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TROUBLING STATES OF AFFAIRS: STATE LICENSING AND USURY LAWS AFFECTING EQUIPMENT FINANCE

By Barry S. Marks and Bill Phillips

Unfortunately for equipment finance professionals, the Dodd-Frank Act pushed back a significant amount of federal preemption of state laws. The act likely will result in increased scrutiny of both bank and nonbank lessors by state attorneys and regulators.

MAKING THE CASE FOR AN ENTERPRISE RISK MANAGEMENT PROGRAM

By Steven E. Byrnes, Christine Williams, Samir Kamat, and Suresh Gopalakrishnan

Enterprise risk management has emerged in recent years to offer a proactive, integrated, and holistic view of the capital and earnings risks facing equipment leasing and finance companies. ERM cuts across both business entities and core functions, and it helps companies create value for shareholders, employees, and clients.

THE ECONOMICS FUELING IT CLOUD COMPUTING

By Susan G. Middleton

At its core, the IT cloud revolution signifies a transition to both a new IT business model and a new technology platform. For IT leasing and financing providers, this means transitioning from providing capital to delivering a broader spectrum of end-user services. This report addresses the factors that will drive continued expansion and adoption.

ARTICLE OF THE YEAR FOR 2011 WINNER ANNOUNCED



Troubling States of Affairs: State Licensing and Usury Laws Affecting Equipment Finance

By Barry S. Marks and Bill Phillips

Equipment finance professionals have long debated the extent to which state licensing and usury laws apply to the industry. While nonbank lessors and lenders sometimes fretted over this issue, national banks and their subsidiaries and affiliates enjoyed immunity from most state regulatory and licensing laws under the federal preemption doctrine.¹ This safe harbor has been lost for the most part under recent federal legislation.

At the same time, recent economic pressure and public attention have increased the pressure on state officials to apply state laws to out-of-state lessors and lenders, whether or not they are bank affiliated. While many of these laws were designed to regulate lending, most lawyers agree that they most likely apply to leases that do not qualify as true leases and that their application to true leases is uncertain.

This article will address selected state licensing and usury laws that may affect equipment finance. The article is based on a series of memoranda surveying the laws of 50 states and the District of Columbia that the authors have prepared for both bank and nonbank clients.² Only commercial (nonconsumer) laws will be discussed, but readers should note that certain commercial loans, particularly microticket transactions, may be treated as consumer transactions for purposes of some states' licensing

or usury laws. While leasing and lending are often lumped together as "equipment finance" for purposes of the article, distinguishing between the two may be important in interpreting specific laws.

Unfortunately for equipment finance professionals, the Dodd-Frank Act pushed back a significant amount of federal preemption of state laws. The act likely will result in increased scrutiny of both bank and nonbank lessors by state attorneys and regulators.

THE EFFECT OF DODD-FRANK ON BANK AFFILIATES – AND OTHERS

The Consumer Financial Protection Act of 2010 was enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). As was widely reported, Dodd-Frank curtails federal preemption of state consumer financial laws with respect to banks.³

A second, less publicized change in law (and the one that we are concerned with in this article) eliminates all federal preemption with respect to bank subsidiaries and affiliates ("bank subsidiaries" in this article):

¹² USCS § 25b

(b) Preemption standard.

(2) Savings clause. This title and section 24 of the Federal Reserve Act (12 U.S.C. 371) do not preempt, annul, or affect the applicability of any State law to any subsidiary or affiliate of a national bank (other than a subsidiary or affiliate that is chartered as a national bank).

(h) Clarification of law applicable to nondepository institution subsidiaries and affiliates of national banks.

(2) Rule of construction. No provision of this title or section 24 of the Federal Reserve Act (12 U.S.C. 371) shall be construed as preempting, annulling, or affecting the applicability of State law to any subsidiary, affiliate, or agent of a national bank (other than a subsidiary, affiliate, or agent that is chartered as a national bank) (12 USCS § 25b(h)).

On May 25, 2011, the Office of the Comptroller of the Currency (OCC) issued proposed revisions to its rules on the scope of preemption in response to the act. (“Office of Thrift Supervision Integration; Dodd-Frank Implementation,” Department of the Treasury Office of Comptroller of the Currency 76 Federal Register 102 (May 26, 2011), pp. 30557–30572.) On page 30562 of the Proposed Rulemaking, the OCC acknowledged this in stating “[t]he Act eliminates preemption of state law for national bank subsidiaries, agents and affiliates.”

These changes in law and regulations have led some banks to consolidate their equipment finance subsidiaries into the bank to regain some of the lost preemption. Other bank subsidiaries have undertaken a review of the state laws within their market area to assure compliance of their products.

Although the issue is essentially unchanged for lenders and lessors that are not bank related, Dodd-Frank may serve to raise the profile of these licensing and usury issues generally. It is likely that independent equipment finance companies as well as bank subsidiaries may face increased scrutiny by state regulators and attorneys general as well as increased attention from plaintiff’s counsel looking for industries vulnerable to class actions.

OVERVIEW: LICENSING AND USURY

Licensing and usury laws are interwoven in many states. For example, in several states, obtaining a lender’s license insulates the lender from application of state usury limitations (*see, e.g.,* Cal. Fin. Code § 22002), and in

others a license is only required if loans exceed the state usury limit or other stated rate (*see, e.g.,* N.Y. Banking Law § 340).

In general, the regulatory system can be said to focus on several factors, each of which should be considered in approaching licensing and usury issues. These factors include the type of product offered (leases or loans?); the nature of equipment financed; the rate of interest charged or implicit in the calculation of rentals; the size of transactions anticipated; whether customers will include sole proprietors or entities other than corporations; and generally, the company’s risk tolerance where civil or criminal penalties may be involved.

In addition to the foregoing, the effectiveness of choice of law and forum selection provisions, along with the common question of whether a corporation or other entity must qualify to do business as a foreign corporation,⁴ should be considered. All of these will be touched on briefly.⁵

LICENSING

General Lending Licenses

As a general rule, state licensing requirements are limited to specific activities. While states commonly require

licenses for activities such as consumer and real estate lending and pawnshop operations, licensing is rarely required for general commercial lending and leasing.

A notable exception is California. Its Finance Lenders Law requires that lenders and brokers obtain a license from the Commissioner of Corporations (Cal. Fin. Code § 22100). The definition of “finance lender” includes any person engaged in the business of making commercial loans, which in turn may consist of lending money and taking as security “any contract or obligation involving the forfeiture of rights in or to personal property, the use or possession of which property is retained by other than the mortgagee or lender, or any lien on, assignment of, or power of attorney relative to wages, salary, earnings, income, or commission” (*id.* § 22009). The definition of “broker” includes “any person who is engaged in the business of negotiating or performing any act as broker

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in connection with loans made by a finance lender” (id. § 22004). Although banks are exempt from the license requirement, it is not clear that bank subsidiaries and affiliates are also exempt (Cal. Fin. Code § 22050).

Other licensing laws of broad application are on the books in Maryland: Md. Financial Institutions Code Ann. § 11-302; Md. Commercial Law Code Ann. § 12-1001 & 1002, and Vermont V. Stat. Ann. title 8 § 2201.

Small Loans

Several states impose licensing or usury limitations on “small loans.” These statutes, which were probably intended to protect consumers, sometimes cover small commercial loans as well.

The Alaska Small Loan Lender License is required for companies making loans of less than \$25,000 and charging an interest rate greater than the basic usury rate for Alaska (Alaska Stat. § 06.20.010). The basic usury rate is 5% above the annual rate charged member banks for advances by the 12th Federal Reserve District on the day on which the contract or loan commitment is made.

The definition of a “consumer finance loan” in Florida includes any loan for an amount less than \$25,000 at a rate of interest greater than 18% per year (Fla. Stat. § 516.01(2)). An entity may not make such loans without a license (id. § 516.02(1)).

Motor Vehicles

Several states require licenses of motor vehicle lessors as well as dealers (e.g., Conn. Gen. Stat. § 14-15; Iowa Code §§ 321F.1 & 321F.2; La. R.S. 32:1254 & La. R.S. 32:1252; and ORC Ann. 4517.02(A)(3), ORC Ann. 4517.01(M), and ORC Ann. 4517.06)).

Some states go further and require a lessor to maintain a place of business in the state as well as obtain a license. These often confusing laws require a lessor to maintain a place of business within the lessee’s state and to obtain a license for such location.⁶ Such laws include KRS § 190.030 (Kentucky) and La. R.S. 32:1254 & La. R.S. 32:1252 (Louisiana).

Purchasers of Installment Sales Contracts

Vendor programs carry unique risks in that many states have laws regulating the financing of personal property sold by vendors. Although we have located no such laws applicable to financings by the vendors themselves, third-party financing, apparently including financing by captives or related entities, is subject to these laws.

Among others, laws regulating “sales finance companies” and other entities that routinely purchase installment sales contracts may be found in Delaware (5 Del. C. § 2902); Florida (Fla. Stat. § 520.52(1)); and Maryland (Md. Financial Institutions Code Ann. §§ 11-401 & 11-403).

Other states regulate only purchases of motor vehicle installment sales contracts (e.g., Miss. Code Ann. § 63-19-7 and Tex. Finance Code §§ 348.501 & 348.00).

USURY GENERALLY

Most usury prohibitions are contained in civil law statutes. Violations of these statutes result in monetary damages that differ from state to state. These penalties can include merely the loss

of the interest exceeding the usury rate, the loss of all interest, the loss of all money loaned, and treble damages calculated based on the amount of the interest paid by borrower.

Many states also have criminal penalties for usury violations, usually involving higher rates of interest than the civil statutes. Moreover, criminal penalties may include incarceration of the owners or officers of the finance company. However, there are few published cases of criminal prosecution by states for violation of usury laws.⁷

Usury claims generally involve three elements: (1) a loan of money or forbearance in the collection of money; (2) an interest rate exceeding that allowed by applicable law; and (3) intent.⁸ The most common defenses used by lenders to insulate themselves from usury claims,⁹ other than the contractual provisions discussed below, operate to negate one or more of these elements.

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Definition of “Loan” and “Interest”

Usury laws apply to interest charged on loans of money or forbearances of the collection of money. Interest is most frequently defined similarly to the definition found in the Georgia usury statute: as “a charge for the use of money computed over the term of the contract at the rate stated in the contract or precomputed at a stated rate on the scheduled principal balance or computed in any other way or any other form.”¹⁰

Under this definition, equipment lessors may argue that lease financings are not subject to usury laws because (a) the lessee pays “rent”¹¹ and not “interest,” and (b) the lessee’s payment obligations serve to compensate the lessor for the lessee’s use of property owned by the lessor (rather than being payment of principal and interest for a loan of money).

Some jurisdictions, such as Florida, clarify this distinction by statute.¹² Other jurisdictions contain case law that generally holds that a lessee may not assert a usury defense in an action to enforce provisions of a true lease.¹³

In the case of a lease intended as security, as opposed to a true lease, it may be imprudent to rely on the parties’ designation of the transaction as a “lease” rather than “loan” or to rely on the argument that payments by the lessee constitute “rent” rather than “principal and interest.” Because the economic reality and substance of the transaction is that of a loan, it is very likely that a court or regulator would recast the payment as principal and imputed interest, then calculate the imputed interest rate and compare it to the maximum rate under applicable law.

The concept of a time-price differential is also used in a few jurisdictions to insulate lenders from the application of usury laws. These jurisdictions recognize that the increased price charged when a good is sold on an installment basis, instead of for an immediately payable amount, does not constitute interest. Some jurisdictions, such as Tennessee, clarify this distinction by statute.¹⁴ Other jurisdictions have case law to this effect. (See, e.g.,

Citipostal v. Unistar Leasing, 283; 724 N.Y.S.2d 555 (4th Dep’t 2001) (neither a credit sale nor a lease constitutes a loan or forbearance).)

Not all states draw this conclusion, however. (See, e.g., *Perez v. Rent-A-Center*, 186 N.J. 188; 892 A.2d 1255; 2006 N.J. LEXIS 176 (2005) (noting that time-price differentials are “interest” and subject to the criminal usury statute).) Relying on the concept of a time-price differential, where available, usually requires that the borrower

acknowledge that it has elected to pay on time rather than in cash for the financed items.¹⁵

Choice of Law

Most loan and lease documents contain choice of law provisions. These provisions are essentially a stipulation by the parties that the contract will be governed by and interpreted under the laws of a certain state regardless of what state law would otherwise apply. For high interest rate loans, the effectiveness of the choice of law provision may determine whether the transaction is enforceable as is, or if the lender will be subject to sanctions for usury.

A good choice of law provision will designate a state either with no usury rate or a usury rate higher than any interest rate that the lender anticipates charging. The state should also bear a “reasonable relation”¹⁶ (or “substantial relation,”¹⁷ depending on the applicable law) to the transaction, as discussed below. For most states, the court will require some connection to the chosen state.¹⁸ Lender documents frequently choose the law of the lender’s home state or the state where the note and payments are accepted by the lender.

The Restatement of the Law (2d) of Conflicts of Laws (the Restatement) utilized by some courts in choice of law cases adds another issue: the possibility that a court will refuse to apply favorable state usury law as a matter of policy. These courts will not apply a choice of law provision if

application of the law of the chosen state **would be contrary to a fundamental policy of a state which** has a

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materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties.¹⁹

A discussion of what constitutes a “fundamental policy of a state” is beyond the scope of this article. Such a standard means more than that the case would be decided differently under the law of the other state.

Generally, most courts have been willing to uphold a choice of law provision, otherwise appropriately made, where the issue of usury was raised. See, for example:

- *Woods-Tucker Leasing Corp. v. Hutcheson-Ingram Development Co.*, 642 F.2d 744 (5th Cir. 1981) (bankruptcy court sitting in Texas that originally held that a Mississippi choice of law provision was used by the lender to “evade the usury laws of Texas” and was therefore ineffective, but reconsidered and held the clause to be valid under UCC §1-105);
- *Kronovet v. Lipchin*, 288 Md. 30, 415 A.2d 1096 (1980) (Maryland court upheld a choice of law provision stating that Maryland law applied with respect to usury issues only and New York law to the balance of the contract);
- *Sarlot-Kantarjian v. First Pa. Mortgage Trust*, 599 F.2d 915 (9th Cir. 1979) (9th Circuit Court of Appeals honored a Massachusetts choice of law provision under the Restatement analysis, specifically noting that California’s public policy against usury is not offended by the adoption of Massachusetts law);
- *Admiral Insurance Co. v. Brinkcraft Development, Ltd.*, 921 F.2d 591 (5th Circuit Court of Appeals honored a New York choice of law provision acknowledging New York bore a reasonable relationship to the transaction as required by Texas UCC §1-105);
- *Snow v. CIT Corp. of the South*, 278 Ark. 554 (1983) (Where four states had direct contact with a sales transaction which was contingent upon a Georgia corporation’s willingness to finance it and the Georgia party insisted as a non-negotiable provision that the transaction be governed by Georgia law, it can-

not be said that the choice of Georgia law was not a reasonable one or had been made to avoid Arkansas’ usury laws);

- *Davidson Oil Country Supply Co. v. Klockner, Inc.*, 908 F.2d 1238 (CA5 1990) (Court enforced a New York choice of law provision rather than applying Texas law, citing UCC § 1-105); and
- *Mell v. Goodbody & Co.*, 10 Ill. App.3d 809 (1973) (Court enforced a New York choice of law provision rather than applying Illinois law).

However, contrary precedent exists. In *O’Brien v. Shearson Hayden Stone, Inc.* (90 Wash. 2d 680, 586 P.2d 830 (1978), *supplemented*, 93 Wash. 2d 51, 605 P.2d 779 (1980)), a class action suit over margin interest rates, the court examined the Restatement rule and determined that, as to a portion of the plaintiff class, Washington law would have applied but for a New York choice of law in the brokerage contracts. The court refused to apply New York law due to the disparity between the 25% rate in the contract and Washington’s 12% limit, which was deemed a “fundamental policy.”

One final note: it stands to reason that an effective forum selection clause,²⁰ combined with a choice of law

provision, increases the probability that the law of the lender’s chosen state will be applied. A forum selection clause is a contractual provision that stipulates that any lawsuit related to the contract may or must be tried in the courts of a chosen state.

Usury Savings Clauses

Many loan and lease forms include “usury savings clauses” that reduce interest rates to the highest rate permitted by applicable law, notwithstanding the stated or implicit interest rate in the contract. If the court applies this provision the loan will be recalculated and not usurious.

Unfortunately, a savings clause is not a panacea. Some courts will refuse to apply the clause on public policy grounds.²¹ Although the clause would seem to indicate an intent to comply with state law, our research indicates the requisite usurious intent is usually presumed

Many loan and lease forms include “usury savings clauses” that reduce interest rates to the highest rate permitted by applicable law, notwithstanding the stated or implicit interest rate in the contract.

if the contract charges a rate in excess of that allowed by law, irrespective of a savings clause.

However, the Florida Supreme Court considered a usury savings clause as a factor in determining this intent without specifically enforcing its terms:

[W]e conclude that a usury savings clause cannot, by itself, absolutely insulate a lender from a finding of usury. Rather, we approve and adopt the Fourth District's holding, that a usury savings clause is one factor to be considered in the overall determination of whether the lender intended to exact a usurious interest rate. Such a standard strikes a balance between the legislative policy of protecting borrowers from overreaching creditors and the need to preserve otherwise good faith, albeit complex, transactions which may inadvertently exact an unlawful interest rate (*Jersey Palm-Gross, Inc. v. Paper*, 658 So. 2d 531, 535 Fla. (1995)).

Criminal Usury

Lenders face additional risk when they rely on a choice of law provision or usury savings clause to make loans exceeding the interest rate of the customer's state. This risk is lower when a state appellate court has issued strong decisions supporting contractual choice of law.²²

When contracting with a borrower in a state with a low usury limit, even a lender that is comfortable with relying on a choice of law or a usury savings clause should carefully consider whether to rely on such provisions in a state with a criminal usury rate below the expected interest rates. First, the lender may face criminal sanctions if the contractual provisions are not honored and the contract is deemed usurious. Secondly, as a policy matter, it is questionable whether simply choosing the law of a favorable state will insulate a lender from criminal liability. One Georgia court summed up the argument concisely:

The parties to a private contract who admittedly make loans to Georgia residents cannot, by virtue of a choice of law provision, exempt themselves from investigation for potential violations of Georgia's usury laws.²³

Notable Usury Statutes

This section will briefly discuss the usury law of several states. We have included these states because of their

size or notable usury provisions. This is by no means intended as an exhaustive list of states that need to be considered for usury purposes. As we discussed above, whether a finance company has usury compliance issues for a particular state can depend on a number of factors including the size of the loan and the type of property being financed.

Florida. In general, the maximum rate of interest is 18% simple interest (Fla. Stat. §§ 687.02 and 687.03(1)). If the loan is for an amount in excess of \$500,000, the maximum rate of interest is 25%. Any person charging an interest rate exceeding 25% is guilty of usury misdemeanor and exceeding 45%, usury felony (id. §§ 687.02(1), 687.03(1), 687.071(2), 687.071(3)).

Georgia. With respect to loans for an amount of \$3,000 or less, the maximum rate of interest is 16% simple interest (Ga. Code § 7-4-2(a)(2)). Also, under § 7-4-2 interest accruing on transactions between \$3,000 and \$250,000 must be **expressed in simple interest terms**. Based on

this language, many practitioners advise that a note or equipment finance agreement must disclose the interest rate in simple interest terms.

Massachusetts. The criminal usury statute ALM GL Ch. 271 § 49 provides that a lender may not contract for interest and expenses (including all sums paid for brokerage, recording fees, commissions, services, extensions of loan, forbearance to enforce payment, and all other sums charged) greater than 20% unless it notifies the attorney general every two years of its

intent to engage in transactions with over 20% interest and maintains records of the transactions.

New Jersey. The civil usury statute limits interest for business or agricultural purpose loans in the amount of \$1,000 to \$50,000 that are not secured by real estate to the greater of 16% or 5% in excess of the discount rate, including any surcharge thereon, or any 90-day commercial paper in effect at the Federal Reserve Bank of New York on the day when such loan is made (N.J. Stat. § 31:1). The civil usury limit does not apply to loans with a principal amount of \$50,000 or more²⁴ (id. § 31:1-1(e)(1)).

Lenders face additional risk when they rely on a choice of law provision or usury savings clause to make loans exceeding the interest rate of the customer's state.

New York. The maximum rate of interest in New York is 16%, except where indicated otherwise in the laws of the state (N.Y. Gen. Oblig. § 5-501(1) and N.Y. Banking Law §14-a).²⁵ For loans for an amount exceeding \$250,000, the maximum rate of interest is 25%, and a rate exceeding that amount is subject to criminal penalties (N.Y. Gen. Oblig. Law § 5-501(6) (a) and N.Y. Penal Law §§ 190.40 & 190.42). If a loan or forbearance is in the amount of \$2,500,000 or more, there is no limitation on the maximum rate of interest, and the criminal usury provisions of the penal law do not apply (N.Y. Gen. Oblig. Law § 5-501(6) (b) and N.Y. Penal Law §§ 190.40 & 190.42).

Interest charged on loans or forbearances made to corporations for business or commercial purposes in the amount of \$100,000 or more and secured in compliance with the UCC Article 9 is not subject to any limitations or criminal usury law, if on the date when the interest is charged or accrued, such interest is not greater than 8 percentage points above the prime rate (N.Y. Gen. Oblig. Law § 5-526). Corporations and limited liability companies cannot assert a defense of usury (N.Y. Gen. Oblig. Law § 5-521(1) & N.Y. Limited Liability Company Law § 1104), but they may assert the defense of criminal usury if the rate exceeds the criminal usury rate (N.Y. Penal Law § 190.40).

In short: The civil usury rate is 16%, but corporations and limited liability companies cannot plead a usury defense if the rate is above 16% and below 25%. The criminal usury rate is 25%. However, for personal property-secured loans to corporations, the usury rate is the greater of 25% or 8% above the prime rate.

New York lenders and those choosing to apply New York law should also note that under New York law, a usurious note is void and the lender forfeits the entire loan balance (Gen. Oblig. § 5-511(1)).

Oregon. No person can make a business or agricultural loan of \$50,000 or less at an annual rate of interest exceeding the greater of 12%, or 5% in excess of the discount rate, including any surcharge on the discount rate, on 90-day commercial paper in effect at the Federal

Reserve Bank in the Federal Reserve district where the person making the loan is located, on the date the loan or the initial advance of funds under the loan is made (ORS § 82.010). The above restriction does not apply if the lender is a financial institution²⁶ or if the loan is secured by a first lien on real property²⁷ (id. §§ 82.010(3), 82.025). There are no restrictions on business or agricultural loans in excess of \$50,000.

Tennessee. Tennessee uses a formula, referred to as the applicable formula rate, to determine the maximum rate of interest that parties may agree to by written contract²⁸ (Tenn. Code Ann. 47-14-103). The applicable formula

rate is the greater of (a) formula rate in effect at the time or (b) the formula rate last published in the Tennessee Administrative Register prior to the date of the contract (id. § 47-14-102(3)). Formula rate is an annual rate of interest 4% above the average prime loan rate (or the average short-term business loan rate, however denominated) for the most recent week for which such an average rate has been published by the board of governors of the Federal Reserve System of the United States or twenty-four percent (24%) per annum, whichever is less (id. § 47-14-102(7)).

As noted above, however, Tennessee recognizes time-price differential calculations.

Texas. The Texas interest and usury laws are complex. The maximum interest rate for commercial transactions will range from 18% to 28% per annum when agreed to by the parties. The Office of the Consumer Credit Commissioner publishes the current usury rates on its website: www.occc.state.tx.us. Rate ceilings cannot be lower than 18% per annum or higher than 24% per annum, except that business, commercial and investment loans may have a ceiling of up to 28% per annum, and certain open-end account credit agreements may only have a ceiling of up to 21% (Tex. Fin. Code § 303.009). To determine whether a commercial loan is usurious, the interest rate is computed by amortizing or spreading, using the actuarial method during the stated term of the loan, all interest at any time contracted for, charged, or received in connection with the loan (id. § 306.004).

Corporations and limited liability companies cannot assert a defense of usury, but they may assert the defense of criminal usury if the rate exceeds the criminal usury rate.

QUALIFICATION TO DO BUSINESS

Qualification involves obtaining a certificate of authority from the secretary of state of any state where a corporation transacts business but was not incorporated. These laws apply generally to corporations and in many states limited liability companies. In most states, these laws do not apply to banks, which are regulated by state banking laws. While the application of these laws to bank subsidiaries has never been clear, it would seem that Dodd-Frank now requires subsidiaries to comply. The Model Business Corporation Act provisions on qualification to do business were drafted to avoid conflicting with the commerce clause of the U.S. Constitution.

This certificate is not the same as a state sales tax registration, a lender's license, a motor vehicle dealer's license, or any of the other licenses and registrations that a leasing company may need in various states. In some instances, however, the certificate of authority is a prerequisite to obtaining another license or registration.

Some corporations prefer not to obtain certificates of authority to transact business in states other than their home state, because they will be required to maintain a registered agent in the state for service of process (and might be sued in the state courts in the state). If qualified to do business, the corporation must file annual reports, pay franchise taxes or other annual fees, and incur additional costs.

Failure to qualify, if required, does not render contracts void or unenforceable, but it does deny the corporation the right to sue in the state courts. As discussed below, however, this right can generally be restored retroactively where desired before filing suit.

Sections 15.02(a) and (b) of the Revised Model Business Corporation Act provide that: ([a] a) foreign corporation transacting business in this state without a certificate of authority shall not maintain a proceeding in any court in this state until it obtains a certificate of authority [and (b)] the failure of a foreign corporation to obtain a certificate of authority does not impair the

validity of its corporate acts or prevent it from defending any proceeding in this state. The exact language, or almost identical language, to subsection (b) above is found in 32 states: Arizona, Arkansas, Connecticut, Delaware, Florida, Georgia, Hawaii, Idaho, Indiana, Iowa, Kansas, Louisiana, Maine, Mississippi, Missouri, Montana, Nebraska, New Hampshire, New Mexico, New York, North Carolina, North Dakota, Oklahoma, Oregon, South Carolina, South Dakota, Tennessee, Virginia, Washington, West Virginia, Wisconsin, and Wyoming.

Although the language is slightly different in other states, all states *other than Alabama* have a cure provision. If the issue is raised in these 49 states, the foreign cor-

poration should be able to dismiss the litigation, qualify to do business, pay any penalties and fees due for failing to qualify when required, and initiate a new lawsuit. However, if the statute of limitations has run out on one's claim between the first lawsuit and the second, that claim may be permanently barred.

In determining whether a corporation is transacting business for the purpose of this requirement, state law generally follows either the Model Business Corporation Act or the Revised Model Business Corporation Act (both are hereinafter referred to as the MBCA). Under both, it is clear that isolated transactions and transactions in interstate (as opposed to intrastate) commerce do not constitute transacting business for purposes of requiring

qualification. Indeed, the U.S. Constitution prevents a state from requiring a foreign corporation to obtain a certificate of authority to do business in the state if its participation in the trade is limited to wholly interstate business.²⁹ This limitation results from the fact that the Constitution grants the U.S. Congress exclusive power over interstate commerce and precludes states from imposing restrictions or conditions on this commerce.³⁰

The MBCA also contains a nonexclusive list of activities that do not, in and of themselves, constitute transacting business such that qualification is required.

"Qualification" involves obtaining a certificate of authority from the secretary of state of any state where a corporation transacts business but was not incorporated. These laws apply generally to corporations and in many states limited liability companies.

Of that list, the following generally apply to equipment finance:

- (1) Maintaining, defending, or settling any proceeding.
- (2) Maintaining bank accounts.
- (3) Soliciting or obtaining orders, whether by mail or through employees, agents, or otherwise, if the orders require acceptance outside this state before they become contracts.
- (4) Creating or acquiring indebtedness, mortgages, and security interests in real or personal property.
- (5) Securing or collecting debts or enforcing mortgages and security interests in real or personal property.
- (6) Transacting business in interstate commerce.
- (7) Owning real or personal property.³¹

It should be noted, however, that not all of the states have enacted versions of the MBCA that include this entire list, and some states include no list at all.³²

In addition to a list of activities that, in and of themselves, do not constitute transacting business, the MBCA has a cure provision under which qualification to do business retroactively cures any failure to obtain qualification for most purposes. Except for the payment of fees and penalties, the principal penalty for failure to qualify to do business in a state is that the foreign corporation will be barred from use of the state's courts.

In Alabama, retroactive cure is not permitted, meaning that the penalty for failure to qualify (if required to do so) is that the offending corporation may not enforce any contract executed in the state. For this reason, Alabama has developed more law on the definition of transacting business than other states. These cases are sometimes confusing and inconsistent, but at least one decision directly addresses leasing. In *Allstate Leasing Co. v. Scroggins* (541 So.2d 17 (Ala. App. 1989)), the Alabama court of appeals held that the lease was void and unenforceable because the lessor should have obtained a certificate of authority prior to entering into this transaction.

Even if we concede that no agent of [the leasing company] has ever set foot in Alabama, it is clear that [the leasing

company's] business consists of owning equipment and collecting rents thereon. ... These pieces of equipment are located in Alabama, on what is intended to be a permanent basis. Alabama citizens, on an ongoing basis, pay rent with respect to that equipment. [The leasing company's] activity in Alabama is not incidental to the sale, installation or servicing of the equipment. Owning that equipment in Alabama and collecting rent from citizens of Alabama are the sum and substance of [the leasing company's] business. Furthermore, this is not an isolated transaction; there have, since 1984, been thirty-one (31) transactions involving about \$350,000 (541 So.2d at p. 18).

For this reason, any leasing company with a significant amount of business in Alabama is well advised to consider qualification to do business in the state. As to the

other states, the general rule of thumb has long been that leasing companies without offices in a given state do not qualify to do business and simply rely on their right to cure any breach of the requirement, if it exists, when they need to.

Before getting too comfortable, however, funders should consider one more case. In North Carolina, *Lease-Comm Corp. v. Renaissance Auto Care* (122 N.C. App. 119, 468 S.E.2d 562 (N.C. App. 1996)) added an interesting issue where the lease originator was not qualified to do business. Although the assignee had obtained a certificate of authority in North Carolina, the

originator had never "cured" its original failure to qualify. The court held that the assignee could not sue in North Carolina.

This case is not an aberration. It is supported by a strict reading of the law. If an originator has an office or is otherwise required to obtain a certificate of authority authorizing it to do business in a state and does not do so, any leases or loans it documents in its name may well be *unenforceable in the hands of a funder or other assignee that is qualified to do business in the state.*

THE NEW FEDERALISM?

Even Alexander Hamilton might blanch at the extent to which federal legislation affects state law regulation of

The general rule of thumb has long been that leasing companies without offices in a given state do not qualify to do business and simply rely on their right to cure any breach of the requirement, if it exists, when they need to.

commerce. Unfortunately, for equipment finance professionals Dodd-Frank pushed back a significant amount of federal preemption of state laws. Now even bank subsidiaries must look to the most restrictive state regulations in setting policy if they wish to steer clear of trouble including criminal penalties.

It will be years before we can gauge the full effect of Dodd-Frank on the leasing industry, but the act likely will result in increased scrutiny of both bank and non-bank lessors by state attorneys and regulators. Whether this results in protecting the citizenry or restricting its access to much-needed capital only time will tell.

One thing is certain: lessors and lenders should become familiar with laws of states in which their customers are located and should be aware that these laws, whether or not applied in the past, may be part of equipment finance in the future.

Endnotes

1. Because the Federal government regulates banks pursuant to the commerce clause of the U.S. Constitution, federal bank regulatory laws preempt state laws. Federal preemption has been held to apply to laws that significantly impair the ability of national banks to exercise their chartered powers. *Barnett Bank v. Nelson*, 517 U.S. 25, 32, 134 L. Ed. 2d 237, 116 S. Ct. 1103 (1996); see also *Bank of America v. City and County of San Francisco*, 309 F.3d 551 (6th Cir. 2002). The categories of laws for which bank subsidiaries previously enjoyed preemption include those set out in 12 C.F.R. §§ 7.4008(d), issued pursuant to Section 25 of 12 U.S.C. 371:

(d) Applicability of state law.

(1) Except where made applicable by Federal law, state laws that obstruct, impair, or condition a national bank's ability to fully exercise its federally authorized non-real estate lending powers are not applicable to national banks.

(2) A national bank may make non-real estate loans without regard to state law limitations concerning:

(i) Licensing, registration (except for purposes of service of process), filings, or reports by creditors;...

(iv) The terms of credit, including the schedule for repayment of principal and interest, amortization of loans, balance, payments due, minimum payments, or term to maturity of the loan, including the circumstances under which a loan may be called due and payable upon the passage of time or a specified event external to the loan; ... and

(x) Rates of interest on loans.

2. The information in this article does not constitute a 50-state survey, but we will mention certain statutory or other

authorities that illustrate the most significant issues. The research for this article was necessarily limited to statutory and some case authorities, although some regulatory information was located, and in some cases statutory interpretation was checked by calls to local government officials. The authors strongly recommend consultation with local counsel and focused research whenever a question arises.

3. 12 USCS § 25b

(b) Preemption standard.

(1) In general. State consumer financial laws are preempted, only if—

(A) application of a State consumer financial law would have a discriminatory effect on national banks, in comparison with the effect of the law on a bank chartered by that State;

(B) in accordance with the legal standard for preemption in the decision of the Supreme Court of the United States in *Barnett Bank of Marion County, N.A. v. Nelson*, Florida Insurance Commissioner, 517 U.S. 25 (1996), the state consumer financial law prevents or significantly interferes with the exercise by the national bank of its powers; and any preemption determination under this subparagraph may be made by a court, or by regulation or order of the Comptroller of the Currency on a case-by-case basis, in accordance with applicable law; or

(C) the State consumer financial law is preempted by a provision of Federal law other than this title.

4. Some of these issues are not new to national bank subsidiaries, as certain laws were never considered to be significant restraints on exercise of their powers.

5. We will not comment on various other state laws that may or may not be escaped due to a choice of law clause, such as Kentucky's unusual limitation on open-ended guaranties, KRS 371.065.

6. Many of these are "anti-curbstoning" laws designed to prevent apparently casual sales by dealers who seek to avoid taxes and liability for hidden defects in the vehicles or their titles.

7. The cases simply may not result in published opinions. As a result, it is frequently difficult to ascertain how a particular court would apply the criminal usury laws in these states.

8. Matthew Bender, *Consumer Credit Law Manual*, § 6.08. See also *Henson v. Columbus Bank & Trust Co.*, 770 F.2d 1566 (11th Cir. 1985); *Vickie Fogie v. Thorn Americas, Inc.*, 95 F.3d 645, 649 (8th Cir. 1996); and *Korwin v. First National Bank of Chicago*, 275 F.2d 755 (7th Cir. 1960) (New York law).

9. Defenses available on a case-by-case basis include: (a) no standing to assert usury (statutes are intended to protect

needy borrowers so only those obligated on the note should be able to assert a claim or defense of usury); (b) estoppel and waiver; (c) res judicata; and (d) statutes of limitations.

10. O.C.G.A. § 7-4-2. Note that certain fees and other charges might be included as “interest” if not clearly related to actual lender expenses or other reasonable purposes.

11. Note, however that merely labeling a loan payment “rent” and not “principal and interest” is not likely to avoid usury restrictions, as in the case of a lease intended as security. *Michie, Banks and Banking* Chapter XI § 32 (2007).

12. See, e.g., Fla. Stat. §§ 687.02 & 687.03.

13. (See, e.g., *Performance Systems, Inc. v. First American National Bank*, 554 S.W.2d 616 (Tenn.); *Orix Credit Alliance, Inc. v. Northeastern Tech Excavating Corp.*, 222 A.D.2d 796, 634 N.Y.S.2d 841 (3rd Dep’t 1995) (holding that defaulting equipment lessee’s defense of criminal usury was negated by the fact that a lease does not constitute a loan or forbearance and did not, therefore, fall within the definition of usury); and *Citipostal, Inc. v. Unistar Leasing*, 283 A.D.2d 916, 724 N.Y.S.2d 555 (4th Dep’t 2001) (neither a lease nor a sale on credit constitutes a loan or forbearance) (citing Orix Credit).

14. See, e.g., Tennessee Code §§ 47-14-102(11) (definition of time-price differential) and 47-14-102(8) (the definition of interest which expressly excludes the time-price differential).

15. Note that such language might theoretically expose the lender to liability as a vendor and weaken the hell-or-high water clause.

16. Most states have adopted the version of the Uniform Commercial Code choice of law provision similar to the following Alabama statute: Code of Ala. § 7-1-301

Territorial applicability; parties’ power to choose applicable law.

(a) Except as otherwise provided in this section, when a transaction bears a reasonable relation to this state and also to another state or nation the parties may agree that the law either of this state or of such other state or nation shall govern their rights and duties.

17. Substantial relation is the standard set out in Restatement of the Law (2d) of Conflict of Laws § 187 (1971).

(1) The law of the state chosen by the parties to govern their contractual rights and duties will be applied if the particular issue is one which the parties could have resolved by an explicit provision in their agreement directed to that issue.

(2) The law of the state chosen by the parties to govern their contractual rights and duties will be applied, even if the particular issue is one which the parties could not have resolved by an explicit provision in their agreement directed to that issue, *unless either*

(a) the *chosen state has no substantial relationship* to the parties or the transaction and there is no other reasonable basis for the parties’ choice, or

(b) application of the law of the chosen state *would be contrary to a fundamental policy of a state which* has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties.

18. New York is a notable exception. New York General Obligations law § 5-1401(1) provides that parties to any contract for \$250,000 or more may agree that New York law will apply to the contract whether or not the contract has a connection to the state. Also compare the original and proposed revised versions of UCC 1-105.

19. Restatement of the Law (2d) of Conflicts of Laws § 187 (1971).

20. A judge is probably more likely to honor a choice of law provision selecting the law of his state rather than the law of another state because of the familiarity of the law to the judge and lawyers involved.

21. A Georgia appellate court held that honoring usury savings clauses to avoid criminal usury would encourage lenders to make blatantly usurious loans and, when discovered by knowledgeable borrowers, avoid prosecution by claiming a reduction under the usury savings clause. *Einstein v. Diprimio* 2000 Ga. App. LEXIS 1140; 2000 Fulton County D. Rep. 3899.

22. Tennessee has specific statutory support for choice of law provisions in the usury context: TCA § 47-14-119, which is part of Tennessee’s general usury statutes. It provides that the parties may select the law of any jurisdiction that bears a reasonable relation to the transaction.

23. *Bankwest, Inc. v. Oxendine*, 266 Ga. App. 771 (2004).

24. The exception is loans where the security given is a first lien on real property on which there is erected or to be erected a structure containing one, two, three, four, five or six dwelling units, a portion of which structure may be used for nonresidential purposes.

25. Interest rate includes 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. *Id.* N.Y. Banking Law § 14a.

26. “Financial institution” means insured institutions, extranational institutions, and credit unions. § 706.008.

27. Under § 82.025, there are other situations to which the restriction does not apply. We do not discuss them for purpose of this memorandum.

28. Contracts to which the applicable formula rate applies may provide for the payment of a fixed rate of interest, a vari-

able rate of interest or any combination of fixed and variable rates in any sequence, subject to certain limitations. Id. § 47-14-106.

29. See e.g. *Goodwin Bros. Leasing, Inc. v. Nousis*, 373 Mass 169.

30. See *Model Business Corporations Act Annotated* (3rd ed.).

31. See *Model Business Corporation, Code* (3rd ed.) § 15.01.

32. For example, the statutes enacted in Ohio vary substantially from the MBCA. Statutes in Illinois, Rhode Island, New Jersey, California, Minnesota, Utah, and Maryland all contain a modified version of the list omitting various of the specific activities which do not, in and of themselves, constitute doing business. *Please note that we have not undertaken to look at the list in all states with respect to this issue.*



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