three alternatives operate most efficiently with a comprehensive definition of interest which includes points, premiums, fees and all other subterfuges.[49]

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40. *Id.*

41. Stricklin v. Investors Syndicate Life Ins. & Annuity Co., 391 F. Supp. 246 (W.D. Okla. 1975).

42. There is no corporate rate ceiling in Oklahoma but the defense of usury is not available to a corporation. OKLA. STAT. tit. 18, § 1.26 (1971); 4 CCH CONSUMER CREDIT GUIDE (OKLA.) ¶ 4178 (1976).

43. Moneylenders Act of 1927, 17 & 18 Geo. 5, c. 21.

44. *See* Note, *An Ounce of Discretion for a Pound of Flesh: A Suggested Reform for Usury Laws*, 65 YALE L.J. 105 (1955).

45. *Id.* at 110.

46. Meth, *A Contemporary Crisis: The Problem of Usury in the United States*, 44 A.B.A.J. 637, 638-40 (1958).

47. *Id.* at 639-40.

48. *Id.* at 640.

49. *See* Loiseaux, *Some Usury Problems in Commercial Lending*, 49 TEX. L. REV. 419, 443 (1971). Professor Loiseaux recommended a statute similar to PA. STAT. ANN.

An innovative fourth alternative is the variable interest rate tied to a reliable index.[50] A high usury ceiling or none at all is necessary for this alternative method to function. This system allows the interest rate to fluctuate with the money market and has met with some acceptance in residential real estate transactions.[51] It has the advantages of profitability to the lender and assurance of a supply of capital to meet borrower demand. However, it has the disadvantages of uncertainty to the borrower, doubtful negotiability under the Uniform Commercial Code[52] and improper notice under the Truth in Lending Act.[53] Commentators have suggested methods of avoiding each of these problems.[54]

INDEXING AS A STABILIZER

The indexing concept was the heart of the Aztec Properties case. The court's decision that principal indexing is violative of federal law was dictum, since it was not necessary to the court's resolution of the case, and further, it may be harmful to the general concept of indexing as a method of buying power stabilization. Did Congress intend in 1933 to set down the maxim that every debt must henceforth be repaid with the identical number of dollars of principal borrowed?[55] The Congressional Record and cases interpreting the Gold Clause Resolution of 1933 are persuasive authority for a different conclusion. The purpose of the Resolution was to insure that there was "only one currency"[56] the value of which was to be controlled by Congress, and not by the international value of gold.[57] In that historical setting, contracts and

tit. 41, § 3 (Supp. 1975-76): "[S]uch interest rate . . . shall include the total amortized cost of such loan, including any points, premiums, finders fees or other charges levied directly or indirectly against the person obtaining the loan . . . ."

50. Comment, *The Variable Interest Note: An Answer to Uncertainty in a Fluctuating Money Market*, 1971 LAW & SOCIAL ORDER 600; Comment, *The Variable Interest Rate Clause and Its Use in California Real Estate Transactions*, 19 U.C.L.A.L. REV. 468 (1972); Comment, *Adjustable Interest Rates in Home Mortgages: A Reconsideration*, 1975 WIS. L. REV. 742.

51. *See* Comment, *Adjustable Interest Rates in Home Mortgages: A Reconsideration*, 1975 WISC. L. REV. 742, 747.

52. UNIFORM COMMERCIAL CODE § 3-104(1)(b) requires a promise or order to pay a *sum certain* in money (emphasis added).

53. 15 U.S.C. §§ 1601-81t (1970), *as amended*, (Supp. IV, 1974), *cited in* Comment, *The Variable Interest Note: An Answer to Uncertainty in a Fluctuating Money Market*, 1971 LAW & SOCIAL ORDER 600, 608 (1971). The purpose of the Act is to require lender disclosure, which notice is difficult to give with a varying interest rate.

54. *E.g.*, Comment, *The Variable Interest Note: An Answer to Uncertainty in a Fluctuating Money Market*, 1971 LAW & SOCIAL ORDER 600.

55. Gold Clause Resolution of 1933, H.R.J. Res. 192, ch. 48, 48 Stat. 112. *See* 31 U.S.C. § 463 (1970).

56. H.R.J. Res. 192, 73rd Cong., 1st Sess., 77 CONG. REC. 4889, 4890 (1933).

57. *Id.* at 4900.

bonds calling for alternative payment in gold were causing $1.69 of currency to be repaid for $1.00 of gold.[58] Gold was being hoarded and leaving the country in great quantities.[59] The emergency was national bankruptcy; it was a crisis of gold value versus dollar value.[60] *Guaranty Trust*, relied on by the court, is largely irrelevant to indexing as a stabilization tool because the case referred only to provisions requiring "payment in (1) gold; (2) a *particular kind of coin or currency* of the United States; or (3) in an amount of United States money measured by gold or a *particular kind of United States coin or currency*."[61] *Guaranty Trust* referred to a "frozen money value"[62] whereas an index clause fluctuates continually with changes in the prices of commodities and services.[63] Gold clauses attempted to stabilize the underlying value of currency; index clauses merely seek to stabilize the buying power of currency.[64]

Commentators believe the Gold Clause Resolution was not intended to affect obligations including index clauses.[65] They argue that the prerogative of the government to control the value of currency remains intact with index clauses.[66] Without the Gold Clause Resolution argument there is little impediment to the future use of index clauses, as applied to either principal or interest. Indexing remains a viable alternative to the crippling statutory maximum interest rate, assuming public education and acceptance occur.[67]

CONCLUSION

The effects of the *Aztec Properties* case are devastating upon the Tennessee businessman. Federal legislation is a temporary solution, but

58. Norman v. B. & O. R.R., 294 U.S. 240, 315-16 (1935).

59. *Id.* at 312.

60. H.R.J. Res. 192, 73rd Cong., 1st Sess., 77 CONG. REC. 4889, 4908 (1933). $6½ billion of bonded indebtedness of the United States, payable alternately in gold, was about to become due and there were only $4 billion in the treasury to meet these debts.

61. 307 U.S. at 252 (emphasis added). "Particular kind of currency" included Federal Reserve notes and circulating notes of Federal Reserve banks and national banking associations except gold coins below the standard of weight provided by law. H.R.J. Res. 192, ch. 48, § 2, 48 Stat. 113 (1933).

62. 307 U.S. at 252.

63. *See* Hirschberg, *Index Value Clauses*, 88 BANKING L.J. 867, 871 (1971); McManus, *Variable Mortgage Note: Route to Increased Housing*, 55 A.B.A.J. 557, 560 (1969).

64. *See* Dawson, *The Gold Clause Decisions*, 33 MICH. L. REV. 647, 683-84 (1935).

65. Dawson, *The Gold Clause Decisions*, 33 MICH. L. REV. 647, 683 (1935); Hirschberg, *Index Value Clauses*, 88 BANKING L.J. 867, 871 (1971).

66. Hirschberg, *Index Value Clauses*, 88 BANKING L.J. 867, 871 (1971).

67. Nebolsine, *The Gold Clause in Private Contracts*, 42 YALE L.J. 1051, 1095 (1933).

eventually the people of Tennessee must recognize the needs of commerce by amending their rigid constitutional usury ceiling. They have many alternative directions to select for supportive legislation. Indexing, despite the court's condemnation of it, is one of these viable alternatives. Until the citizens act, other borrowers are free to enter loan transactions, promise to pay the market rate and then later hide behind the "protection" of a usury statute which has, since 1859, defeated its own object by driving money out of the state.[68]

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68. *See* notes 25-29 *supra* and accompanying text.