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Lenders Beware: Michigan Supreme Court Ruling Greatly Limits Usury Savings Clauses

Client Alert

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A recent Michigan Supreme Court case has greatly limited the effectiveness of so-called “usury savings clauses” in loan agreements. These clauses, common to virtually all commercial loan or credit agreements, are designed to avoid violation of usury laws. They typically state that the parties do not intend to charge interest above the legal limit and that any amounts determined to exceed the limit will instead be applied to principal or will be refunded to the borrower.

Michigan, like most states, has usury statutes that limit the interest lenders may charge in lending transactions. Courts have made clear that they will not be bound by the labels parties place on charges and payments and may determine that items labeled as something else (e.g., fees, equity riders, reimbursements, etc.) should instead be treated as interest. This reclassification, along with changes in an external index on which a floating interest rate is based, can lead to violation of usury limits. Usury savings clauses are inserted in loan agreements to avoid this result.

The recent case, *Soaring Pine Capital Real Estate and Debt Fund II, LLC v Park Street Group Realty Services, LLC*, No. 163320, involved a loan from a non-bank lender to a company that used the proceeds to “flip” houses in Detroit that were subject to tax foreclosure – buy them, renovate them, and sell them. The note for the loan had a stated interest rate of 20%, which was already very high. In addition, there was a \$50,000 “upfront” fee, a \$1,000 per house “success fee” and other fees and charges, all of which the trial court held constituted disguised interest, pushing the effective interest rate above the 25% criminal usury limit specified in MCL 438.41. The borrower paid interest on the loan for a while, but then stopped paying, and the lender sued to enforce the note. The borrower alleged that the fees and charges

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constituted disguised interest and, when added to the stated interest rate of the loan, caused interest on the loan to exceed 36%. The lender pointed to the usury savings clause in the loan documentation, arguing that if recharacterization of other charges resulted in usurious interest charges, the clause should be invoked to apply excess interest to principal.

The trial court agreed with the borrower that the additional amounts caused the loan to exceed usury limits but held that the usury savings clause was enforceable so that the note was not facially usurious. The trial judge found that the lender had in fact violated the criminal usury statute by *collecting* interest in excess of the statutory limit, but that the note did not on its face *charge* usurious interest because of the savings clause. As a result, the trial court barred the lender from collecting interest but did not bar collection of the principal amount of the loan. The parties appealed and the Court of Appeals affirmed. Both parties appealed to the Michigan Supreme Court.

The Michigan Supreme Court held *a usury savings clause is ineffective if the loan agreement otherwise requires a borrower to pay an illegal interest rate*, even if some of the interest is labeled something else, such as a “fee” or “charge.” The risk that the rate will be found usurious (because, for example, charges or fees are recharacterized as interest) falls on the lender. The Court found that the public policy behind Michigan’s usury statutes is to protect borrowers from excessive interest charged by lenders. The Court rejected defendant’s contention that the usury limits should not be applied in the case of sophisticated transaction parties, finding no basis in the statutes for such a distinction.

The Court announced an exception only for events outside of the parties’ control that may increase interest rates, noting that it is consistent with public policy under these limited circumstances to permit the lender to recover at the maximum legal rate. This exception could apply to instances such as when interest rates are tied to outside indexes such as SOFR or Federal Reserve rate increases.

The Michigan Supreme Court declined to rule on whether the fees and charges in the case at hand were in fact usurious and remanded the case to the trial court to determine whether the note was usurious on its face.

The Court, however, held that *suing* to recover an illegally high interest rate is not, by itself, a crime. The Court stood on the principle of “free access to the courts” and aimed to avoid the chilling effects that it could have on plaintiffs seeking to recover in collection suits.

A curious question is whether the rule of *Soaring Pine* will apply in the case of a corporation borrower (the borrower in this case was a limited liability company). The Court noted the Michigan Limited Liability Company Act (MCL 450.4212) provides that LLCs may pay any rate of interest so long as not in excess of the criminal usury limit. The analogous provision of the Michigan Business Corporation Act (MCL 450.1275) does not contain this same qualification; it authorizes a Michigan corporation to agree in writing to pay any rate of interest and prohibits the defense of usury.

Lenders may be unable to rely on choice-of-law provisions to avoid the result of the *Soaring Pine* opinion. Specifying in the loan documents that the law of another state (often New York) governs the transaction may not be enforced by a court (at least with respect to usury issues) because of the

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public policy underlying the usury statutes. The Michigan Supreme Court noted that “courts have a duty to refuse to enforce a contract that is contrary to public policy.”

Particularly in debt tranches below senior debt (such as mezzanine debt or debt provided by non-bank lenders), which often carry higher rates of interest, the *Soaring Pine* opinion presents risks to lenders, who will be unable in most cases to rely on usury savings clauses to avoid penalties for usurious interest. Lenders will want to check loan details and may need to restructure current contracts to ensure the documents are not facially usurious. Criminal and civil usury penalties are significant. Criminal penalties include imprisonment of up to five years and fines of up to \$10,000. Civil usury penalties include the waiving of interest and the borrower’s recovery of attorneys’ fees. In addition, application of the wrongful-conduct rule may lead to the inability to recover principal as well as interest.

Attorneys providing legal opinions in loan transactions should also consider the effect of the case on their enforceability opinions.

For questions about this case and its implications, please contact the Butzel transaction team.

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