Question of the Month: What are the new risks for real estate lenders in Rhode Island?

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For many years, lenders in Rhode Island have included a variation of the following phrase, known as a Usury Savings Clause, in loan agreements and promissory notes:

"If, from any circumstance whatsoever, the payee should ever receive as interest an amount which would exceed the highest lawful rate, such amount which would be excessive interest shall be (a) applied to the reduction of the principal balance evidenced hereby or (b) refunded to the maker, and in no event shall be applied to the payment of interest."

The hoped for impact of the Usury Savings Clause is for a lender to be able to transform any payments made by a borrower in excess of the maximum lawful interest rate and to re-characterize them as an additional payment of principal or if necessary to refund them to the borrower. Unfortunately, a recent Rhode Island Supreme Court case means that commercial real estate lenders in Rhode Island may no longer rely upon these Usury Savings Clauses to save their loans from being treated as usurious.

In the recently decided case NV One, LLC, et al. v. Potomac Realty Capital, LLC, the lender provided a $1.8 million loan to the borrower. The loan documents establish a default interest rate equal to "the lesser of (a) 24% and (b) the maximum rate of interest... under applicable law." The loan documents also include a Usury Savings Clause which states that any interest payments received in excess of the maximum allowable interest rate "shall be deemed to have been a payment made by mistake and shall be refunded to the maker."

In February of 2009, the borrower received a notice of default for failure to comply with the renovation time schedule set forth in the loan documents. One month later, the lender began accruing interest at the 24% default rate set forth in the loan documents. On December 14, 2009, following receipt of demand and foreclosure notices from the lender, the borrower filed a complaint against lender alleging fraud, breach of contract and usury. The Rhode Island Superior Court trial justice found that the lender violated the usury statute.

The Rhode Island Supreme Court concluded that the loan was usurious on its face due to the 43.48% effective annual interest rate levied on the actual funds disbursed; however, the court also discussed in its opinion whether the Usury Savings Clause could nevertheless be used to

fix the agreement to eliminate the lender's otherwise clear violation of the usury statute. The court stated that the Usury Savings Clause cannot salvage the agreement because the interest rate provisions in the loan documents were contrary to the public policy goal of protecting borrowers from "avaricious lenders." Instead, lenders must bear the burden of ensuring that interest rates charged to borrowers do not exceed the limits set forth in Rhode Island General Laws Â§6-26-2.

Although the Rhode Island Supreme Court's statements relating to the Usury Savings Clause were not necessary to the court's decision, and thus are legally deemed "dicta" which is not binding law at this time, we believe that the court's statements provide guidance as to how the law will evolve in Rhode Island. Lenders must provide loans to borrowers at interest rates that do not exceed usury limits as the Usury Savings Clause can no longer be relied upon to fix an otherwise illegal loan. Violating the usury laws in Rhode Island carries stiff penalties as a court may invalidate the lender's promissory note and terminate the applicable mortgage if the interest rate is deemed usurious. However, the good news for lenders is that there are specific strategies and structures that avoid usurious interest rates and protect a lender in the event of a borrower's default. These strategies and structures should be incorporated into your loan documents.

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