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## Rate Regulation at the Crossroads of Usury and Unconscionability: The Case for Regulating Abusive Commercial and Consumer Interest Rates under the Unconscionability Standard

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# HOUSTON LAW REVIEW

## ARTICLE

### RATE REGULATION AT THE CROSSROADS OF USURY AND UNCONSCIONABILITY: THE CASE FOR REGULATING ABUSIVE COMMERCIAL AND CONSUMER INTEREST RATES UNDER THE UNCONSCIONABILITY STANDARD

*Steven W. Bender\**

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## I. INTRODUCTION

For centuries, America has tried to subdue abusive interest rates with the inflexible interest ceilings of usury regulation. The 1980s, however, brought dramatic change as several states deregulated interest controls,<sup>1</sup> and Congress preempted state usury ceilings for significant areas of consumer lending.<sup>2</sup>

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1. Refer to text accompanying notes 58-63 *infra*.

2. Refer to text accompanying notes 64-71 *infra*.

At the same time, lenders devised new financing schemes to elude remaining usury regulation and shelter effective rates of return outrageous on their face.

In the 1980s and 1990s rent-to-own operations have charged consumers up to the equivalent of 300 percent annual interest,<sup>3</sup> rates for "rapid refund" income tax transactions reached 520 percent on an annualized basis,<sup>4</sup> pawnshops charged as much as 690 percent,<sup>5</sup> and the newly fashioned "auto pawn" transaction charged effective annual rates of up to 900 percent.<sup>6</sup> Other loan hybrids such as check cashing services<sup>7</sup> and installment payments of insurance premiums<sup>8</sup> often charge similarly outrageous rates.

Freed from usury controls by deregulation or federal preemption, rates for more traditional loans have spiraled out of control as well.<sup>9</sup> Small consumer loans by finance companies in deregulated states have exceeded a 200 percent annual return,<sup>10</sup> and deregulated home equity and car loans exceeded 100 percent.<sup>11</sup>

3. *Rent-to-Own: Providing Opportunities or Gouging Consumers?: Hearing Before the House Comm. on Banking, Finance and Urban Affairs*, 103d Cong., 1st Sess. 68, 69 (1993) [hereinafter *Hearing*] (statement of Rep. Henry B. Gonzalez).

4. *Rapid Refunds Warning*, ACCI NEWS. (American Council on Consumer Interests, Columbia, Mo.), Mar. 1993 (reporting results of a survey by the State Consumer Protection Board of New York).

5. See, e.g., *Quick Cash, Inc. v. State*, 605 So. 2d 898, 900 (Fla. Dist. Ct. App. 1992) (holding that Florida's Division of Consumer Services had statutory authority to seek to enjoin a car pawn operation allegedly charging 690% annual interest).

6. See KATHLEEN E. KEEST, NATIONAL CONSUMER LAW CENTER, USURY AND CONSUMER CREDIT REGULATION § 5.5.1.3, at 85 (Supp. 1993) (describing an auto pawn transaction as one in which the borrower pledges her car as security for a small loan and at the same time leases the car from the lender).

7. See Elizabeth Ryan, *Plus Ça Change: Part II (Or, Check Cashers as Lenders: The More Things Change, the Worse They Get)*, NCLC REPS. CONSUMER CREDIT AND USURY EDITION (National Consumer Law Center, Boston, Mass.), July-Aug. 1993, at 25 (describing Virginia litigation filed in 1993 against check cashing companies charging up to a 2044% return for services that are the functional equivalent of loans).

8. See *Bank of the West v. Superior Court*, 833 P.2d 545, 548 (Cal. 1992) (confronting an automobile insurance premium financing program charging over 126% annual interest).

9. For example, there are notorious pockets of abuse in even the competitive first mortgage lien market. See Ronald Kessler, *Woman Fights 142 Percent Loan Rate*, WASH. POST, July 31, 1984, at B1 (describing a 62-year old disabled homeowner needing money for utilities who obtained a one-year first lien loan at 142%).

10. See, e.g., *First Occasional "Can You Top This One!" Award*, NCLC REPS. CONSUMER CREDIT AND USURY EDITION (National Consumer Law Center, Boston, Mass.), Sept.-Oct. 1993, at 30 (reporting that a Utah finance company was making small, short-term loans at rates of 278%).

11. See Walt Bogdanich, *After Deregulation: Critics Charge Lenders Exploit Most Vulnerable*, WALL ST. J., Apr. 8, 1985, at 19 (describing a car dealer who reserved the right to charge 500% interest and loan companies that charged 127% interest);

These astounding rates evidence that free market control offers borrowers scant protection from abusive lenders. Consumer advocates therefore urge that the government enact blanket usury ceilings for both loan and quasi-loan transactions.<sup>12</sup> The lending industry desires a market solution free of statutory and judicial control.<sup>13</sup>

This Article builds on the argument that the usury solution is flawed and urges a compromise between usury and market control that employs the variable fairness standard of unconscionability to police unfair interest pricing. The Article examines American and comparative usury and unconscionability regulation to develop appropriate guidelines for unconscionability's new duty. It then proposes a model statute articulating the unconscionability standard for consumer loans.<sup>14</sup> Finally, the Article advocates employing usury controls under a limited regime of "spot treatment," rather than blanket control, for persisting pockets of lender abuse the unconscionability standard may fail to deter.<sup>15</sup>

#### A. *The Six Percent Solution: A Brief History of American Interest Pricing Regulation by a Fixed Fairness Standard*

Until recent years, the Bible and England were the two strongest influences on America's regulation of abusive interest rates.<sup>16</sup> In England, and elsewhere in Europe, religious opposition to charging any interest at all shifted as the industrial world developed to moral opposition to abusive interest.<sup>17</sup> In 1545, England became the first European country to establish a statutory rate of interest.<sup>18</sup> This "legal" rate gave lenders the certainty of knowing that rates below the legal rate were

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Michael Hudson, *Loan Scams that Prey on the Poor*, BUS. & SOC'Y REV., Winter 1993, at 11 (describing home equity loan abuses in deregulated states).

12. Refer to text accompanying note 86 *infra*.

13. See, e.g., Kenneth Howe, *Banks Losing War, Industry Chief Says*, SAN FRANCISCO CHRON., Nov. 2, 1988, at C4 (reporting that the president of the American Bankers Association called for less consumer-oriented regulation).

14. Refer to Part II(G) *infra*.

15. Refer to text accompanying notes 417-21 *infra*.

16. See generally Jarret C. Oeltjen, *Usury: Utilitarian or Useless?*, 3 FLA. ST. U. L. REV. 167, 171-80 (1975) (presenting a general history of interest rates in England and America).

17. See Marion Benfield, *Money, Mortgages, and Migraine—The Usury Headache*, 19 CASE W. RES. L. REV. 819, 831 (1968) (describing the change from prohibiting interest in the Middle Ages to prohibiting only unconscionable rates after the Reformation).

18. A Bill Against Usury, 1545, 37 Hen. 8, ch. 9 (Eng); see Oeltjen, *supra* note 16, at 173 (discussing the English statute that made taking interest legal but subject to regulation).

immune from attack. Though England repealed its usury laws in 1854,<sup>19</sup> the English experience had already set the standard of interest regulation followed by the American colonies: interest was allowed, but restricted by statute to a maximum single digit rate.<sup>20</sup>

During the nineteenth and twentieth centuries, here, as in England, arguments against regulating interest rates gained favor. A few states repealed their usury laws, notably Massachusetts in 1867, while in others legislative and judicial exceptions eroded usury controls.<sup>21</sup>

The first significant exception was the so-called "corporate exemption."<sup>22</sup> In 1850, New York became the first state to legislatively prohibit corporate borrowers from asserting the statutory defense of usury.<sup>23</sup> Eventually, a majority of states enacted similar statutes excluding corporate borrowers from the protection of general usury statutes.<sup>24</sup> Some states went further, excluding loans made for business purposes regardless of whether the borrower was a corporation or an individual.<sup>25</sup>

Following on the heels of the corporate exemption was the "time-price" exemption. Borrowed from English courts

19. Oeltjen, *supra* note 16, at 174; see Benfield, *supra* note 17, at 821 n.6 (citing the Usury Laws Repeal Act of 1854).

20. American interest pricing regulation has never been uniform. For example, most colonies initially adopted a 6% maximum, but Massachusetts fixed an 8% rate, and Virginia a 5% rate. SIDNEY HOMER & RICHARD SYLLA, *A HISTORY OF INTEREST RATES* 274-75 (3d ed. 1991). At the time of settlement of the colonies, England's Statute of Anne limited interest to 5%. Mark B. Riley, Note, *Usury Legislation—Its Effects on the Economy and a Proposal for Reform*, 33 VAND. L. REV. 199, 201 n.9 (1980).

21. 1867 Mass. Acts 56. See generally James M. Ackerman, Note, *Interest Rates and the Law: A History of Usury*, 1981 ARIZ. ST. L.J. 61, 86-88. Several states repealed their usury statutes during this period, but most reenacted them later. See Benfield, *supra* note 17, at 826.

22. Refer to note 351 *infra* for a discussion of the rationale for this exemption.

23. 1850 N.Y. Laws 172 (codified and amended at N.Y. GEN. OBLIG. LAW § 5-521 (McKinney 1989)). In *New York Dry Dock Bank v. American Life Ins. & Trust Co.*, 3 N.Y. 344 (1850), the court held that a loan of £48,000 from an English lender for a promised repayment of £50,000 plus 6% interest was usurious and ruled the corporate borrower had no obligation to repay any part of the loan. New York's legislatively created "corporate exception" to its usury law resulted from public outrage over the *Dry Dock* decision. See Ackerman, *supra* note 21, at 87-88.

24. See, e.g., DEL. CODE ANN. tit. 6, § 2306 (1974) ("No corporation shall interpose the defense of usury in any action."); KAN. STAT. ANN. § 17-7105 (1988) ("No corporation shall plead any statute against usury in any court in any suit instituted to enforce the payment of any bond, note or other evidence of indebtedness issued or assumed by it."); see DEE PRIDGEN, *CONSUMER CREDIT AND THE LAW* § 10.03[2] (1991) (stating that most states exempt corporations from usury statutes).

25. See PRIDGEN, *supra* note 24, § 10.03[2] (explaining that a substantial minority of states do not extend the protection of their usury statutes to business loans made to individuals).

interpreting England's usury statutes, this doctrine employed the strained judicial fiction that merchants don't receive "interest" when selling their goods on time.<sup>26</sup> Merchants charging more for goods paid over time than goods purchased for cash were thus freed from usury. After its rapid spread, this exemption persisted until the mid-twentieth century when some courts began rethinking and rejecting it<sup>27</sup> and several state legislatures enacted retail installment sales acts with rate ceilings directed specifically at merchants' credit sales.<sup>28</sup>

Another significant exemption from the single digit ceiling of American usury statutes was conceived in the early 1900s to facilitate small consumer loans that could not be made profitably at such rates. Legitimate lenders' refusals to make unprofitable loans were driving desperate consumer borrowers to loan sharks who exacted exorbitant, illegal rates.<sup>29</sup> To reclaim the consumer lending market for more reputable lenders, most state legislatures passed special small loan legislation that allowed lenders submitting to licensing and consumer protection regulation to charge double digit rates on consumer loans below a specified dollar amount.<sup>30</sup>

Despite the emergence of these exemptions, as of the early 1970s all but two states still restricted rates of consumer loans,<sup>31</sup> and several regulated rates of commercial loans.<sup>32</sup>

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26. See generally KEVIN W. BROWN & KATHLEEN E. KEEST, NATIONAL CONSUMER LAW CENTER, USURY AND CONSUMER CREDIT REGULATION § 9.3.2.1.1, at 224 (1987) (stating that the difference between the time price and the cash price was labeled the "time price differential" and not treated as interest).

27. See *Hare v. General Contract Purchase Corp.*, 249 S.W.2d 973, 978 (Ark. 1952) (affirming the case at bar based on the doctrine of stare decisis but announcing the future rule that increased credit sale prices may create a question of fact concerning whether the transaction is a loan that may be attacked for usury).

28. See, e.g., MD. CODE ANN., COM. LAW II § 12-610 (1990) (setting a maximum rate of 24% on installment sale agreements); see BROWN & KEEST, *supra* note 26, § 9.3.2.1.1, at 224 (citing state legislative action as the major force behind the decline of the time price exception).

29. Rates of 150-300% were being charged for consumer loans. See James T. Campen & William H. Lazonick, *Regulation of Small Loan Interest Rates: Public Policy and Consumer Welfare*, 1 NEW ENG. J. BUS. & ECON. 30, 30 (1980).

30. See, e.g., N.H. REV. STAT. ANN. § 399-A (1983) (setting a maximum interest rate of 2% per month up to \$600 and 1½% per month for amounts between \$600 and \$1500 for lenders submitting to the prescribed licensing requirements); see BROWN & KEEST, *supra* note 26, § 2.3.3.1 (explaining that many states adopted small loan laws in the early twentieth century patterned on the Uniform Small Loan Law). See generally Oeltjen, *supra* note 16, at 177 (discussing early solutions to "loan shark" domination of small loans).

31. See Christopher C. DeMuth, *The Case Against Credit Card Interest Rate Regulation*, 3 YALE J. ON REG. 201, 202 (1986) (citing Massachusetts and New Hampshire as the two states without such regulation).

32. See, e.g., TEX. REV. CIV. STAT. ANN. art. 5069-1.04(b)(2) (Vernon 1987) (limiting interest on commercial loans in excess of \$250,000 to 28% and imposing lower



These circumstances prompted a resurgence in the late twentieth century of the usury policy debate—a debate whose battle lines had been drawn centuries before.

*B. Point/Counterpoint—The Usury Policy Debate*

In 1787, Jeremy Bentham articulated the classic freedom of contract objection to interest pricing regulation: no person of "sound mind" who is "acting freely" should be hindered from striking a loan bargain on terms she finds acceptable.<sup>33</sup> Usury proponents decry this depiction of loan bargaining as rosy-eyed and idealistic<sup>34</sup> by arguing that lenders' bargaining strength over borrowers prevents the arms-length negotiation Bentham presupposes.<sup>35</sup> Correct or not, their argument misses the mark; a fixed ceiling on rates doesn't necessarily ensure fair bargains. Usury statutes impose an arbitrary cap on rates without regard to the operational costs of the particular lender, the degree of risk the individual borrower presents, or the borrower's level of sophistication.<sup>36</sup> As a result, only a narrow class of borrowers benefits from usury's approach—those borrowers who would otherwise have paid above the ceiling rate under a free market system because of ignorance or desperation, but whose credit standing would have garnered them the ceiling rate if they were bargaining equals.<sup>37</sup>

Rate ceilings are useless to correct bargaining inequalities for other borrowers. A consumer deserving of a ten percent rate but unable to bargain equally is protected little by a thirty-six percent rate ceiling.<sup>38</sup> Usury does no more than place

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ceilings for other loans).

33. Jeremy Bentham, *Defence of Usury*, in 3 THE WORKS OF JEREMY BENTHAM 3 (John Bowring ed.) (Edinburgh, William Tait 1843).

34. See Robin A. Morris, *Consumer Debt and Usury: A New Rationale for Usury*, 15 PEPP. L. REV. 151, 156 (1988) (challenging Bentham's free market argument).

35. See Jacob S. Ziegel, *Consumer Credit Regulation: A Canadian Consumer-Oriented Viewpoint*, 68 COLUM. L. REV. 488, 490 (1968) (noting that consumers typically lack both equality of bargaining power and appreciation of the legal consequences of consumer credit transactions).

36. See Riley, *supra* note 20, at 206 (explaining that usury statutes do not consider the variables that determine the cost of lending).

37. See Robert W. Johnson, *Regulation of Finance Charges on Consumer Installment Credit*, 66 MICH. L. REV. 81, 94 (1967) (noting that rate ceilings do not benefit high risk borrowers because lenders will simply refuse to make loans to them, and do not benefit low risk borrowers because lenders will already lend to them at rates lower than the ceiling); Oeltjen, *supra* note 16, at 214 (asserting that rate ceilings fail to protect consumers from paying unconscionable interest, especially for credit sales).

38. See Robert W. Johnson, *The New Law of Finance Charges: Disclosure, Freedom of Entry, and Rate Ceilings*, 33 LAW & CONTEMP. PROBS. 671, 684 (1968)

an arbitrary limit on the extent of the unfair advantage a lender can take. The reflex response to redress this egregious example might be to lower the rate ceiling (to, say, twelve percent) and thereby better protect these less risky borrowers. This adjustment, however, would increase the ranks of borrowers most deserving of protection but, in fact, least protected by usury: those borrowers unable to qualify for credit at or below the legal limit. Further adjustment to the rate maximum serves only to shift borrowers from one class to the other. When the ceiling is too high, large numbers of borrowers gain no real protection; low ceilings fail to serve credit-risky borrowers and, in fact, may drive them to the illegal lending market.<sup>39</sup> The elusiveness of the appropriate balance of protection is endemic to the usury solution.

Usury proponents offer unconvincing answers to these objections. They argue that the illegal loan market flourished at the turn of the century not because it is an unavoidable consequence of low rate ceilings, but because law enforcement was lax.<sup>40</sup> The persistence of the illegal market is now less significant to the debate, however, because lenders and merchants have developed creative evasions of usury regulation that are exploitative but nonetheless legal. Rent-to-own operators, for example, sometimes charge rates that rival those in the illegal market.<sup>41</sup> Though proponents admit that you cannot help everyone, they claim that usury statutes "undoubtedly benefit more borrowers by limiting contract interest rates than they harm by restricting credit."<sup>42</sup> Such head counting impedes the search for a more complete solution to the problem of abusive interest pricing. Moreover, borrowers excluded from the legal loan market by arbitrary rate ceilings are the

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(observing that a 20% usury ceiling "does not protect consumers who deserve a rate of twelve per cent but pay eighteen per cent because of carelessness or indifference").

39. Oeltjen, *supra* note 16, at 214. "Loan-sharking" provides a prime example of the illegal lending market and involves lenders who operate outside legal loan limits and who usually collect debts in an offensive manner. Exorbitant rates charged by those involved in illegal lending are further inflated to compensate for the added risk of usury penalties if caught. Note, *An Ounce of Discretion for a Pound of Flesh: A Suggested Reform for Usury Laws*, 65 YALE L.J. 105, 107 (1955-56) [hereinafter *Ounce*]; see also Lionel Bently & Geraint G. Howells, *Loansharks and Extortionate Credit Bargains-2*, 1989 CONV. & PROP. LAW. 234, 240 (noting that usury ceilings send high risk borrowers to loan sharks who charge "disproportionately high rates thinking that they 'might as well be hanged for a sheep as a lamb'").

40. See George J. Wallace, *The Uses of Usury: Low Rate Ceilings Reexamined*, 56 B.U. L. REV. 451, 488 n.150 (1976) (arguing that inadequate enforcement efforts and poor legislative drafting encouraged illegal lending in the early 1900s).

41. Refer to note 3 *supra* and accompanying text.

42. BROWN & KEEST, *supra* note 26, § 2.4.1, at 38.

very borrowers the usury rationale most seeks to protect: the poor and uneducated.<sup>43</sup>

Some usury advocates argue paternalistically that usury protects such high risk borrowers from themselves.<sup>44</sup> Noting the disruptive consequences, both psychological and economic, of seemingly inevitable default,<sup>45</sup> these proponents argue that usury is a "legitimate use of paternalism."<sup>46</sup> This unflagging allegiance to consumer welfare may be laudable, but their argument is flawed both in theory and practice.<sup>47</sup> The premises underlying scholarship advocating usury's paternalistic function are that (1) usury statutes in fact exclude high risk borrowers from the lending market, (2) these borrowers are prone to default, and (3) a responsible society should prevent the harmful consequences of default by excluding these borrowers from the lending market. The first premise is the most dubious. A high risk borrower excluded from the legal lending market may resort to the illegal one.<sup>48</sup> Usury limits intended to protect the most vulnerable borrowers from disruptive debt collection and the other consequences of default may instead

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43. See Riley, *supra* note 20, at 214 (explaining that the presence of rate ceilings prompts lenders to be reluctant to lend in the small loan market, which primarily serves the poor).

44. See BROWN & KEEST, *supra* note 26, § 2.4.1, at 38 (asserting that borrowers who have already borrowed large amounts should not be allowed to go further into debt); Benfield, *supra* note 17, at 879 (proposing that borrowers who can only borrow at excessive interest rates should be forbidden from borrowing).

45. See Wallace, *supra* note 40, at 458-59 (explaining the psychological strain of high risk credit); see also Campen & Lazonick, *supra* note 29, at 44-45 (arguing that extending credit to high risk borrowers is not in their best interest because of difficulties in repaying the debt). See generally Morris, *supra* note 34, at 167-68 (discussing the effects of default).

46. Morris, *supra* note 34, at 174.

47. The debate between usury critics and supporters may reflect an impasse over public moral values. Compare *id.* at 177 ("Usury laws are a useful and reasonable tool for limiting consumer debt. . .") with Michael Kawaja, *The Case Against Regulating Consumer Credit Charges*, 5 AM. BUS. L.J. 319, 328-29 (1967) ("[The paternalistic argument] is at odds with one of the basic tenets of our economic system which is constructed upon a belief that consumers should be free to make their own choices (including whether and how much they will borrow).").

48. See HILLEL BLACK, *BUY NOW, PAY LATER* 177-78 (1961) (speculating that large numbers of debtors rejected by finance companies turn to loan sharks); see also Jarret C. Oeltjen, *Pawnbroking on Parade*, 37 BUFF. L. REV. 751, 773 (1989) (arguing that pawnshop usury rates should be set high enough so that people are not forced to turn to loan sharks). See generally NATIONAL COMM'N ON CONSUMER FINANCE, CONSUMER CREDIT IN THE U.S. 104-05 (1972) [hereinafter CONSUMER CREDIT REPORT] (describing the characteristics of loan sharks). But see Campen and Lazonick, *supra* note 29, at 36 n.7 (observing that only people desperate for cash seek out loan sharks, not those who borrow for typical consumer purchases or debt consolidation). However, consumers do frequent the rent-to-own industry to purchase consumer durables, often at exorbitant rates. Refer to note 3 *supra* and accompanying text.

drive them to the market with the most notorious collection record. Moreover, these usury advocates assume that only abstinence can prevent the harmful consequences of default. There may be less drastic means. For example, pawn shops avoid the trauma of loan collection because they already possess the collateral and the debtor assumes no personal liability.<sup>49</sup> Strict enforcement of fair debt collection laws can deter any creditor misconduct in collecting conventional loans.<sup>50</sup>

Usury opponents also criticize usury in economic terms<sup>51</sup> related inextricably to those freedom of contract concerns articulated above. The economist's critique of usury is best summarized as follows:

Those [economists] who oppose interest rate restrictions view credit markets as relatively efficient when left alone to operate freely. According to this position free competitive markets lead to an optimum allocation of resources and maximum individual satisfaction. Consequently, interferences with normal credit flows by use of imposed ceilings on lending or deposit rates can only create inefficiencies in financial markets which hamper production and exert an adverse influence on the distribution of goods and services.<sup>52</sup>

The usury advocate might answer that rate controls are needed for borrowers unable to allocate resources efficiently<sup>53</sup> because they cannot comparison shop for interest rates effectively despite rate disclosure mandated by statute<sup>54</sup> and

49. See Oeltjen, *supra* note 48, at 773 (stating that pawnshops present a less critical problem "because if the payment is not made, there is no harassment of the debtors, no lawsuits, no loss of worktime due to court appearances, and no bad credit reports").

50. See CONSUMER CREDIT REPORT, *supra* note 48, at 101 (noting that legislation is often adequate but enforcement insufficient).

51. The author agrees with Professor Warren that "[i]t is time to usher in a new, realistic era of consumer protection" in which economists challenge legislators "to take into consideration the economic implications of consumer-oriented legislation." William D. Warren, *Consumer Credit Law: Rates, Costs, and Benefits*, 27 STAN. L. REV. 951, 961 (1975). Although economic principles should not always determine the legislative outcome, they should be considered as a relevant factor in policy setting.

52. Norman N. Bowsher, *Usury Laws: Harmful When Effective*, 56 FED. RES. BANK OF ST. LOUIS 16, 17 (1974).

53. See Geoffrey Giles, *The Effect of Usury Law on the Credit Marketplace*, 95 BANKING L.J. 527, 529 (1978) (explaining that the economic argument for usury controls is that small loan interest rates are inelastic because consumers will enter into the loans regardless of the costs).

54. See Oeltjen, *supra* note 48, at 771-72; Kawaja, *supra* note 47, at 325 (explaining that an assumption underlying usury advocates' argument that consumers cannot shop for better rates is that consumers do not understand required disclosures).

because, even if they could comparison shop effectively, they are reluctant to do so because of the stigma of being rejected by other creditors.<sup>55</sup> This is said to give every creditor a monopoly over any prospective applicant, permitting rates unaffected by the "competition." The usury solution, however, overshoots the mark and has too many negative side effects. If consumers' inability to understand rates prevents effective competition, rate disclosure should be reformed and consumer education pursued.<sup>56</sup> The stigma of creditor rejection discouraging comparison shopping should similarly be addressed by more direct solutions.

### C. *The Nays Have It: The Recent Cycle of Rate Deregulation in America*

Usury critics have had some success at various times in American history,<sup>57</sup> but the "remarkable" development of more widespread deregulation occurred abruptly in the late 1970s and early 1980s.<sup>58</sup> As a result of double digit inflation, rates extended to even the most creditworthy borrowers bumped up against usury ceilings.<sup>59</sup> Some states responded by raising existing usury ceilings, a few opting for a variable limit tied to indices reflecting inflationary changes.<sup>60</sup> These reforms made loans to more creditworthy borrowers viable despite inflation, but they ignored the larger economic and contractual concerns

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55. See Jeffrey Davis, *Revamping Consumer-Credit Contract Law*, 68 VA. L. REV. 1333, 1355 (1982) (stating that often consumers prefer not applying with other creditors over risking rejection); see also Oeltjen, *supra* note 16, at 211 (noting that most consumers only shop locally for credit, resulting in a monopoly for local lenders). See generally Kawaja, *supra* note 47, at 325 (enumerating the reasons put forth by usury advocates to support the argument that the consumer credit market is ineffective in allowing consumers to obtain competitive rates).

56. See Giles, *supra* note 53, at 530 (asserting that consumer education would be better for loan market efficiency than interest ceilings); Kawaja, *supra* note 47, at 330 (advocating rate statement reform). Refer to Part II(H) *infra* for a discussion of these and other potential market perfection reforms.

57. Massachusetts repealed its usury statute in 1867, and by 1900, 11 states had no usury limit. See Ackerman, *supra* note 21, at 86-87 (discussing the status of usury laws in America during the late nineteenth century). Usury ceilings were re-enacted later in most of those states. Refer to note 21 *supra*.

58. See DeMuth, *supra* note 31, at 213 (discussing the factors leading to the easing of usury laws).

59. See Ackerman, *supra* note 21, at 105-07 (noting that when the prime rate was 20% in April 1980, the federal rate ceiling for business and agricultural loans was 21%).

60. See, e.g., DEL. CODE ANN. tit. 6, § 2301(a) (1974 & Supp. 1992) (setting the maximum rate at the Federal Reserve discount rate plus 5%). See generally BROWN & KEEST, *supra* note 26, § 2.4.1 at 37 (discussing how states adapted their usury statutes to deal with high inflation).

of usury critics. Loans to willing but more risky borrowers were still effectively outlawed.<sup>61</sup> Some states receptive to more substantial reform repealed their general usury limits, leaving only piecemeal consumer credit controls in place,<sup>62</sup> and several repealed usury limits for even consumer credit transactions.<sup>63</sup>

Usury critics won more important victories in Congress. Congress responded to inflation outpacing state usury limits with the Depository Institutions Deregulation and Monetary Control Act of 1980<sup>64</sup> (DIDMCA), which preempted state regulation of certain consumer loans. DIDMCA overrode state usury restrictions on loans secured by first liens on residential real estate or residential mobile homes.<sup>65</sup> As DIDMCA sets no rate

61. See Riley, *supra* note 20, at 221 (explaining that the sliding scale maximum does not account for the lender's risk or cost so high risk borrowers are still unable to get loans). Compared to fixed rate standards, which demand legislative amendment, variable interest rate usury caps adjust readily to inflationary changes, but they nonetheless exclude high risk borrowers from the legal lending market when their risks exceed the variable cap. Thus, the variable rate solution does nothing to address the fundamental problem of the usury standard. *See id.*

62. BROWN & KEEST, *supra* note 26, § 2.4.1, at 37 (noting that special usury ceilings governing retail installment sales and small consumer loans were typically retained by the states); *see, e.g.*, IDAHO CODE § 28-42-201 (Supp. 1994) (stating that parties may contract for any rate not otherwise prohibited); *id.* § 28-41-101 (Supp. 1994) (regulating certain consumer loans).

63. See HOMER & SYLLA, *supra* note 20, at 425 (discussing state interest rate legislation in the mid-1980s); DeMuth, *supra* note 31, at 213, 234 (listing Arizona, California, Delaware, Illinois, Montana, New Hampshire, New Jersey, New Mexico, Nevada, New York, Oregon, South Carolina, South Dakota, and Virginia as among the states that repealed their limits on credit card rates).

64. Pub. L. No. 96-221, 94 Stat. 132 (1980). Congress in 1974 had already imposed federal usury limits on business and agricultural loans over \$25,000. Act of Oct. 29, 1974, Pub. L. No. 93-501, § 202, 88 Stat. 1558. That legislation expired in 1977. *Id.* § 206, 88 Stat. 1560. However, it was reenacted from 1979 to 1981. Act of Nov. 5, 1979, Pub. L. No. 96-104, 93 Stat. 789. Business and agricultural loans over \$25,000 were again temporarily governed by federal law as part of DIDMCA. That regulation expired in April 1983. Pub. L. No. 96-221, § 512, 94 Stat. 164 (1980).

65. 12 U.S.C. § 1735f-7a(a) (1988). First lien loans are preempted by DIDMCA whether purchase money or not, thus removing usury limits on home equity loans, and even automobile loans, if secured by a first lien on residential property. *See Smith v. Fidelity Consumer Discount Co.*, 898 F.2d 907, 908 (3d Cir. 1990) (holding that DIDMCA preempted state usury law when an automobile lender acquired first liens on realty by refinancing and consolidating prior liens on residences). DIDMCA applies to loans by lenders regulated by a federal agency, lenders making residential real estate loans exceeding \$1,000,000 per year, and lenders meeting certain other eligibility criteria. 12 C.F.R. § 590.2(b) (1994). This broad scope encompasses most lenders. States were allowed to "opt out" of this DIDMCA preemption, though that opportunity expired April 1, 1983. 12 U.S.C. § 1735f-7a(b)(2) (1988). Colorado, Georgia, Hawaii, Idaho, Iowa, Kansas, Maine, Massachusetts, Minnesota, Nebraska, Nevada, North Carolina, South Carolina, South Dakota, and Wisconsin opted out of some or all of this first lien preemption. KEEST, *supra* note 6, § 3.2.2.4, at 39. Opt out rights might seem inconsistent with federal repeal of usury limits. The practical effect, however, was to shift the burden to usury proponents at a time when high inflation made reenactment of state ceilings difficult. *See BROWN & KEEST, supra*

ceiling,<sup>66</sup> these consumer loans are subject to no express state or federal limits.<sup>67</sup> DIDMCA also allows federally chartered or insured lenders<sup>68</sup> to make other loans at the greater of a DIDMCA federal rate ceiling<sup>69</sup> or the rate otherwise allowed by state law.<sup>70</sup>

In combination, state deregulation and federal preemption<sup>71</sup> have freed more transactions from usury control than ever before in American history. But, as the "fixed" fairness control of usury lost ground in the late twentieth century, a "variable" fairness standard—the unconscionability doctrine—has emerged in contract law to take its place.

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note 26, § 2.4.1, at 37 (explaining that if a state failed to act its usury limits were effectively repealed).

66. Federal law does require creditors offering variable rate home loans to specify a "cap" on the rate, but leaves that amount to the parties' agreement. 12 C.F.R. § 226.30 (1994).

67. Refer to note 86 *infra* for a discussion of whether the unconscionability standard applies to loans subject to federal preemption.

68. *E.g.*, 12 U.S.C. § 1785 (1988); 12 U.S.C. § 1831d (1988 & Supp. V 1993).

69. The DIDMCA ceiling is 1% above the discount rate on 90-day commercial paper in effect at the local federal reserve bank. 12 U.S.C. § 1831d(a) (Supp. IV 1992).

70. *Id.*; 12 U.S.C. § 1785(g) (1988). This is based on the federal preemption "rate" established previously for national banks by the federal National Bank Act. 12 U.S.C. § 85 (1988). It is unsettled whether the "most favored lender" doctrine applying to national banks under that Act applies to lenders under DIDMCA. *See* PRIDGEN, *supra* note 24, § 10.04[3]. As with DIDMCA's first mortgage preemption, states were allowed, and six exercised, "opt out" rights. Colorado, Iowa, Massachusetts, Maine, North Carolina and Wisconsin opted out; Maine, however, rescinded its opt out. KEEST, *supra* note 6, § 3.4.3, at 47. Unlike DIDMCA's first mortgage preemption, the opt out period for federally chartered and insured depositories has no expiration date, so states may still opt out. *See* Pub. L. No. 96-221, § 521, 94 Stat. 164 (1980) (setting no deadline for states to opt out for federally insured and foreign banks).

71. Apart from DIDMCA's preemption, the National Bank Act preempts state rate regulation of national banks and thus shields the credit card industry from restrictive state usury limits. *See, e.g.,* Marquette Nat'l Bank v. First of Omaha Serv. Corp., 439 U.S. 299, 308, 318 (1978) (finding that credit card interest rates charged by national banks are governed by § 85 of the National Bank Act, allowing the higher of a federal rate or the state rate for the state in which the bank is chartered). There is also federal preemption for loans by federally chartered credit unions, certain agricultural loans and housing loans insured by the FHA or VA. *See* Federal Credit Union Act, 12 U.S.C. § 1785(g) (1988) (Insured credit union may charge interest at specified rate "notwithstanding any state constitution or statute which is hereby preempted"); Federal Land Bank v. Wilson, 719 F.2d 1367, 1372 (8th Cir 1983) (finding that Congress preempted state usury laws for credit transactions involving Federal Land Bank); KEEST, *supra* note 6, § 3.2.3 (discussing preemption of state usury law for housing loans insured by the FHA and VA).

*D. Rate Regulation at the Crossroads of Usury and Unconscionability*

The unconscionability concept has roots at least as deep as the Roman fair exchange doctrine of *laesio enormis*.<sup>72</sup> In the last few centuries, equity courts have invoked unconscionability to deny specific performance of contracts conveying land for grossly inadequate consideration and, occasionally, to police unfairness in other contracts.<sup>73</sup> The codification of the unconscionability concept in section 2-302 of the Uniform Commercial Code (UCC) has prompted legislative and judicial acceptance of policing fairness of bargains generally. Section 2-302's unconscionability standard has been applied freely by analogy to bargains outside its scope<sup>74</sup> and is often adopted as a matter of common law separate from the UCC.<sup>75</sup> Employed by almost every recent uniform act governing consensual transactions, the unconscionability standard has been adopted in multiple codifications in almost every state.<sup>76</sup> It has also been inducted into the Restatement (Second) of Contracts,<sup>77</sup> thereby entering

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72. See Dando B. Cellini & Barry L. Wertz, *Unconscionable Contract Provisions: A History of Unenforceability from Roman Law to the UCC*, 42 TUL. L. REV. 193, 193 (1967). Refer to notes 325-27 *infra* and accompanying text for a discussion of *laesio enormis*. Some commentators attribute the origin of unconscionability to the desire to regulate unfair interest rates. See Morris, *supra* note 34, at 153 n.12 (stating that the common law of unconscionability derived from the church doctrine of usury); K.L. Fletcher, *Review of Unconscionable Transactions*, 8 U. QUEENSLAND L.J. 45, 48 (1973) (stating that the English Court of Chancery developed the unconscionability doctrine to police transactions that eluded usury regulation).

73. See SINAI DEUTCH, UNFAIR CONTRACTS 46-49 (1977) (discussing the role the equity courts have played in denying enforcement of contracts on unconscionability grounds).

74. See generally JOHN D. CALAMARI & JOSEPH M. PERILLO, CONTRACTS § 9-39, at 403-04 (3d ed. 1987) (listing various instances when the UCC's unconscionability provision has been applied to contracts not involving the sale of goods). Section 2-302 has also been applied directly to contracts other than for the sale of goods, although these decisions should properly have applied § 2-302 by analogy. See, e.g., *White River Conservancy Dist. v. Commonwealth Eng'rs, Inc.*, 575 N.E.2d 1011, 1017 (Ind. Ct. App. 1991) (finding an 18% rate in an engineering services contract conscionable under § 2-302).

75. See, e.g., *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445, 448-49 (D.C. Cir. 1965) (noting that inclusion of an unconscionability provision in the then recently enacted UCC did not preclude the court from developing a similar common law rule to address unfairness before the effective date of the UCC); see also Morris G. Shanker & Mark R. Abel, *Consumer Protection Under Article 2 of the Uniform Commercial Code*, 29 OHIO ST. L.J. 689, 703 (1968) (noting that *Walker-Thomas* established that unconscionability could be asserted without statutory authority).

76. Refer to Parts II(B)(1) to II(B)(5) *infra* for discussion of certain uniform acts codifying unconscionability.

77. See RESTATEMENT (SECOND) OF CONTRACTS § 208 (1981) (incorporating language derived from § 2-302(1) of the UCC).



the general common law of contracts.<sup>78</sup>

There is little question that courts have the authority to apply the unconscionability standard to interest rates.<sup>79</sup> Sec-

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78. CALAMARI & PERILLO, *supra* note 74, § 9-39, at 403.

79. One commentator has questioned judicial authority to apply the unconscionability standard to interest pricing. See Bernard H. Goldstein, *Unconscionability: Some Reconsiderations with Particular Reference to New-Type Mortgage Transactions*, 17 REAL PROP., PROB. & TR. J. 412, 416 (1982) (suggesting that mortgage interest rates cannot be held unconscionable when usury restrictions have been repealed or preempted). Corbin, in contrast, believed unconscionability could be employed in the absence of usury protection. 1 ARTHUR L. CORBIN, CORBIN ON CONTRACTS, § 129, at 556 (1963) (arguing that very high interest rates may be found unconscionable in the absence of a usury statute).

One potential argument against applying the unconscionability standard to interest pricing as distinct from other contracts is that the legislature, by creating exceptions to usury or abolishing usury entirely, made a statement of public policy in favor of freedom of contract with no fairness control. Proponents of this argument might cite examples of enactments repealing usury that expressly recognized the potential application of unconscionability as supporting the denial of such a challenge if such language is not employed. See ALA. CODE § 8-8-5 (1993) (removing interest rate ceilings on loans and credit sales of \$2000 or more and expressly providing that "all laws relating to unconscionability in consumer transactions . . . shall apply to transactions covered by this section"); see also CAL. FIN. CODE §§ 22450.5, 24450.5 (West Supp. 1994) (stating that California's general unconscionability statute applies to loans made by personal property brokers and consumer finance lenders and that "a loan found to be unconscionable . . . shall be deemed to be in violation of this division and subject to the remedies specified in this division"). It is unlikely that legislatures repealing usury intended interest pricing to be free from the now established unconscionability standard of fairness review, at least without an express statement to that effect. Moreover, decisions have long applied the unconscionability standard to loans exempted from a state's usury laws by the "corporate exemption." Refer to text accompanying notes 22-24 *supra*. See, e.g., *Levin v. Johnson (In re Chicago Reed & Furniture Co.)*, 7 F.2d 885, 885 (7th Cir. 1925) (holding that the court of equity would not enforce a harsh and oppressive contract despite a statute exempting corporations from state usury laws); *Metal-Built Prods., Inc. v. Bornstein (In re Metal-Built Prods., Inc.)*, 3 B.R. 176, 178-179 (Bankr. E.D. Pa. 1980) (noting that the usury defense was not available to a corporate borrower, but concluding that the bankruptcy court can determine the conscionability of claims before it because equitable considerations are invoked when a creditor seeks a preferred position in bankruptcy); *First Mut. Corp. v. Grammercy & Maine, Inc.*, 423 A.2d 680, 687 (N.J. Super. Ct. Law Div. 1980) (noting that courts have refused to enforce interest rates on grounds of unconscionability even though the borrowers were corporations not entitled to the usury defense). A California appellate court in 1965 concluded that it had no authority to review the conscionability of a loan excluded from California's usury restrictions. See *Peoples Fin. & Thrift Co. v. Mike-Ron Corp.*, 46 Cal. Rptr. 497, 501-502 (Dist. Ct. App. 1965). However, that case was disapproved by a more recent California appellate decision. See *Carboni v. Arrospide*, 2 Cal. Rptr. 2d 845, 847 n.5 (Ct. App. 1991). But see *Williams v. Alphonse Mtge. Co.*, 144 So. 2d 600, 602 (La. Ct. App. 1962) (holding that the court had no discretion to find interest unconscionable when the legislature authorized charging above the statutory limit for the disputed loan).

Applying the unconscionability standard to interest pricing already governed by usury is less certain. For example, a state ceiling rate of 60% could be substantively unfair for creditworthy borrowers. It is doubtful, however, that such borrowers could challenge the 60% rate as unconscionable, at least without showing what has been termed "procedural unfairness." The Uniform Consumer Credit Code appears to

tion 2-302 governs credit sales of goods.<sup>80</sup> At least one state has an unconscionability statute for contracts generally.<sup>81</sup> State unfair trade practices acts, many of which proscribe unconscionable conduct expressly<sup>82</sup> or implicitly,<sup>83</sup> may govern the loan. In the equitable contexts of bankruptcy and judicial foreclosure proceedings, challenges to interest pricing have been pursued for decades as a matter of common law.<sup>84</sup> The only significant open questions as to a court's ability to review interest rates under an unconscionability standard arise when the challenged rate complies with an express usury limit provided by applicable state law<sup>85</sup> or when the loan is subject to federal preemption of state usury limits.<sup>86</sup>

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adopt this approach in stating that "a charge . . . expressly permitted by this Act is not in itself unconscionable." UNIF. CONSUMER CREDIT CODE § 5.108(3), 7 U.L.A. 811 (1974); *see also* Seaboard Fin. Co. v. Wahlen, 260 P.2d 556, 562 (Utah 1953) (stating that the "wholly unconscionable rate" was sanctioned by Utah's usury statute).

80. *See, e.g.,* Mobile Am. Corp. v. Howard, 307 So. 2d 507 (Fla. Dist. Ct. App. 1975) (applying § 2-302 to interest pricing of installment sale of mobile home); Jones v. Star Credit Corp., 298 N.Y.S.2d 264, 266 (Sup. Ct. 1969) (applying § 2-302 to the purchase of a freezer under a retail installment contract).

81. *See* CAL. CIV. CODE § 1670.5 (West 1985) ("If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract . . ."); *see also* Carboni v. Arrospide, 2 Cal. Rptr. 2d 845, 847 n.5 (Ct. App. 1991) (noting that § 1670.5 applies the doctrine of unconscionability to *all* contracts).

82. *E.g.,* OHIO REV. CODE ANN. § 1345.03 (Anderson 1993) ("No supplier shall commit an unconscionable act or practice in connection with a consumer transaction.").

83. *See* Kugler v. Romain, 279 A.2d 640, 652 (N.J. 1971) (construing New Jersey trade practices statutes to proscribe unconscionable conduct). New Jersey later amended its statutes to explicitly proscribe unconscionable conduct. *See* N.J. STAT. ANN. § 56:8-2 (West 1989) ("The act, use or employment by any person of any unconscionable commercial practice . . . is declared to be an unlawful practice . . .").

84. *See, e.g.,* Levin v. Johnson (*In re* Chicago Reed & Furniture Co.), 7 F.2d 885, 885-86 (7th Cir. 1925) (holding that a \$300 commission for making a \$2000 loan was oppressive and refusing to enforce the loan in the bankruptcy court); Metal-Built Prods., Inc. v. Bornstein (*In re* Metal-Built Prods., Inc.), 3 B.R. 176, 179 (Bankr. E.D. Pa. 1980) (finding interest in excess of 100% "draconian" but not unconscionable in a suit by a creditor of a bankrupt corporation); *In re* Elkins-Dell Mfg. Co., 253 F. Supp. 864, 866-74 (E.D. Pa. 1966) (holding that unconscionability is a valid defense in a bankruptcy court); Cheshire Mtge. Serv., Inc. v. Montes, 612 A.2d 1130, 1137-38 (Conn. 1992) (holding that a home improvement loan was conscionable because the loan charges were "in the middle of the market" and the borrowers were not oppressed or unfairly surprised); Hamm v. Taylor, 429 A.2d 946, 948-49 (Conn. 1980) (reversing the trial court's reduction of an effective annual interest rate from 16¼% to 12% for a mortgage debt of \$20,000 when no evidence of circumstances surrounding the loan was presented to support or negate a finding of unconscionability); Means v. Anderson, 32 A. 82, 82 (R.I. 1895) (holding that an interest rate was high but not unconscionable for a loan of \$25 for one month at 10% interest, but permitting mortgagor to redeem on payment of \$25 and interest at 6% per annum when the loan had not been repaid for 11 months).

85. Refer to note 79 *supra*.

86. When federal law allows the greater of a federal rate or the rate allowed

The law of unfair interest regulation in the 1990s is at an historic crossroads. Lower inflation since the early 1980s has halted the dramatic surge of deregulation and given usury proponents the opportunity to retake ground they lost in the 1980s. They are targeting specific industry abuses in their quest to establish new usury limits and reestablish old ones. The credit card industry narrowly escaped a federally imposed usury limit in 1991.<sup>87</sup> In 1993, bills were introduced in Congress to annul DIDMCA's preemption of nonpurchase money (home equity) first mortgage loans<sup>88</sup> and to subject rent-to-own transactions to existing usury limits in a majority of states on retail installment sales.<sup>89</sup> Consumer advocates are also urging

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by state law, rates would be limited under state law by the unconscionability standard if there was no state usury ceiling. Refer to notes 68-70 *supra* and accompanying text. The analysis is more problematic with regard to DIDMCA preemption of first mortgage loans because DIDMCA does not specify an alternate federal rate for such loans. Applying the unconscionability standard as a matter of state common law, however, does not appear to be precluded by either express or implied preemption. Section 501 of DIDMCA preempts "[t]he provisions of the constitution or the laws of any State expressly limiting the rate or amount of interest" 12 U.S.C. § 1735f-7a (1988). The unconscionability standard does not "expressly limit" the interest rate, as it employs a case-by-case analysis of fairness.

Implicit preemption depends on whether the unconscionability standard would frustrate the purposes of Congress in enacting DIDMCA. See, e.g., *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941) (finding that federal preemption of state law occurs when state law obstructs Congress from achieving its objectives). Enacted during rampant inflation, DIDMCA was intended to "enhance the stability and viability of our Nation's financial system and [was] needed to facilitate a national housing policy and the functioning of a national secondary market in mortgage lending." SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, DEPOSITORY INSTITUTIONS DEREGULATION ACT, S. REP. NO. 368, 96th Cong., 1st Sess. 19 (1979). DIDMCA's purpose was to free home loans from restrictive state rate ceilings that prevented loans at prevailing market rates. The unconscionability standard would further that purpose by validating market rates reflecting inflationary risks, while prohibiting abusive rates charged without relation to risks and costs.

Even if DIDMCA does preempt state unconscionability standards, the standard might exist under the federal common law. See *Perdue v. Crocker Nat'l Bank*, 702 P.2d 503, 516 n.19 (Cal. 1985) (raising the issue, but not deciding it, in an analogous preemption challenge to the unconscionability standard as applied to bank NSF charges).

87. In November, 1991, the Senate passed a bill imposing a federal variable ceiling on credit card rates. After the banking industry's acrimonious reaction drew threats of a presidential veto, the bill was tabled. See generally Todd M. Finchler, *Capping Credit Card Interest Rates: An Immodest Proposal*, 12 ANN. REV. BANKING L. 493, 499-500 (1993) (describing the events leading to the Senate's Credit Card Cap proposal). The impetus for that failed legislation, industry's slow response to reductions in the inflation rate, is ironic given lenders' critique of usury ceilings as unresponsive to increases in the inflation rate.

88. H.R. 3153, 103d Cong., 1st Sess. (1993). This legislation was introduced by Rep. Joseph P. Kennedy II on September 28, 1993 as the Home Equity Protection Act of 1993. Certain other home equity loan protection from this Act, although not the annulment of DIDMCA preemption, was enacted as part of the Riegle Community Development and Regulatory Improvement Act of 1994. Pub. L. No. 103-325.

89. H.R. 3136, 103d Cong., 1st Sess. (1993). This legislation would classify rent-

Congress to either enact a federal usury ceiling for consumer loans generally (and their functional equivalents) or to remove existing federal preemption to restore state usury limits.<sup>90</sup> Industry continues to lobby the free market standard.<sup>91</sup> This Article advocates settling the regulatory tug-of-war<sup>92</sup> through adoption of the unconscionability standard as a compromise to police unfair interest pricing.

*E. An Argument for Regulating Unfair Interest Rates Under the Variable Fairness Standard of Unconscionability*

Unconscionability's aim to redress overreaching in contracts is consistent with usury's rationale: the protection of borrowers from overreaching creditors.<sup>93</sup> Moreover, unconscionability is more resistant to evasion. Because usury regulation typically recognizes a violation only when certain discrete elements are present,<sup>94</sup> lenders can skirt usury by structuring transactions so as to avoid one or more of these elements. Rent-to-own transactions, when terminable at the consumer's will, may not fulfill the element of a loan or that of an obligation to repay principal.<sup>95</sup> Pawnbrokers structure their transactions as

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to-own transactions within the scope of these statutes presumably whether or not state law agreed. See 139 CONG. REC. H7142 (daily ed. Sept. 28, 1993) (statement of Rep. Gonzales) (describing a proposal to subject rent-to-own transactions to restrictions on credit sales and retail installment sales).

90. *Consumer Groups Back Bill that Would Regulate Home-Improvement Loans*, BALT. EVENING SUN, May 20, 1993, at 12A (reporting testimony of Michelle Meier of Consumers Union before the Senate Banking Committee in favor of legislation introduced eventually as H.R. 3153).

91. See generally Finchler, *supra* note 87, at 500 (describing industry reaction to the Senate credit card interest rate cap proposal).

92. See generally Warren, *supra* note 51, at 966 (noting a lack of consensus on consumer credit regulation despite decades of regulatory experience). These parties battle a regulatory tug-of-war of "loosening and [then] tightening of consumer credit regulation [that] has been evident through much of the twentieth century." BROWN & KEEST, *supra* note 26, § 1.2, at 14 n.3 (describing credit industry pressure for loosened regulation which succeeds until egregious abuse leads to reimposition of restrictions).

93. Cf. *Scarr v. Boyer*, 818 P.2d 381, 383 (Mont. 1991) (stating that usury laws provide protection for borrowers without real bargaining power against overreaching creditors).

94. These elements are the existence of a loan or forbearance, an obligation to repay principal, interest charged in excess of the allowed maximum, and usurious intent. See BROWN & KEEST, *supra* note 26, § 9.3.2.

95. See, e.g., *Givens v. Rent-A-Center, Inc.*, 720 F. Supp. 160, 162 (S.D. Ala. 1988) (holding that a week-to-week or month-to-month rental agreement is not a credit sale), *aff'd*, 885 F.2d 879 (11th Cir. 1989). But see *Miller v. Colortyme, Inc.*, 518 N.W.2d 544 (Minn. 1994) (holding that a rent-to-own transaction constitutes a credit sale subject to Minnesota's general usury statute). Usury statutes similarly may or may not apply to income tax refund assignment transactions. See *Cullen v.*

sale/repurchase options rather than as loans.<sup>96</sup> Lenders also exploit the often narrow statutory definition of "interest" by imposing unregulated fees and costs.<sup>97</sup> Retail vendors might inflate the cash price of their goods to keep compensation designated as interest within legal limits.<sup>98</sup> These evasion devices operate without regard to the underlying purpose of usury. Once sanctioned by courts, they at best allow legitimate profit when credit cannot be extended profitably below legal rates. At worst, however, they permit overreaching by creditors of needy and unsophisticated borrowers.<sup>99</sup> Evasion devices cannot elude the unconscionability standard, which operates in the law of contracts generally.<sup>100</sup> Whether the transaction involves a pawnshop, a rent-to-own center, a vendor, or a third party lender, its terms must withstand scrutiny as being either conscionable or unconscionable.

The one pro-usury argument the unconscionability standard may not address is the paternalistic claim that usury protects uncreditworthy borrowers from high risk borrowing doomed to default.<sup>101</sup> An unconscionability standard might validate high but nonetheless fair rates and thus fail to protect these borrowers from themselves. However, the unconscionability standard is flexible enough to protect these borrowers. Several states' codifications of unconscionability proscribe loans made with no reasonable probability of repayment.<sup>102</sup> Although this author

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Bragg, 350 S.E.2d 798, 800 (Ga. Ct. App. 1986) (holding that the state usury law does not apply to a tax refund assignment). See generally KEEST, *supra* note 6, § 5.5.3 (discussing assignment of tax refunds in relation to usury laws).

96. See Oeltjen, *supra* note 48, at 755, 784 n.166 (noting that many states therefore regulate pawnbroker rates by specific statutes, but observing that in the 1980s at least fifteen states did not have such statutes).

97. See Ackerman, *supra* note 21, at 96.

98. See Jeffrey E. Allen & Robert J. Staaf, *The Nexus Between Usury, "Time Price" and Unconscionability in Installment Sales*, 14 UCC L.J. 219, 231-32 (1981) (citing *Jones v. Star Credit Corp.* as an example of a case wherein a retail vendor attempted to circumvent the usury statute by inflating the initial purchase price in a credit sale). Shifting risk factors, such as the buyer's credit, to the price of the good penalizes the defaulting buyer who must pay unearned postdefault interest as part of the cash price. *Id.* at 233-34.

99. Cf. Ackerman, *supra* note 21, at 99 ("Avoidance may be better than the application of some laws, but is clearly less desirable than a rational law of interest rates.").

100. Refer to text accompanying notes 74-78 *supra*.

101. Refer to notes 44-50 *supra* and accompanying text.

102. For example, both the Uniform Consumer Credit Code (1974 Act) and the Uniform Consumer Sales Practices Act employ this standard. UNIF. CONSUMER CREDIT CODE § 5.108(4)(a), 7A U.L.A. 167 (1974) ("In applying . . . [the unconscionability provision], consideration shall be given to . . . [a] belief by the seller, lessor, or lender at the time a transaction is entered into that there is no reasonable probability of payment in full of the obligation by the consumer or debtor . . ."); UNIF.

opposes usury's paternalistic goal and opposes the use of unconscionability to reach the same end, the doctrine is flexible enough to encompass this goal if a legislature or a court believes saving people from "problematic debt situations"<sup>103</sup> justifies limiting their freedom to obtain credit from a willing lender at a fair rate.

The unconscionability standard addresses the primary argument of usury opponents as well: usury ceilings drive to abusive illegal lenders those borrowers too uncreditworthy to borrow at or below legal limits.<sup>104</sup> Under the unconscionability standard, legitimate lenders would be able to compete to lend to these borrowers at high but nonetheless fair and therefore legal rates. Under the logic of unconscionability, for every borrower, no matter how credit-risky, there is a fair rate; that is, a rate justified by the risks and other circumstances of the loan.<sup>105</sup>

The unconscionability standard is an irresistibly compelling regulatory replacement for usury.<sup>106</sup> Industry, however, prefers the free market standard and rejects both the usury and unconscionability standards.<sup>107</sup> Consumer advocates may tolerate

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CONSUMER SALES PRACTICES ACT § 4(c)(4), 7A U.L.A. 241 (1971) ("In determining whether an act or practice is unconscionable, the court shall consider circumstances such as . . . [whether] the supplier knew or had reason to know: . . . that when the consumer transaction was entered into there was no reasonable probability of payment of the obligation in full by the consumer . . ."). Even if a high rate is fair given the borrower's poor credit standing, the loan might be struck down as unfair if the borrower had no chance of repaying the loan. *Cf. Fidelity Fin. Servs., Inc. v. Hicks*, 574 N.E.2d 15, 20 (Ill. App. Ct. 1991) (holding that an unfair trade practices act claim was stated by allegations that the lender structured loan payments to precipitate default and foreclosure).

103. See *Morris*, *supra* note 34, at 178 (discussing the need to consider the social impact of problematic debt caused by over-leveraged borrowers).

104. Refer to text accompanying note 39 *supra*.

105. Refer to Part II(C)(3) *infra* for a discussion of risk as a factor in determining a fair interest rate.

106. Two commentators have advocated the use of unconscionability to control American interest rates. The idea was first expressed in a 1955 Yale Law Journal note advocating adoption of the unconscionability standard for commercial borrowers left unprotected by the corporate exemption from usury in most large commercial and industrial states. See Ounce, *supra* note 39. That author did not consider the use of unconscionability for consumer loans. More recently, a commentator dubbed the unconscionability standard a "compromise" model of rate regulation, but preferred the "free market" model with unconscionability employed only "if some marginal protection is deemed essential." Oeltjen, *supra* note 16, at 231-35; see also Susan P. McAllister, Note, *Judicially Imposed Usury Penalties in the Absence of Statutory Penalties: Can Freedom of Contract Co-Exist with Public Policy After Merritt v. Knox*, 68 N.C. L. REV. 1021, 1033 (1990) (advocating that courts use the unconscionability standard as a "safety net" to protect against overreaching lenders when a usury statute is repealed or modified after a loan is made and the court applies those changes retroactively).

107. Commentators have often noted attempts by various industries to avoid or

unconscionability while vigorously pursuing reenactment of comprehensive usury limits.<sup>108</sup> Criticism of the unconscionability standard can be expected from both.

Industry advocates favoring a free market approach with no unconscionability "safety net" can mine the wealth of noted scholarship critical of the unconscionability standard as applied to contracts generally, particularly its codification in section 2-302 of the UCC. Unconscionability's staunchest opponent, the late Professor Leff, compared unconscionability to both usury and Roman *laesio enormis*<sup>109</sup> as seeking "fairness of distribution" rather than "efficiency of allocation,"<sup>110</sup> a felony in the economists' (if not the emperor's) code. Leff viewed unconscionability not as a market-perfecting strategy, such as contract's and torts' prohibition of fraud, but as the free market's "covert enemy."<sup>111</sup>

Other commentators have observed that courts' use of unconscionability sometimes has inefficient results; clauses that operate in both parties' interests are voided. For example, the "add-on" clause employed by the merchant in *Williams v. Walker-Thomas Furniture Co.*<sup>112</sup> may be justified by the risks creditors face of not otherwise being made whole on the debtor's default.<sup>113</sup> The unconscionability standard might raise costs to consumers generally if lenders, forced to forgo clauses like the "add-on" clause, increase the cost of credit to compensate for their additional risk.<sup>114</sup> Unlike other clauses, unfair interest rates do not invite the same inefficient use of the

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oppose interest rate regulation of any kind. See, e.g., Finchler, *supra* note 87, at 500 (describing banking industry opposition to a Senate proposal to cap credit card interest rates); James P. Nehf, *Effective Regulation of Rent-to-Own Contracts*, 52 OHIO ST. L.J. 751, 752 (1991) (discussing regulation of the rent-to-own industry and noting that industry's assertion that usury laws are not applicable to rent-to-own transactions).

108. See, e.g., Davis, *supra* note 55, at 1338 (discussing regulation of the consumer credit industry and pressure from consumer groups for more regulation due to the perceived inadequacy of the unconscionability doctrine).

109. Refer to the text accompanying notes 325-27 *infra* for a discussion of *laesio enormis*.

110. Arthur A. Leff, *Thomist Unconscionability*, 4 CANADIAN BUS. L.J. 424, 427-28 (1979).

111. *Id.* at 427.

112. 350 F.2d 445, 447 (D.C. Cir. 1965).

113. See Richard A. Epstein, *Unconscionability: A Critical Reappraisal*, 18 J.L. & ECON. 293, 306-08 (1975) (arguing that "add-on" clauses in consumer credit sales make good economic sense, despite being attacked on unconscionability grounds).

114. See MARVIN A. CHIRELSTEIN, *CONCEPTS AND CASE ANALYSIS IN THE LAW OF CONTRACTS* 74 (2d ed. 1993) (discussing the *Williams v. Walker-Thomas Furniture Co.* decision and suggesting that the lender will increase its interest rate to compensate for having its "add-on" provision disallowed).

unconscionability standard. That standard should imperil only rates exceeding the risks of the transaction.<sup>115</sup> Unlike certain other clauses, the lender whose rate is held unconscionable cannot reallocate the risks for future transactions by raising the cost of the credit.<sup>116</sup> That cost itself is already unconscionable.<sup>117</sup> Professor Leff's scholarship also counsels that even if free market control of fairness proves ineffective, offensive clauses can be controlled better by legislation than by unconscionability's expensive case-by-case method of achieving consumer justice.<sup>118</sup> The most cogent observation in this unsettled debate, however, is that "[a]ll of the arguments about [which is] the proper forum for effecting social change probably have some merit."<sup>119</sup> Professor Leff's criticism of unconscionability is inapposite, however, when applied to unfair interest pricing. A legislature could outlaw add-on clauses and avoid case-by-case adjudication of consumer policy, but the legislative

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115. Refer to Part II(C)(3) *infra* for a discussion of the standard courts should employ in gauging rate fairness.

116. See Epstein, *supra* note 113, at 308-15 (discussing unconscionability as applied to typical contract clauses).

117. One commentator has observed in a broader context that courts could efficiently restructure transactions "to allow the weaker party a larger share of the gains, provided the stronger party receives enough benefit to keep the transaction mutually beneficial." DAVID W. BARNES & LYNN A. STOUT, *THE ECONOMICS OF CONTRACT LAW* 68 (1992) (Teacher's Manual). The unconscionability standard as applied to unfair interest pricing will not lessen the lender's incentives to bargain.

Usury regulation has been criticized as giving creditors an economic incentive to oppose consumer protection legislation. See Warren, *supra* note 51, at 958 (arguing that creditors, squeezed between low interest rate ceilings and moves to extend consumer protection legislation, have an incentive to oppose any protective legislation that would increase their costs). Consumer protection measures often entail costs passed to consumers through higher interest rates. If unrealistic rate ceilings prevent that transfer, creditors must oppose measures the legislature has not "costed out." There is no similar concern under the unconscionability standard, as higher costs would justify a higher rate.

118. See Arthur A. Leff, *Unconscionability and the Crowd—Consumers and the Common Law Tradition*, 31 U. PITT. L. REV. 349, 354-57 (1969) (criticizing the inefficiency of case-by-case litigation of "unconscionable" clauses in consumer transactions); see also *In re Elkins-Dell Mfg. Co.*, 253 F. Supp. 864, 872 (E.D. Pa. 1966) (reasoning that regulation of the financing industry should rest with the legislature, due to its ability to conduct a broad investigation encompassing the problem as a whole and avoiding piecemeal regulation). But see Benfield, *supra* note 17, at 884 (noting that the *Elkins-Dell* factors for determining the fairness of interest pricing argue against legislatures fixing rates for business loans, as "[c]ourts can take such factors into consideration in the particular case; the legislature cannot tailor its rules finely enough to do so"). See also H. James Stedronsky, Note, *Unconscionability and Standardized Contracts*, 5 N.Y.U. REV. L. & SOC. CHANGE 65, 79 n.87 (1975) (criticizing the result when government replaces flexible market checks and balances with rigid rules).

119. Robert A. Hillman, *Debunking Some Myths About Unconscionability: A New Framework for UCC Section 2-302*, 67 CORNELL L. REV. 1, 29 (1981).



alternative to adjudication of interest rate fairness is usury. Moreover, outlawing add-on clauses allows the loan transaction to proceed, though perhaps at a higher price, but usury statutes deny loans to risky borrowers as a class.<sup>120</sup> This result compels solutions other than usury to remedy the problem of unfair interest pricing.<sup>121</sup>

The unconscionability standard has also been criticized as applied specifically to interest pricing. Lenders decry its uncertainty and lack of standards. Unconscionability's case-by-case factual analysis forces them to "act at their peril or at least without sufficient objective standards for them to know in advance of litigation whether their loans are valid."<sup>122</sup> Judges have applied the unconscionability standard to interest rates in a manner claimed to be too subjective and logically inconsistent.<sup>123</sup> This recalls early criticism of the UCC and the price cases thereunder; courts were accused of applying the unconscionability standard irrationally, and, worse, section 2-302 was believed to encourage them to behave that way.<sup>124</sup>

There is some truth to the accusation that the unconscionability standard is uncertain. Despite its uncertainty, however, unconscionability is less offensive to freedom of contract than the alternative of more certain usury limits, and less offensive to those who value fairness over certainty than the free market alternative. This Article articulates the unconscionability standard to the extent possible to lessen lender uncertainty while promoting borrower enforcement.<sup>125</sup> Moreover, any risk of

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120. Refer to text accompanying notes 36-43 *supra*.

121. Legislation can nonetheless play a role in achieving consumer—and commercial—justice in interest pricing. This Article proposes codifying the unconscionability standard, at least for consumer credit, in order to ease the burden on consumers of adjudicating rate unfairness on a case-by-case basis. Refer to Part II(G) *infra* for a proposed statute for consumer credit.

122. Jack C. Merriman & James J. Hanks, Jr., *Revising State Usury Statutes in Light of a Tight Money Market*, 27 MD. L. REV. 1, 17 (1967) (advocating variable rate ceilings for consumer and small business loans and freedom of contract for business loans of \$10,000 or more).

123. See Edward A. Giedgowd, *The Expansion of California's Unconscionability Doctrine to Interest Charged on Loans*, 47 CONSUMER FIN. L.Q. REP. 98, 104 (1993) (criticizing the court's ruling in *Carboni v. Arrospide*, 2 Cal. Rptr. 2d 845 (Ct. App. 1991) that an interest rate of 200% per annum was unconscionable, for inconsistent reasoning and a result-oriented approach).

124. See Arthur A. Leff, *Unconscionability and the Code—The Emperor's New Clause*, 115 U. PA. L. REV. 485, 550 (1967) (criticizing the ruling in *American Home Improvement, Inc. v. MacIver*, 201 A.2d 886 (N.H. 1964) for a lack of analysis of the economic factors involved in a transaction held to be unconscionable); see also WALTER K. OLSON, *THE LITIGATION EXPLOSION* 211 (1991) (describing the unconscionability standard as one "of almost dreamlike floating indeterminacy").

125. Cf. John A. Spanogle, Jr., *Analyzing Unconscionability Problems*, 117 U. PA. L. REV. 931, 936 (1969) (stating that the stabilizing effect on contracts of the

borrower strike suits exploiting uncertainty can be reduced by granting courts explicit authority to levy attorneys' fees for such tactics.<sup>126</sup>

Consumer advocates level their own criticisms against the unconscionability standard. They argue that the high transaction costs of case-by-case judicial intervention<sup>127</sup> burden those "incapacitated borrowers who are least able to absorb such costs."<sup>128</sup> Arguably, these critics should prefer expensive protection to the free market model. Moreover, the unconscionability standard can be augmented with the measures proposed in this Article to make claims less expensive and daunting to pursue, particularly for consumer borrowers.<sup>129</sup>

The author predicts that debate in the next few decades will follow that under the UCC and shift from the propriety of employing unconscionability, here in place of usury, to the appropriate standard for its application.<sup>130</sup> The remainder of this Article seeks to anticipate the latter debate by examining possible standards for applying unconscionability to interest pricing and proposing a model statute to guide courts' use of the doctrine.

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unconscionability doctrine is dependent on the courts' ability to devise "solid definitions of the basic concepts" of the doctrine).

126. See Ounce, *supra* note 39, at 110 (arguing that discretion to assess attorneys' fees and costs has prevented vexatious lawsuits by borrowers in England, and proposing adoption of this technique by American courts). The model statute proposed for consumer transactions adopts this approach. Refer to Part II(G) *infra*.

127. See, e.g., Morris, *supra* note 34, at 173-74 (noting that defining unconscionability standards requires the intervention of the courts resulting in high transaction costs).

128. *Id.* at 173. Another commentator predicts that applying the unconscionability standard to interest pricing would add significantly to the caseload of "already burdened judicial and administrative systems." Riley, *supra* note 20, at 222.

129. One commentator argues against employing unconscionability because consumers frequently are unaware that the interest charged them is unreasonable. See Maxine M. Long, *Trends in Usury Legislation—Current Interest Overdue*, 34 U. MIAMI L. REV. 325, 338 (1980) (arguing that consumers continue to sign agreements without reading or understanding them despite disclosure of interest and finance charges required by law). However, borrowers could similarly be unaware they had been charged usurious rates. Perhaps this commentator believes lenders might be more tempted to charge excessive rates when the legal standard is less explicit. This temptation can be reduced, however, by expressing the standard of unconscionability as clearly as possible and backing that standard with remedial teeth. Refer to Part II(G) *infra* for a summary of the standards proposed for consumer loans.

130. See DEUTCH, *supra* note 73, at 78 (observing such a shift in the criticism of § 2-302).

## II. DRESSED FOR SUCCESS: DEVELOPING STANDARDS TO REGULATE INTEREST PRICING THROUGH UNCONSCIONABILITY

Certain recurring issues have plagued the application of the unconscionability standard in areas other than interest pricing, particularly under section 2-302 of the UCC. These issues can be framed for interest pricing as follows:

(1) Must procedural unfairness<sup>131</sup> be shown in proving interest pricing unconscionable?

(2) If so, what elements constitute procedural unfairness?

(3) When is interest substantively unfair?

(4) What remedies should courts grant to redress rates held unconscionable? Should the lender forfeit all principal and interest, interest only, or only the interest that exceeds a fair rate?

(5) Should the answer to any of these questions turn on whether the loan is for a consumer or a commercial purpose?

To anticipate and resolve these questions for interest pricing, this Article examines general unconscionability scholarship, the classic price unconscionability cases under section 2-302, more recent statutory codifications of unconscionability, and American and comparative statutes and courts applying unconscionability to interest rates. American and comparative usury statutes and federal loan disclosure regulation are also explored as analogous sources to resolve these issues for interest pricing.

### A. *Developing Standards: Unconscionability Scholarship and the Classic Price Unconscionability Cases*

Price unconscionability cases decided under section 2-302 are particularly relevant to standards for policing interest pricing.<sup>132</sup> If the standards of unconscionability for regulating cash and credit prices for goods differ too much, sellers on credit might shift their returns from the cash price to the cost of credit, or vice versa, depending on the differing standards applied. This shifting has occurred in the past when usury limited interest rates but no comparable controls limited price.<sup>133</sup>

131. "Procedural unfairness" is defined by at least one commentator as "bargaining naughtiness." Leff, *supra* note 124, at 487.

132. Several cases applying the unconscionability standard to interest pricing regard the classic UCC price unconscionability cases as persuasive authority. See, e.g., *Carboni v. Arrospide*, 2 Cal. Rptr. 2d 845, 847-48 (Ct. App. 1991) (stating that cases analyzing UCC § 2-302 can be used to help interpret the state's unconscionability statute and indicating that those cases which found unconscionability on the basis of gross price disparity may be used as analogous authority for finding unconscionability based on a "shockingly high" interest rate).

133. See, e.g., Allen & Staaf, *supra* note 98, at 231-35 (noting the irony that

1. *The Procedural v. Substantive Debate Under Section 2-302.* UCC scholars have debated vigorously whether an excessive price alone, without proof of specific bargaining misconduct, is unconscionable.<sup>134</sup> The late Professor Leff first observed and coined the distinction between “bargaining naughtiness” in the contract formation process and “evils in the resulting contract” as “procedural” and “substantive” unconscionability.<sup>135</sup> Most courts applying section 2-302 purport to require some combination of procedural and substantive unfairness to support a finding of unconscionability, but the issue is unsettled.<sup>136</sup> Several courts acknowledge a “sliding scale” whereby unusually harsh terms permit a lesser quantum of contract formation unfairness to support unconscionability.<sup>137</sup> Some decisions, particularly those involving excessive prices, appear to hold that substantive terms can be so unfair as to be unconscionable without proof of any procedural unfairness.<sup>138</sup>

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retail installment sales acts that regulate the price of merchant credit may encourage merchants to inflate the cash price to permit sales to persons too uncreditworthy to obtain credit under the legal limit); Richard S. Brooks, Note, *Is The High Mark-up in Low Income Areas Unconscionable?*, 16 HOW. L.J. 406, 409 n.15 (1971) (stating that bloated cash prices are employed to circumvent usury laws). Several of the price unconscionability cases under § 2-302 involved challenges to the price of goods sold on credit despite facial compliance with the applicable usury standard. See, e.g., *Kugler v. Romain*, 279 A.2d 640 (N.J. 1971) (stating that an excessive credit price was unconscionable in light of the respondent's deceptive trade practices, even if the excessive price was not per se unconscionable).

134. Compare Epstein, *supra* note 113, at 315 (stating that unconscionability in its “substantive dimension” only undercuts the private right of contract so that more social harm than good is done) with JAMES J. WHITE & ROBERT S. SUMMERS, *UNIFORM COMMERCIAL CODE* § 4-7, at 200 (3d ed. 1988) (favoring the interpretation that excessive price alone is a sufficient basis for finding unconscionability). Other commentators appear to stake a middle ground by advocating dispensing with procedural unfairness if substantive unfairness is extreme. See, e.g., DEUTCH, *supra* note 73, at 282 (stating that in extraordinary cases when a term is excessively unreasonable and unfair it is unconscionable regardless of whether procedural fairness is present).

135. See Leff, *supra* note 124, at 487; see also Alan Schwartz, *A Reexamination of Nonsubstantive Unconscionability*, 63 VA. L. REV. 1053 (1977) (labelling these classifications as “nonsubstantive” and “substantive”).

136. WHITE & SUMMERS, *supra* note 134, § 4-7, at 199; Hillman, *supra* note 119, at 2-3.

137. See Spanogle, *supra* note 125, at 950.

138. Refer to note 150 *infra* and accompanying text. Historical resolution of this issue provides little guidance. In 1804, Lord Eldon articulated what became an often-cited standard in equity that inadequacy of price alone does not justify relief unless it shocks the court's conscience. *Coles v. Trecothick*, 9 Ves. Jun. 234, 246, 32 Eng. Rep. 592, 597 (1804). See generally KEVIN M. TEEVEN, *A HISTORY OF THE ANGLO-AMERICAN COMMON LAW OF CONTRACT* 315-16 (1990) (stating that mid-nineteenth century cases often invoked Eldon's dictum, although oppression or other “sharp practices” were usually also present); Cellini & Wertz, *supra* note 72, at 198 (stating that unless it was so excessive as to shock the conscience, inadequacy of consideration required another element of unfairness for relief); John P. Dawson,

Section 2-302's drafting history does not resolve the debate.<sup>139</sup> Section 2-302's plain language does not deny the court's power to dispense with procedural proof "should it be moved to exercise it by the extremity of the situation before it,"<sup>140</sup> but it also does not preclude a court from insisting on such proof. Commentators have taken well-defined sides on the question. Freedom of contract proponents support requiring procedural proof. They argue that courts otherwise function as "price regulators," with the result that freedom of contract principles are "severely circumscribed."<sup>141</sup> Because bargains procured through procedural "naughtiness" were never assented to, courts can properly intervene.<sup>142</sup>

Such proponents also justify proof of procedural unfairness as efficient.<sup>143</sup> One argues that competitive markets work best

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*Economic Duress—An Essay in Perspective*, 45 MICH. L. REV. 253, 281 n.73 (1947) (stating that appellate decisions seem to make extreme inadequacy the primary basis for relief even with additional factors present). In practice, most equity cases have held an excessive price unconscionable only with proof of other inequitable factors. See Spanogle, *supra* note 125, at 951 (stating that older case doctrine recognized price disparity as a potential area for abuse but relief was not usually granted unless the price disparity was accompanied by additional inequitable factors). Some commentators and equity courts analyze gross price disparity as presumptive of fraud, and presumably would uphold such a bargain if the party seeking to enforce the contract proved both parties bargained deliberately over price. 3 SPENCER W. SYMONS, POMEROY'S EQUITY JURISPRUDENCE § 927, at 634-37 (5th ed. 1941). Reading these equity authorities together, a grossly excessive price could apparently be struck down without proof of unfairness in the contract's formation, but it is unclear if proof of fair bargaining would change that result. See James Gordley, *Equality in Exchange*, 69 CAL. L. REV. 1587, 1654 (1981) (observing by reviewing American equity cases that courts have granted relief for extremely one-sided exchanges more often than commentator and court remarks would indicate). See generally Hillman, *supra* note 119, at 36-37 (analogizing issues in equitable unconscionability to current issues surrounding § 2-302). Commentators in any event dispute equity's influence on the meaning of § 2-302. Compare Leff, *supra* note 124, at 533 (stating that equity unconscionability cases are irrelevant as a guide to the meaning of § 2-302) with Hillman, *supra* note 119, at 37-41 (arguing that Professor Leff erred in calling equity cases "irrelevant," especially noting that § 2-302 requires a "balancing" very similar to the equitable balancing used by chancellors).

139. See M.P. Ellinghaus, *In Defense of Unconscionability*, 78 YALE L.J. 757, 774 (1969) (stating that the current version of § 2-302 is less "unequivocal" than the 1948 draft, which had more definitely indicated that unconscionability could be found independent of a fair bargaining process).

140. *Id.* at 775.

141. Harvey L. Zuckman, *Walker-Thomas Strikes Back: Comment on the Pleading and Proof of Price Unconscionability*, 30 FED. B.J. 308, 311 (1971).

142. See DEUTCH, *supra* note 73, at 122 (stating that a showing of procedural unconscionability demonstrates that the contract terms were never assented to). Freedom of contract proponent Richard Epstein argued that the unconscionability doctrine should only be used to "facilitate the setting aside of agreements that are as a matter of probabilities likely to be vitiated by the classical defenses of duress, fraud, or incompetence." Epstein, *supra* note 113, at 295-96 (footnote omitted).

143. See BARNES & STOUT, *supra* note 117, at 65-66 (opining that consumers

when buyers are encouraged to seek out the most efficient seller.<sup>144</sup> Manipulating rules of proof to encourage efficiency, however, likely will have little practical impact on most consumers' failure to comparison shop, whether caused by laziness, ignorance, embarrassment, haste, or their general expectation of fair pricing in the marketplace.<sup>145</sup> Moreover, it seems more efficient to encourage merchants to price fairly than to require that consumers protect themselves. A consumer who knows that the law tolerates excessive pricing might be compelled to search the marketplace for every purchase, or risk exploitation by the first seller.<sup>146</sup>

The strongest argument in support of substantive unfairness alone is that procedural defects almost always accompany grossly inequitable terms.<sup>147</sup> Consumers could readily prove some procedural unfairness in almost every case of substantively unfair terms,<sup>148</sup> and it would seem an efficient use of judicial resources to dispense with that proof. Cogent support comes from those "classic" consumer price unconscionability cases<sup>149</sup> which held or have been read to support that unconscionability can be based on excessive price alone.<sup>150</sup> These cases

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should function as rational maximizers and that therefore courts should not create a better deal than the parties made).

144. Edward A. McQuoid, Note, *UCC Section 2-302 and the Pricing of Goods: Are the Courts More Than the Market Will Bear?*, 33 U. PITT. L. REV. 589, 597 (1972).

145. See Roundtable Discussion of *Unconscionability*, 31 U. PITT. L. REV. 547, 556-57 (1970) (Professor R. Stanton Wettick, Jr. remarking that most consumers' failure to comparison shop is caused by the typical consumer's experience in selecting a product, knowing that stores offer only one price that the consumer must take or leave).

146. See Melvin A. Eisenberg, *The Bargain Principle and its Limits*, 95 HARV. L. REV. 741, 781 (1982) (stating that consumers will not search for a slightly lower price, but when the price could be significantly lower, as under legal tolerance of excessive pricing, consumers will feel the need to search several marketplaces).

147. See, e.g., Spanogle, *supra* note 125, at 967 (stating that it is rare to find gross price disparity without other inequitable factors); David G. Dennis, Note, Kelly v. Widner: *Unconscionability Through the Looking Glass*, 53 MONT. L. REV. 99, 106 (1992) (stating that procedural defects almost always accompany other inequitable factors); see also 1 THOMAS D. CRANDALL ET AL., UNIFORM COMMERCIAL CODE § 4.8.4, at 4:82 (1993) (stating that the presence of an excessive price is strong evidence of the seller's misconduct in the negotiations).

148. Cf. Hillman, *supra* note 119, at 22 (arguing that unconscionability based on substantive unfairness alone makes it unnecessary for courts to manipulate the facts to find procedural unfairness).

149. Support also comes from equity's approach of treating certain groups as unable to protect themselves and deserving of special protection, without much inquiry into the actual bargaining of each particular case. See Leff, *supra* note 124, at 556-57 (discussing how class stereotypes influenced chancellors in equitable unconscionability cases).

150. See *American Home Improvement, Inc. v. MacIver*, 201 A.2d 886 (N.H. 1964) (finding unconscionability when a financing application left blank at the time

each involved circumstances from which a court could find sufficient procedural defects if such a finding was deemed necessary.<sup>151</sup> Dispensing with procedural proof will also increase

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of making the contract resulted in the homeowner being charged \$2,568.60 for goods valued at \$959); *Toker v. Perl*, 247 A.2d 701 (N.J. Super. Ct. Law Div. 1968) (finding a credit price of \$1,092.96 unconscionable when the freezer's "maximum" value was \$300), *aff'd on other grounds*, 260 A.2d 244 (N.J. Super. Ct. App. Div. 1970); *Toker v. Westerman*, 274 A.2d 78 (N.J. Union County Dist. Ct. 1970) (holding unconscionable a credit price that was 2½ times the freezer's reasonable retail value); *Jones v. Star Credit Corp.*, 298 N.Y.S.2d 264 (Sup. Ct. 1969) (finding a selling price of \$900, with a credit price of \$1,439.69, for a freezer valued at \$300 unconscionable as a matter of law); *Central Budget Corp. v. Sanchez*, 279 N.Y.S.2d 391 (Civ. Ct. N.Y.C. 1967) (allowing defendant purchasers of an automobile the opportunity to present evidence that the purchase price of \$939.75 plus a service charge of \$242.47 was so excessive as to be unconscionable as a matter of law); *State v. ITM, Inc.*, 275 N.Y.S.2d 303 (Sup. Ct. 1966) (holding unconscionable cash prices about 2½ times the retail market price and credit prices about 3 times the retail market price); *Frostifresh Corp. v. Reynoso*, 274 N.Y.S.2d 757 (Dist. Ct. 1966) (finding a cash price of \$900 with a credit charge of \$245.88 unconscionable for an appliance the seller admitted cost it \$348), *rev'd on other grounds*, 281 N.Y.S.2d 964 (App. Term. 1967). Corbin hailed *MacIver* as a "famously just decision . . . demonstrating that price alone can be sufficient unconscionability to invalidate a contract." CORBIN, *supra* note 79, § 128, at 30 (Supp. 1993). See generally Eisenberg, *supra* note 146, at 753 n.41 (stating that the facts in many of the cases cited above may suggest some form of high-pressure selling, but few cases develop the issue and none based their holding on it). Two leading price cases from the D.C. Court of Appeals insist that absence of meaningful choice be shown to sustain a finding of unconscionability. See *Morris v. Capitol Furniture & Appliance Co.*, 280 A.2d 775 (D.C. Ct. App. 1971) (noting the requirement of absence of meaningful choice and holding that there was ample support for the trial court's holding that no unconscionability existed where a buyer failed to comparison shop and paid \$832, including a \$219.30 credit charge, for goods costing only \$234.35); *Patterson v. Walker-Thomas Furniture Co.*, 277 A.2d 111 (D.C. Ct. App. 1971) (requiring a showing of the absence of meaningful choice as well as unreasonable contract terms when the appellant claimed excessive pricing after defaulting on her payments). Refer to note 161 *infra* for a discussion of the absence of meaningful choice. See also *In re Colin*, 136 B.R. 856, 858-59 (Bankr. D. Or. 1991) (stating that the rent-to-own price itself may not make a contract unconscionable because that would undermine the "economic principles upon which the economy of this country operates"); *Lundstrom v. Radio Corp. of America*, 405 P.2d 339, 342 (Utah 1965) (stating that because parties can bargain over price, an excessive price alone is not unconscionable in the absence of fraud, deception, or misrepresentation).

151. See Jeffrey C. Fort, *Understanding Unconscionability: Defining the Principle*, 9 LOY. U. CHI. L.J. 765, 780 (1978) (stating that decisions which found excessive price alone unconscionable involved parties of clearly disparate bargaining ability). For example, *MacIver* involved price unfairness "accompanied by circumstances which rendered it questionable whether defendant [consumer] had assented to the contract." See Lewis A. Kornhauser, Note, *Unconscionability in Standard Forms*, 64 CAL. L. REV. 1151, 1160 (1976) (referring to *MacIver*, in which the seller violated a New Hampshire statute requiring disclosure of the finance charge and charged \$2568.60 for goods valued at \$959); see also *Perl*, 247 A.2d 701 (finding that the seller misrepresented the price of a freezer by stating the freezer was "included" in a food plan then seeking to charge a price 2½ times its value); *Frostifresh*, 274 N.Y.S.2d 757 (finding that the seller exploited its customer's inability to read English by misrepresenting the freezer's true price). Similarly, the seller in *ITM* misrepresented that the consumers would earn enough in referrals to purchase the merchandise

certainty by eliminating the case-by-case determination of sufficient procedural unfairness.<sup>152</sup> Moreover, it avoids embarrassing proof of consumer incompetence, necessity, and the like.

2. *Procedural Unfairness Under Section 2-302.* Courts and legislatures may insist on proof of procedural unfairness. Moreover, some courts employ a "sliding scale" analysis whereby more procedural unfairness permits a finding of unconscionability on less substantive unfairness.<sup>153</sup> Either way, it is necessary to examine what suffices as procedural unfairness. Neither section 2-302 nor its official comments explain the nature of procedural unfairness. Section 2-302 defines unconscionability in terms of itself.<sup>154</sup> Its official comments<sup>155</sup> explain the concept in the uncertain terms of "oppression"<sup>156</sup> and "unfair surprise."<sup>157</sup> Courts have done little to define the standard

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without using their own money and that the products were not available elsewhere at the prices sold. *ITM*, 275 N.Y.S.2d at 314, 321. Finally, *Jones v. Star Credit Corp.* involved a door-to-door sale (invariably suspect) to a welfare recipient.

152. One commentator argued that requiring procedural unfairness actually aids certainty because of the difficulty in formulating a standard for when price is substantively unfair. See DEUTCH, *supra* note 73, at 145. He argued that requiring some showing of procedural unfairness takes pressure off the need for exactitude in the standard for substantive excess, which he alleged to be unachievable. *Id.* This author believes that there is just as much, if not more, uncertainty inherent in the standard for procedural unfairness, and this Article attempts to provide a more exacting standard for substantive unfairness than has emerged in the § 2-302 cases. Refer to Part II(C)(3) *infra*.

153. Refer to the text accompanying note 137 *supra*.

154. See U.C.C. § 2-302 (1990).

155. *Id.* at cmt. 1.

156. It is unclear whether "oppression" refers to unfairness in contract formation, or to the unfair effect of the contract itself, but either way it offers little practical guidance to courts. See Leff, *supra* note 124, at 499 (discussing how "oppression" was theoretically chosen to clarify § 2-302, but is actually a word chosen for this ambiguity). Commentators have speculated that oppression as applied to procedural unfairness implies "some form of compulsion resulting from a lack of opportunity to codetermine terms." See Spanogle, *supra* note 125, at 943.

157. See DEUTCH, *supra* note 73, at 187 n.83 (stating that there are no "fair surprises"); Spanogle, *supra* note 125, at 942 (arguing that "unfair surprise" and "oppression" are terms as ambiguous as "unconscionable"). If unfair surprise describes an offensive contract term hidden in boilerplate, it may not encompass price terms that are "often expressly agreed upon so that surprise cannot be claimed." See *id.* at 951 (stating that such express agreement makes excessive pricing a unique "harsh term"); McQuoid, *supra* note 144, at 598 (stating that price is almost always explicitly considered by the buyer as it is frequently the most important term). The same explicit consideration might be given to interest rates, though some consumers may pay more attention to the monthly payment amount. See generally 1 JOHN R. FONSECA, HANDLING CONSUMER CREDIT CASES § 7:3, at 264 (3d ed. 1986) (discussing how consumer preferences for the amount of the monthly payment vary with economic status). Federal, and often state, requirements that consumer loan rates be disclosed conspicuously may make surprise unlikely in theory, though disclosure legislation may not have this effect in practice. Refer to note 408 *infra* and



more precisely. Some courts apparently fear that a definition would unduly constrain the concept as a check on fairness.<sup>158</sup> Nonetheless, at least four factors appear relevant in proving procedural unfairness under section 2-302, whether they are said to result in oppression, unfair surprise, or some other shorthand expression of unfairness, such as lack of sophistication,<sup>159</sup> financial necessity, fraud (or other sharp practices),<sup>160</sup> or lack of choice.<sup>161</sup> Courts have not clearly articulated the

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accompanying text.

On the other hand, unfair "surprise" might exist for such obvious terms as price if the complaining party assumed the price was reasonable. That party is "surprised" upon discovering sometime later that the price agreed to is substantively excessive. *Cf.* Richard J. Hunter, Jr., *Unconscionability Revisited: A Comparative Approach*, 68 N.D. L. REV. 145, 153 (1992) (defining price unconscionability as a failure by the seller to apprise the buyer of contract terms that depart from "common expectations"); Stedronsky, *supra* note 118, at 83 (arguing that cases finding unconscionability on "significant cost-price disparity" appear to be examples of both substantive and procedural unconscionability as the buyers were unaware of the excessive price). Such unfair surprise could result from the seller's nondisclosure. *See* American Home Improvement, Inc. v. MacIver, 201 A.2d 886 (N.H. 1964) (finding unconscionability when the financing application failed to inform the homeowner of the interest rate and charges resulting in what the court held to be an excessive price); *cf.* Besta v. Beneficial Loan Co., 855 F.2d 532 (8th Cir. 1988) (finding it procedurally unfair for the lender not to disclose to the borrower that a different loan program it offered would be more advantageous). Unfair surprise could result from the seller's affirmative fraud as to the buyer's true cost. *Cf.* Frostifresh Corp. v. Reynoso, 274 N.Y.S.2d 757 (Dist. Ct. 1966) (finding that the buyer was misled that the purchase would not cost the buyer money), *rev'd on other grounds*, 281 N.Y.S.2d 964 (App. Term. 1967). It could also result from the buyer's lack of sophistication, or her inability to comprehend the transaction, or both. *Id.* (noting that the seller required a freezer buyer who spoke only Spanish to sign a contract written in English). *See generally* John E. Murray, Jr., *Unconscionability: Unconscionability*, 31 U. PITT. L. REV. 1, 59-66 (1969) (discussing and analyzing how landmark unconscionability cases have or could have applied § 2-302).

158. *See, e.g.,* Nu Dimensions Figure Salons v. Becerra, 340 N.Y.S.2d 268, 272 (Civ. Ct. 1973) (noting that the term "unconscionable" contains both procedural and substantive elements yet declining to further define the term).

159. Lack of sophistication was described in one case as "mental or physical disability or a wide disparity of knowledge or experience." *In re Estate of Vought*, 334 N.Y.S.2d 720, 729 (Sup. Ct. 1972), *aff'd*, 360 N.Y.S.2d 199 (App. Div. 1974); *see also* RESTATEMENT (SECOND) OF CONTRACTS § 208 cmt. d (1981) (listing factors contributing to unconscionability and including knowledge that the weaker party is unable to protect her interests because of an infirmity such as ignorance, illiteracy, or inability to understand the agreement).

160. *See* DEUTCH, *supra* note 73, at 136 (discussing how courts have found unconscionability in "sharp practices" such as deception and chicanery).

161. Lack of choice should be distinguished from insistence in several cases on so-called "absence of meaningful choice." *See e.g.,* Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965) (stating that "meaningful choice" is a question of facts and circumstances that may be negated by a "gross inequality of bargaining power" or by facts surrounding the contract's making). Lack of choice means the party could not have gotten a different (better) contract term elsewhere, resulting in a take-it-or-leave-it, or "adhesion," contract. *See generally* DEUTCH, *supra* note 73, at 147 (discussing the similarity between "lack of choice" and "absence of

requisite proof of these factors or specified a recipe for their successful combination. Though several commentators have proposed carefully drawn formulas for courts to follow under section 2-302, their notable efforts have had little impact on the courts.<sup>162</sup> This Article therefore examines other relevant sources of aid in articulating a standard of procedural unfairness for interest pricing.<sup>163</sup>

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meaningful choice" and analyzing the tests and factors used to distinguish them). *Henningsen v. Bloomfield Motors, Inc.*, 161 A.2d 69 (N.J. 1960) presents the classic example of a car buyer who would have confronted the same warranty exclusion term from other car manufacturers, so the only choice was to accept the term or forgo the purchase. Absence of meaningful choice is not merely the lack of choice, it is the lack of "meaningful" choice. One commentator correctly criticized the court's conclusion in *Morris v. Capitol Furniture & Appliance Co.*, 280 A.2d 775 (D.C. Ct. App. 1971) that the buyer of allegedly overpriced furniture who was free to compare shop had no "absence of meaningful choice," observing:

[T]he [*Morris*] court was imprecise in stating that because the customer had been free to indulge in comparative shopping, he could not later claim "absence of meaningful choice." The elements of absence of meaningful choice . . . are not necessarily related to the possibility of purchasing elsewhere but rather the question of whether such a choice is meaningful. In some cases, even if the possibility existed to purchase somewhere else, it was, nevertheless, not meaningful.

DEUTCH, *supra* note 73, at 146-47 (footnotes omitted). Courts employing this formulation should not overlook its initial articulation in *Williams v. Walker-Thomas Furniture Co.*:

Whether a meaningful choice is present in a particular case can only be determined by consideration of all the circumstances surrounding the transaction. . . . Did each party to the contract, considering his obvious education or lack of it, have a reasonable opportunity to understand the terms of the contract, or were important terms . . . minimized by deceptive sales practices?

350 F.2d at 449. Whether stated as oppression, unfair surprise or absence of meaningful choice, courts such as *Williams* insisting on procedural unfairness tend to require proof of one or some combination of the factors identified of lack of sophistication, financial necessity, seller sharp practice, and lack of choice. See WHITE & SUMMERS, *supra* note 134, § 4-3, at 187 (stating that courts which find a lack of "meaningful choice" usually base their holding on both consumer ignorance and "seller's guile").

162. See CALAMARI & PERILLO, *supra* note 74, at 406; Davis, *supra* note 55, at 1336 n.8 (stating that courts have not adopted the analytical framework proposed by classic unconscionability scholarship, but that those works have contributed by identifying relevant factors in an unconscionability case and by showing the "difficulty of analyzing them in a systematic way"). The primary contribution that has entered the mainstream of unconscionability case law is the courts' adoption of Professor Leff's terminology and argument for the relevance of both substantive and procedural unfairness.

163. Refer to Parts II(B) (codifications of unconscionability more recent than the UCC), II(C) (American interest pricing cases), II(D) (comparative rate regulation), and II(E) (American usury regulation) *infra*.

3. *Substantive Unfairness Under Section 2-302.* Regardless of whether courts require procedural unfairness, the challenged term must be proven substantively unfair. Section 2-302 does not specify a measure of substantive unfairness. The classic price unconscionability cases also have not produced a clear standard of substantive unfairness.<sup>164</sup> They do, however, suggest several possible measures:

(1) Price Over Cost—the sales price of the good compared to merchant cost;

(2) Net Profit—the sales price compared to the merchant's total costs of operation, including the cost of the good sold;

(3) Retail Price Comparison—the sales price compared to that of other retailers selling the same good; or

(4) Similarly Situated Retailer Comparison—the sales price compared to just those "similarly situated" merchants.<sup>165</sup>

The price over cost measure, employed in at least one case,<sup>166</sup> measures substantive unfairness too crudely because it disregards the merchant's operational costs.<sup>167</sup> The retail price measure is more accurate.<sup>168</sup> Commentators advocate that the retail price comparison be made only to "similarly situated sellers"<sup>169</sup> to avoid penalizing inefficient lower income area

164. See Spanogle, *supra* note 125, at 953 (stating that the decisions do not express their reasoning in enough detail). But see Ellinghaus, *supra* note 139, at 790 ("That the precise degree of disparity required for a finding of unconscionability has not been defined is a matter for rejoicing rather than for sorrow.").

165. This standard has been urged to address the higher costs of operation of "ghetto merchants" compared to other sellers. See WHITE & SUMMERS, *supra* note 134, § 4-5, at 192 (arguing that any standard which fails to account for costs will run merchants out of low income areas).

166. See *Frostifresh Corp. v. Reynoso*, 274 N.Y.S.2d 757 (Dist. Ct. 1966) (finding unconscionability when a freezer costing the merchant \$348 was sold for a cash price of \$900 and a credit price of \$1,145), *rev'd on other grounds*, 281 N.Y.S.2d 964 (App. Term. 1967).

167. See DEUTCH, *supra* note 73, at 149 (stating that considering only the variance between the retail and wholesale prices ignores the seller's costs and risks and is therefore an inaccurate means of determining unconscionability).

168. As with the price over cost measure, this would be relatively uncomplicated to apply, though it may be difficult to determine the sample of merchants to be used. For example, would the purchaser of a name brand appliance need to offer proof of every price throughout the country? If some narrower sample was employed, however, counsel might seek to manipulate the sample of merchants chosen. Adopting the standard of similarly situated merchants still presents the problem of how to define and limit the "similarly situated" seller.

169. See, e.g., WHITE & SUMMERS, *supra* note 134, § 4-5, at 192 (arguing that fairness requires comparing only sellers with similar costs and risks to avoid driving merchants from low income areas); see also Richard E. Speidel, *Unconscionability, Assent, and Consumer Protection*, 31 U. PITT. L. REV. 359, 373 (1970) (noting that costs, efficiency, and risks are variable among sellers and advocating a net profit comparison for determining substantive unconscionability). It is unclear whether

merchants who may receive the same actual profit as merchants generally despite higher prices.<sup>170</sup> Even as modified, however, the retail price standard is flawed. It is difficult to determine the scope of "similarly situated sellers."<sup>171</sup> Moreover, the retail price standard would validate a price in line with those of similarly situated sellers without regard to the possibility of price distortion caused by a monopoly or price fixing.<sup>172</sup>

The net profit measure is the most accurate gauge of unfairness of price and related terms such as interest. This standard avoids defining the scope of comparative sellers. Rather, it scrutinizes the costs of the particular seller, such as cost of the good, overhead, commissions and the like.<sup>173</sup> This standard is admittedly more complicated than the market price comparison because the merchant's costs must be allocated to the particular sale. Merchants might also try to manipulate this standard.<sup>174</sup> Nevertheless, this author advocates the net profit measure as the most accurate way to discern price unfairness.<sup>175</sup>

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those price unconscionability cases using a retail price standard determined retail price by reference to other retailers in general or some more limited class of similarly situated sellers. See, e.g., *Murphy v. McNamara*, 416 A.2d 170, 175 (Conn. Super. Ct. 1979) (making a comparison to the "retail sales price" of a television); *Jones v. Star Credit Corp.*, 298 N.Y.S.2d 264, 265 (Sup. Ct. 1969) (making a comparison to the "maximum retail value" of a freezer); *State v. ITM, Inc.*, 275 N.Y.S.2d 303, 320 (Sup. Ct. 1966) (making a comparison to the "retail market price" of various consumer goods).

170. A 1968 FTC study concluded that ghetto merchants charged higher prices for consumer durable goods than other sellers, but their profits did not differ significantly because of higher salaries, commission expenses, and credit costs, among other reasons. FEDERAL TRADE COMM'N REPORT ON DISTRICT OF COLUMBIA CONSUMER PROTECTION PROGRAM 14-15 (1968) [hereinafter FTC REPORT].

171. For example, is the similarly situated seller chosen by reference to location alone, or to size? A Sears department store in a low income neighborhood could likely operate more efficiently than a neighboring "mom and pop" operation. A small-scale merchant would likely argue that only those stores charging similar prices are similarly situated. This standard, if employed, would defeat the purchaser's claim.

172. See *Perdue v. Crocker Nat'l Bank*, 702 P.2d 503, 512 (Cal. 1985) (stating that while it is unlikely that a price set by a competitive market is unconscionable, oligopoly prices "should not be immune from scrutiny"); see also *California Grocers Ass'n, Inc. v. Bank of America*, 27 Cal. Rptr. 2d 396, 403 (Ct. App. 1994) (treating as relevant the NSF fees of other financial institutions and noting that the record did not establish that the California banking industry was oligopolistic).

173. The credit risk posed by the buyer would also be relevant when goods are purchased on credit.

174. For example, a self-employed merchant could pay herself an excessive salary and assert that as part of each product's cost. See WHITE & SUMMERS, *supra* note 134, § 4-5, at 193 (showing how merchants may lower their apparent profits through various distortions).

175. A tolerable consequence of focusing more precisely on the actual profit of the challenged seller is that an inefficient seller with costs higher than those of similarly situated sellers would presumably go unpenalized. Conversely, the net prof-

The amount of disparity the courts will tolerate must be determined for any standard employed to gauge substantive fairness. Courts and commentators have struggled in drawing the line.<sup>176</sup> Although the price unconscionability cases appear to disdain a fixed mathematical solution,<sup>177</sup> successful claims of price unconscionability typically involve a disparity ratio in excess of two to one.<sup>178</sup>

A few commentators have urged use of the two to one ratio to allocate the burden of proving price unfairness. Notably, Professor Speidel proposed that proof by the consumer of a two to one retail price comparison ratio would shift to the merchant the burden of proving that its actual net profits were reasonable.<sup>179</sup> This approach rightly places the burden of disclosing

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its standard arguably penalizes merchants who operate more efficiently (cheaply) than competitors. Cf. Note, *Inadequacy of Consideration as a Factor in Determining Unconscionability Under Section 2-302 of the Uniform Commercial Code*, 67 MICH. L. REV. 1248, 1255 (1969) (arguing that it is unfair to penalize sellers for high profits attributable to efficient operations or desirable business locations). However, sellers should desire to seek more efficient means of operation to gain a greater market share even if they must share their efficiency profits with consumers.

176. See Reuben Hasson, *Unconscionability in Contract Law and in the New Sales Act—Confessions of a Doubting Thomas*, 4 CANADIAN BUS. L.J. 383, 394 (1979-80):

Let us suppose that in a given case a dealer admits that he makes net profits of 60% and the evidence shows that other similarly situated dealers make profits of between 15% and 70% and that the average profit is 25%. Does the court give relief . . . on the ground that 60% is considerably in excess of the 15% profit that many dealers make and considerably in excess of the average profit? Your guess is as good as mine.

177. See, e.g., *Jones v. Star Credit Corp.*, 298 N.Y.S.2d 264, 267 (Sup. Ct. 1969) (stating that courts are reluctant to reduce § 2-302 to a mathematical formula).

178. See, e.g., *Murphy v. McNamara*, 416 A.2d 170 (Conn. Super. Ct. 1979) (finding unconscionability when the credit price of a television was over 2½ times the "regular retail sales price"); *Toker v. Perl*, 247 A.2d 701 (N.J. Super. Ct. Law Div. 1968) (finding unconscionability when a freezer's credit price was over 3½ times the "maximum value" and the cash price was over 2½ times that value), *aff'd on other grounds*, 260 A.2d 244 (Sup. Ct. 1970); *Toker v. Westerman*, 274 A.2d 78 (N.J. Union County Dist. Ct. 1970) (finding unconscionability when the credit price of a refrigerator was over 3 times the "reasonable retail value," and the cash price was approximately 2½ times that value); *Jones v. Star Credit Corp.*, 298 N.Y.S.2d 264 (Sup. Ct. 1969) (finding unconscionability when a freezer credit price was over 4 times the "maximum retail value," and the cash price was 3 times that value); *State v. ITM, Inc.*, 275 N.Y.S.2d 303, 320 (Sup. Ct. 1966) (finding unconscionability when the time price for various appliances ranged from 2 to 6 times the seller's cost); *Frostifresh Corp. v. Reynoso*, 274 N.Y.S.2d 757 (Dist. Ct. 1966) (finding unconscionability when the cash price of freezer was over 2½ times the merchant's cost) *rev'd on other grounds*, 281 N.Y.S.2d 964 (App. Term 1967). But see *Scheirman v. Coulter*, 624 P.2d 70 (Okla. 1980) (holding it not unconscionable for a consumer to purchase cookware on credit for \$457 when the items were advertised later in a department store sale for \$100).

179. See Speidel, *supra* note 169, at 372-73; see also WHITE & SUMMERS, *supra* note 134, § 4-5, at 193-94 (suggesting that a prima facie showing of unconscionability be established by a markup of two to three times cost or a price two to three

costs and justifying the price charged on sellers who possess that information. However, this solution is incomplete. It is unclear what happens to consumers who cannot establish the threshold ratio. Presumably, the seller need not reveal its net profit and the sale is validated even if the market price itself is unfair.<sup>180</sup> If the ratio is established, Professor Speidel proposed that the merchant's net profit be compared to that of similarly situated sellers, presumably for their retail transactions in general.<sup>181</sup> If there is "gross disparity" here, the merchant's price is unconscionable.<sup>182</sup> This leaves the question of what constitutes "gross" disparity for this purpose. A two to one ratio?<sup>183</sup>

Despite decades of effort by courts and commentators, a definitive standard for determining substantive price unfairness has not been articulated. The approach advocated by this author would examine the net profit made by the seller (or lender) on the transaction challenged, but would not include a mathematical formula conclusive of either fairness or unfairness.

4. *Remedies for Unconscionable Pricing Under Section 2-302.* Section 2-302 provides that the court may remedy an unconscionable contract or clause by "refus[ing] to enforce the contract," by enforcing "the remainder of the contract without the unconscionable clause," or by "so limit[ing] the application of any unconscionable clause as to avoid any unconscionable result."<sup>184</sup> The statute thus authorizes relieving the victim of price unfairness of all or some remaining payment obligation, but it does not appear to contemplate recovery of affirmative damages. Several courts have construed it to deny restitution of past excessive payments made.<sup>185</sup> Similarly, courts uniformly

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times the retail price of either similarly situated or other merchants generally); Zuckman, *supra* note 141, at 319 (agreeing with Professor Speidel but advocating a ratio of 1.7 or 1.8 to 1 rather than 2 to 1).

180. Presumably the seller's net profits on the challenged transaction would be unconscionable only if grossly excessive compared to the net profits in general of similarly situated sellers. See Speidel, *supra* note 169, at 373, 374. Thus, high net profits in the industry would insulate a price from challenge regardless of whether that market was competitive.

181. See *id.* at 373.

182. *Id.*

183. Speidel stated only that a two to one ratio would be acceptable for the threshold purpose of requiring the seller to justify its excessive retail price. *Id.*

184. U.C.C. § 2-302(1) (1990).

185. See, e.g., *Vom Lehn v. Astor Art Galleries, Ltd.*, 380 N.Y.S.2d 532, 541 (Sup. Ct. 1976) (holding that damages could not be recovered on the basis of an unconscionable contract when the plaintiff paid \$67,000 for an Oriental jade carving

deny punitive damages under section 2-302.<sup>186</sup>

The classic price unconscionability cases illustrate the narrow range of remedies courts award under section 2-302. Though the trial court in *Frostifresh Corp. v. Reynoso* had allowed the seller only its cost for the overpriced freezer, the appellate court awarded a reasonable profit over all costs incurred in the sale.<sup>187</sup> A later New York court did relieve a freezer buyer from further payments, but that buyer had already paid so much in excess of the freezer's value the seller was "amply compensated."<sup>188</sup> These decisions give sellers no incentive to be reasonable<sup>189</sup>—the message is gouge as gouge can, for at worst, if the victim fights back, sellers are limited to a fair profit and can even keep excessive profits already paid

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worth less than half that amount); *Best v. United States Nat'l Bank*, 714 P.2d 1049, 1056 (Or. Ct. App. 1986) (concluding that the doctrine of unconscionability is not a basis for affirmative relief in a class action suit by depositors challenging the validity of the bank's NSF service charge), *aff'd on other grounds*, 739 P.2d 554 (1987). But see *WHITE & SUMMERS*, *supra* note 134, § 4-8, at 204 (observing conversely that § 2-302 does not expressly preclude restitutionary recovery). The theory of economic duress, if proven, does allow restitution to the victim. See E. ALLAN FARNSWORTH, *CONTRACTS* § 4.19, at 282-83 (2d ed. 1990). Borrowing out of financial distress to obtain a necessity may not constitute economic duress, unless the lender's wrongful act or threat caused the distress. Unconscionability, therefore, goes beyond duress in denying enforcement of certain bargains resulting from the exploitation of distress, whether or not the promisee created the distress. See Eisenberg, *supra* note 146, at 759.

186. See, e.g., *Pearson v. National Budgeting Sys., Inc.*, 297 N.Y.S.2d 59, 60 (App. Div. 1969) (denying recovery of punitive damages by a plaintiff induced to buy a freezer at an unconscionable price).

187. 281 N.Y.S.2d 964, 965 (App. Term. 1967) (granting plaintiff seller recovery of net cost for refrigerator freezer, plus reasonable profit, in addition to trucking and service charges necessarily incurred and reasonable finance charges after finding that contract price of \$1145.88 was unconscionable for an appliance that the seller admitted cost \$348), *rev'g* 274 N.Y.S.2d 757 (Dist. Ct. 1966).

188. See *Jones v. Star Credit Corp.*, 298 N.Y.S.2d 264 (Sup. Ct. 1969) (holding that contract price was to be amended to \$619.88 for a \$300 freezer unit).

189. See Craig Horowitz, *Reviving the Law of Substantive Unconscionability: Applying the Implied Covenant of Good Faith and Fair Dealing to Excessively Priced Consumer Credit Contracts*, 33 UCLA L. REV. 940, 960 (1986) (arguing that consumers have little to gain by suing a merchant due to the high cost of legal representation and the time and effort required to bring a lawsuit); Donald B. King, *The Tort of Unconscionability: A New Tort for New Times*, 23 ST. LOUIS L.J. 97, 122-23 (1979) (pleading for unconscionable conduct to be classified as a tort because otherwise the most a company has to lose under contract theory is its unfair advantage under the unconscionable contract); see also FONSECA, *supra* note 157, § 4:9, at 139 (noting that the *Frostifresh* appellate court's remedy encourages unconscionable contracts since creditors are aware that courts will allow a net profit from the deal). For a similar criticism of *Frostifresh* from a distinguished contracts theorist, see IAN R. MACNEIL, *CONTRACTS, EXCHANGE TRANSACTIONS AND RELATIONS* 4-10 (2d ed. 1978) (Teacher's Manual) (explaining that sellers under the *Frostifresh* recovery rule suffer no penalty for unconscionable behavior because the unconscionability sanctions under § 2-302 are "to put it mildly, not very potent").

them.

This remedial imbalance has sparked debate on how to secure stronger remedies for unfair pricing. Section 2-302 appears to expressly sanction nonenforcement of the contract, so a court might deny the seller recovery of any amount still unpaid, not just that in excess of a fair profit.<sup>190</sup> Some commentators have advocated this remedy,<sup>191</sup> but the few cases employing it can be distinguished readily on their unusual facts.<sup>192</sup> Thus, nonenforcement has not yet entered the mainstream of remedies for price unfairness under section 2-302.<sup>193</sup>

Some commentators advocate compensating victims of unconscionable conduct for emotional distress, or awarding punitive damages. One urges courts to award punitive damages directly under existing section 2-302 for unconscionable conduct that is a "first cousin to fraud;"<sup>194</sup> another advocates that unconscionable conduct in general be actionable as a tort independent of the UCC.<sup>195</sup> Courts thus far have refused to award

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190. See U.C.C. § 2-302 (1990):

If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.

191. See, e.g., Ellinghaus, *supra* note 139, at 782 (advocating that courts consider refusing to enforce, rather than rewriting, contracts characterized by "overall imbalance"); Brooks, *supra* note 133, at 428 n.79 (suggesting that to maintain the spirit and intent of § 2-302, courts should refuse any enforcement of the contract and allow buyers to recover all payments).

192. The court in *American Home Improvement, Inc. v. MacIver*, 201 A.2d 886 (N.H. 1964) refused to enforce an unfairly priced home improvement contract, relieving the homeowner from any payment obligation. Because the contractor had performed only a "negligible amount" of work, the contract was essentially executory. *Id.* at 887. Moreover, the court concluded a state disclosure statute had been violated and its purpose would be furthered by refusing to enforce the contract. *Id.* at 888. The court in *State v. ITM, Inc.*, 275 N.Y.S.2d 303 (Sup. Ct. 1966) also refused to enforce retail installment contracts for the purchase of various appliances. This result can be explained by the court's finding that, in addition to being unconscionable, the contracts resulted from an illegal lottery "referral selling" scheme and constituted a public nuisance. *Id.* at 328. As such, refusing to enforce the contracts may have been the usual remedy for contracts found void against public policy.

193. See *WHITE & SUMMERS*, *supra* note 134, § 4-8, at 201 (stating with regard to unconscionability in general that courts only occasionally refuse to enforce entire contracts).

194. *Id.* at 203-04 (suggesting the use of punitive damages in situations where sellers persuade unsophisticated buyers to pay two or three times the going market price and to believe the transaction is a "good deal"); cf. *Smith v. First Family Fin. Serv., Inc.*, 626 So. 2d 1266 (Ala. 1993) (holding that summary judgment for a lender was improper on a claim that the lender committed fraud by concealing excessive loan origination costs). See generally Frank J. Cavico, *Punitive Damages for Breach of Contract—A Principled Approach*, 22 ST. MARY'S L.J. 357 (1990) (discussing the applicability of punitive damages).

195. See King, *supra* note 189, at 123 (proposing that unconscionable conduct be



tort remedies unless the merchant's conduct constitutes some established tort such as fraud.<sup>196</sup> One innovative commentator, recognizing that courts were awarding tort remedies to redress breaches of the implied covenant of good faith in insurance contracts, theorized that excessively priced consumer goods would breach that covenant as implied for merchants.<sup>197</sup> In the mid-1980s it made sense to hitch unconscionability to the rising star of the bad faith tort, but that star has since fallen for borrowers, as several jurisdictions recently have refused to remedy bad faith in a lender-borrower relationship as a tort separate from a contract claim.<sup>198</sup>

Another "remedy" possible in bankruptcy is to equitably subordinate claims involving some "inequitable conduct" that injures other creditors or confers an unfair advantage.<sup>199</sup> Available under existing law,<sup>200</sup> this sanction might be deployed to deter unconscionable conduct.

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classified as a tort, allowing a damaged party to sue for emotional distress and suffering).

196. See, e.g., *F.N. Roberts Pest Control Co. v. McDonald*, 208 S.E.2d 13 (Ga. Ct. App. 1974) (affirming a jury award of \$4425 exemplary damages and \$5575 general damages from an excessively priced home improvement contract procured through fraud); *Star Credit Corp. v. Ingram*, 347 N.Y.S.2d 651 (N.Y. Civ. Ct. 1973) (awarding punitive damages of \$15,000 to deter a refrigerator and food plan sales scheme involving fraudulent representations and "grossly unconscionable profit").

197. See Horowitz, *supra* note 189, at 975 (proposing that a breach of the implied covenant of good faith should give rise to tort remedies).

198. See, e.g., *Careau & Co. v. Security Pac. Business Credit, Inc.*, 272 Cal. Rptr. 387, 404 (Ct. App. 1990) (holding that there was no basis for a tort recovery for breach of an implied covenant of good faith in a contract between a corporation and a bank because no "special relationship" existed); *Rodgers v. Tecumseh Bank*, 756 P.2d 1223, 1226-27 (Okla. 1988) (declining to extend the implied duty of good faith and fair dealing imposed upon contracts of insurance to contracts for commercial loans). See generally Kerry L. Macintosh, *Gilmore Spoke Too Soon: Contract Rises From the Ashes of the Bad Faith Tort*, 27 LOY. L.A. L. REV. 483 (1994) (detailing the sudden reversal of fortunes for the bad faith tort which has died in every application except insurance).

199. See *In re Castletons, Inc.*, 990 F.2d 551, 559 (10th Cir. 1993) (authorizing equitable subordination when (1) the claimant engages in some type of inequitable conduct, (2) the misconduct resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant, and (3) equitable subordination of the claim is not inconsistent with the Bankruptcy Code); *Equity Mortgage, Inc. v. Johnson (In re Johnson)*, 149 B.R. 284, 287-88 (Bankr. D. Conn. 1993) (declining to decide trustee's claim that mortgage debt implicated principles of equitable subordination because mortgage loan transaction was unconscionable); Note, *Bankruptcy: Equitable Subordination of Unconscionable Claims*, 40 S. CAL. L. REV. 165 (1967) (examining the nature and proposed criteria governing the decision in bankruptcy to subordinate a security agreement negotiated at arm's length between a lender and the bankrupt because the judge finds it unconscionable).

200. See 11 U.S.C. § 510(c)(1) (1988).

5. *The Consumer/Commercial Party Distinction Under Section 2-302.* Application of section 2-302 appears to support the same standard for unconscionability for both consumer and commercial transactions. Though courts applying section 2-302 are generally not solicitous of commercial parties claiming unconscionability,<sup>201</sup> commercial parties are not automatically excluded from its protection.<sup>202</sup> A few have been successful on proof they were "poorly educated, 'over a barrel,' or the victim of fine print."<sup>203</sup>

### B. Statutory Unconscionability—General

Several commentators have puzzled over the trickle of price unconscionability cases under section 2-302 since the flurry of cases in the late 1960s and early 1970s.<sup>204</sup> The best explanation is that section 2-302, applicable only to sales of goods<sup>205</sup>

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201. See CRANDALL ET AL., *supra* note 147, § 4.8.5, at 4:83-84 (noting that there are few instances in which commercial contracts have been found unconscionable); FARNSWORTH, *supra* note 185, § 4.28, at 330-32; WHITE & SUMMERS, *supra* note 134, § 4-9, at 205-10 (analyzing unconscionability in commercial settings). One commentator explained that the cold shoulder given commercial parties results from the "far greater opportunities for inequities in bargaining power, lack of choice, unfair surprise, and deception in relations between individual customers and a corporation than in merchant-to-merchant relations." See DEUTCH, *supra* note 73, at 137.

202. A majority of the Permanent Editorial Board Study Group, which in 1990 recommended revision of Article 2 of the UCC, does not believe § 2-302 should be revised to distinguish between consumer and commercial contracts. See PEB STUDY GROUP, PRELIMINARY REPORT ON UNIFORM COMMERCIAL CODE ARTICLE 2 at 81 (1990).

203. WHITE & SUMMERS, *supra* note 134, § 4-9, at 207; see, e.g., *Weaver v. American Oil Co.*, 276 N.E.2d 144, 145-48 (Ind. 1971) (holding that when a provision in a service station lease exculpating the lessor oil company for its negligence and compelling the lessee to indemnify the lessor for loss resulting from lessor's negligence was not explained to the lessee, who had left high school after 1½ years, the hold harmless clause was unconscionable); *Rozeboom v. Northwestern Bell Tel. Co.*, 378 N.W.2d 241, 244-45 (S.D. 1984) (stating that an individual businessperson was not a professional and could not negotiate with the defendant telephone company, thus the clause limiting liability of the telephone company for omission of a listing to the amount paid by the businessperson was unconscionable and unenforceable). Professor Farnsworth observed more generally that the successful commercial cases involve some "imbalance" in the parties' relationship. FARNSWORTH, *supra* note 185, § 4.28, at 331; see also CRANDALL ET AL., *supra* note 147, § 4.8.5, at 4:84 (noting that successful commercial cases usually involve companies that vary in size, with the small companies persuading courts that they lack the resources to deal effectively with the larger companies); Hillman, *supra* note 119, at 43-44 (suggesting that dealings between merchants should be carefully scrutinized when one of the merchants involved is in a position of dependency or is poorly educated).

204. See, e.g., Horowitz, *supra* note 189, at 958-60 (speculating that the demise was caused by "doctrinal disarray" from "confused judicial reasoning" in the classic price unconscionability cases, as well as inadequate remedies in § 2-302).

205. U.C.C. § 2-102 (1990) ("Unless the context otherwise requires, this Article

and unchanged since its inception, has been replaced as the preferred vehicle for pursuing unfair pricing claims by subsequent state law ranging from price controls on consumer goods during natural disasters<sup>206</sup> to California's statutory prohibition of unconscionability in contracts generally.<sup>207</sup> Price litigation has slowed under section 2-302 but thrives under newer statutes<sup>208</sup> that offer more detailed standards as well as more potent remedies.<sup>209</sup>

1. *Statutory Unconscionability—The Procedural v. Substantive Debate.* Unfortunately, these newer statutes do not resolve the procedural unfairness debate. Many do not address the issue at all.<sup>210</sup> A few have been construed to require more

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applies to transactions in goods.”).

206. See, e.g., N.Y. GEN. BUS. LAW § 396-r (McKinney 1984):

During any abnormal disruption of the market for consumer goods and services vital and necessary for the health, safety and welfare of consumers, resulting from stress of weather, convulsion of nature . . . [or] national or local emergency . . . , no merchant shall sell or offer to sell any such consumer goods or services for an amount which represents an unconscionably excessive price.

207. See CAL. CIV. CODE § 1670.5 (West 1985):

If the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause, or it may so limit the application of any unconscionable clause as to avoid any unconscionable result.

208. For examples of statutes under which price unconscionability claims might be brought, see such unfair trade practice statutes as the Uniform Consumer Sales Practices Act, adopted in Kansas, Ohio, and Utah, and such consumer credit statutes as § 5.108 of the Uniform Consumer Credit Code, adopted in its 1968 version by Colorado, Guam, Indiana, Oklahoma, Utah, Wisconsin (based on both the UCCC and the National Consumer Law Center's National Consumer Act), and Wyoming, and in its revised 1974 version, or working drafts leading to the 1974 version, by Idaho, Iowa, Kansas, Maine, and South Carolina.

The Uniform Consumer Sales Practices Act provides:

In determining whether an act or practice is unconscionable, the court shall consider circumstances such as the following of which the supplier knew or had reason to know:

. . .

(2) that when the consumer transaction was entered into the price grossly exceeded the price at which similar property or services were readily obtainable in similar transactions by like consumers.

UNIF. CONSUMER SALES PRACTICES ACT, § 4, 7A U.L.A. 241 (1971).

The Uniform Consumer Credit Code identifies factors to be considered in determining unconscionable transactions, including a “gross disparity between the price of the property or services sold or leased and the value of the property or services measured by the price at which similar property or services are readily obtainable in credit transactions by like consumers.” UNIF. CONSUMER CREDIT CODE § 5.108, 7A U.L.A. 167-68 (1974).

209. In contrast, uncertain standards and tepid remedies are blamed for the decline in price litigation under § 2-302. Refer to note 204 *supra*.

210. See, e.g., UNIF. CONSUMER CREDIT CODE § 5.108 (4)(c), 7A U.L.A. 168 (1974)

than excessive price alone.<sup>211</sup> Those that require such proof also expressly recognize that gross price disparity is inevitably accompanied by procedural unfairness.<sup>212</sup> These statutes seem to anticipate that victims of excessive pricing will be able to prove the requisite procedural unfairness.<sup>213</sup>

**2. Statutory Unconscionability—Procedural Unfairness Standards.** These statutes do, however, offer more pointed guidance than section 2-302 on what constitutes procedural unfairness. For example, both the Uniform Consumer Sales Practices Act and the Uniform Consumer Credit Code (UCCC) detail the procedural factors courts should consider in determining conscionability.<sup>214</sup> Both specify taking advantage of the

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(providing that courts may consider the disparity of price in deciding the conscionability of the consumer credit sale transaction, but failing to expressly state that disparity alone supports a finding of unconscionability).

211. See, e.g., *People ex. rel. Hartigan v. Knecht Serv., Inc.*, 575 N.E.2d 1378, 1386 (Ill. App. Ct. 1991) (rejecting the contention that unconscionably high prices alone are sufficient to find a contract in violation of the Illinois Consumer Fraud Act in a suit against a plumbing, heating, and air conditioning business with respect to advertising, servicing, and charging of customers).

212. The Uniform Land Transactions Act, not adopted by any state, provides that price disparity in real estate sale contracts "does not, of itself, render the contract unconscionable." § 1-311(b)(4), 13 U.L.A. 502 (1977). Other real estate uniform and model acts employ the same approach. See UNIF. COMMON INTEREST OWNERSHIP ACT § 1-112(b)(4), 7 U.L.A. 261 (1982) ("A disparity between the contract price and the value of the property measured by the price at which similar property was readily obtainable in similar transactions does not, of itself, render the contract unconscionable."); UNIF. CONDOMINIUM ACT § 1-112(b)(4), 7 U.L.A. 450, 451 (1980) (adopted in eleven states) ("[A] disparity between the contract price and the value of the real estate measured by the price at which similar real estate was readily obtainable in similar transactions does not, of itself, render the contract unconscionable."); MODEL REAL ESTATE COOPERATIVE ACT § 1-112(b)(4), 7B U.L.A. 248 (1981) (adopted in Virginia) ("[A] disparity between the contract price and the value of the cooperative interest measured by the price at which similar cooperative interests were readily obtainable in similar transactions does not, of itself, render the contract unconscionable."); MODEL REAL ESTATE TIME-SHARE ACT § 1-105 (b)(4), 7B U.L.A. 363 (1980) (adopted in Massachusetts and Rhode Island) ("[A] disparity between the contract price and the value of the time share measured by the price at which a similar time share was readily obtainable in similar transactions does not, of itself, render the contract unconscionable.).

213. See, e.g., UNIF. LAND TRANS. ACT § 1-311, cmt. 2, 13 U.L.A. 503 (1977) ("In practically all cases where a claim is made that there is a gross disparity between price and value, there will be other factors [beyond gross disparity alone] which prevented one of the parties from reasonably protecting his interests.).

214. UNIF. CONSUMER SALES PRACTICES ACT § 4(c), 7A U.L.A. 241 (1971) (listing six factors that should be considered in determining whether an act is unconscionable: (1) the supplier's knowingly taking advantage "of the inability of the consumer reasonably to protect his interests"; (2) the price "grossly exceeding" the price at which similar items were readily obtainable; (3) the consumer's inability to "receive a substantial benefit from the subject of the transaction"; (4) "no reasonable probability of payment"; (5) excessive "one-sided[ness] in favor of the supplier"; and (6) the seller's having made "a misleading statement of opinion on which the consumer was

consumer's inability to protect her interests because of "physical infirmity, ignorance, illiteracy, inability to understand the language of an agreement, or similar factors."<sup>215</sup> Though more specific than the plain language of section 2-302, these factors have long been identified in UCC case law.<sup>216</sup> These more recent codifications do not specify a recipe for successful proof, leaving that task to the court's discretion and to commentator speculation.

*3. Statutory Unconscionability—Substantive Unfairness Standards.* These statutory codifications of unconscionability more recent than section 2-302 offer guidance on both the appropriate benchmark for determining excessive price and the extent of disparity necessary.<sup>217</sup> Most refer to comparable retail prices, not the seller's net profits.<sup>218</sup> For example, the 1974 UCCC and the Uniform Consumer Sales Practices Act

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likely to rely to his detriment"); UNIF. CONSUMER CREDIT CODE § 5.108, 7A U.L.A. 167-68 (1974) (listing five factors to be considered in deciding whether a transaction was unconscionable when made or was induced by unconscionable conduct: (a) the seller's belief that there is "no reasonable probability of repayment"; (b) knowledge by the seller of "the inability of the consumer to receive substantial benefits"; (c) "gross disparity" between price and value; (d) separate insurance charges; and (e) the seller's knowingly taking advantage of the inability of the consumer to protect his interests because of "mental infirmities, ignorance, illiteracy, inability to understand the language of the agreement, or similar factors").

215. UNIF. CONSUMER SALES PRACTICES ACT § 4(c)(1), 7A U.L.A. 241 (1971). The 1974 UCCC adds mental infirmities and whether the seller, lessor, or lender took "knowing" advantage of the consumer to the list of factors. UNIF. CONSUMER CREDIT CODE § 5.108(4)(e), 7A U.L.A. 168 (1974). See also South Carolina's adoption of the UCCC, which directs the court to consider "the relative sophistication . . . [and] the relative bargaining power of the debtor and creditor." S.C. CODE ANN. § 37-5-108(9) (Law. Co-op. 1989).

216. Section 2-302 case law also considers relevant both seller deception and the claimant's financial necessity. See *Jones v. Star Credit Corp.*, 298 N.Y.S.2d 264, 266 (Sup. Ct. 1969) (noting that the very limited financial resources of the purchaser can be considered in determining unconscionability). The Uniform Consumer Sales Practices Act refers specifically to a seller's misleading statements of opinion. § 4(c)(6), 7A U.L.A. 241 (1971). Financial necessity could be considered under that Act and the UCCC as either a "similar factor" preventing the consumer from protecting her interests, or as one of the unspecified circumstances a court can consider in determining conscionability. See UNIF. CONSUMER SALES PRACTICES ACT § 4(c), 7A U.L.A. 241 (1971); UNIF. CONSUMER CREDIT CODE § 5.108, 7A U.L.A. 167-68 (1974).

217. See UNIF. CONSUMER CREDIT CODE § 5.108(4)(c), 7A U.L.A. 168 (1974) (instructing the court to consider whether there exists "gross disparity between the price of the property or services sold or leased and the value of the property or services measured by the price at which similar property or services are readily obtainable in credit transactions by like consumers"); UNIF. CONSUMER SALES PRACTICES ACT § 4(c)(2), 7A U.L.A. 241 (1971) (providing that the court shall consider whether "the price grossly exceed[s] the price at which similar property or services were readily obtainable in similar transactions by like consumers").

218. Refer to notes 165-75 *supra* and accompanying text for a discussion of some possible measures of substantive unfairness of price.

both direct courts to compare the price challenged to that at which "similar property or services" are "readily obtainable" by "like consumers."<sup>219</sup> The Uniform Land Transactions Act,<sup>220</sup> Uniform Condominium Act,<sup>221</sup> Uniform Common Interest Ownership Act,<sup>222</sup> Model Real Estate Cooperative Act,<sup>223</sup> and the Model Real Estate Time-Share Act<sup>224</sup> adopt this reference for the real property transactions they govern. A few other statutes call for a comparison of the contract price to the "value" received by the complaining party.<sup>225</sup> It is unclear how courts should assess "value," but these statutes do not appear to contemplate reference to the actual profits of the seller or lender.

Those statutes directing comparison to retail price typically compare the retail price obtainable "by like consumers,"<sup>226</sup> an acknowledgement that different consumers present different risks<sup>227</sup> and that low income area merchants often have higher than average operating costs.<sup>228</sup> The National Consumer Act,<sup>229</sup> however, refers to the price obtainable "by other consumers,"<sup>230</sup> presumably inviting a court to "compare ghetto

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219. See UNIF. CONSUMER CREDIT CODE § 5.108(4)(c), 7A U.L.A. 168 (1974); UNIF. CONSUMER SALES PRACTICES ACT § 4(c)(2), 7A U.L.A. 241 (1971); see also S.C. CODE ANN. § 38-39-80 (Law. Co-op. Supp. 1993) (stating that service charges for an insurance premium payment agreement cannot substantially exceed those that are "usual and customary").

220. UNIF. LAND TRANS. ACT § 1-311(b)(4), 13 U.L.A. 502 (1977) (not adopted by any state). The more recent Uniform Land Security Interest Act does not contain an unconscionability provision.

221. UNIF. CONDOMINIUM ACT § 1-112(b)(4), 7 U.L.A. 451 (1980).

222. UNIF. COMMON INTEREST OWNERSHIP ACT § 1-112(b)(4), 7 U.L.A. 261 (1982) (adopted in Connecticut, Nevada, and West Virginia, though Nevada omitted this subsection).

223. MODEL REAL ESTATE COOPERATIVE ACT § 1-112 (b)(4), 7B U.L.A. 248 (1981).

224. MODEL REAL ESTATE TIME-SHARE ACT § 1-105(b)(4), 7B U.L.A. 363 (1980).

225. See, e.g., ILL. ANN. STAT. ch. 815, para. 515/3(a)(3) (Smith-Hurd 1993) (providing that a home repair contract is unconscionable when "an unreasonable difference exists between the value of the services, materials and work to be performed and the amount charged"); TEX. BUS. & COM. CODE ANN. § 17.45(5) (Vernon 1987) (defining unconscionability to include "gross disparity between the value received and consideration paid"). The National Consumer Act offered in 1970 by the National Consumer Law Center as a consumer-oriented alternative to the UCCC refers in § 5.107(3)(c) to gross disparity as measured by the price at which similar goods or services are obtainable "or by other tests of true value."

226. See, e.g., UNIF. CONSUMER CREDIT CODE § 5.108(4)(c), 7A U.L.A. 168 (1974).

227. See Shanker & Abel, *supra* note 75, at 706-07 (recognizing that the credit-worthiness of some buyers is much less than others, justifying higher prices to address the seller's higher risk).

228. See Nehf, *supra* note 107, at 824 (presuming that the cost of providing merchandise under a rent-to-own plan to low income consumers is high).

229. This Act, issued in 1970 by the National Consumer Law Center, and the UCCC jointly influenced Wisconsin's consumer code.

230. NATIONAL CONSUMER LAW CENTER, NATIONAL CONSUMER ACT § 5.107(3)(c) (1970).

prices with general retail prices outside the ghetto, door-to-door prices with store prices, and prices charged by different branches of a single chain."<sup>231</sup> If a statute or court adopts a retail price comparison for interest pricing, the "other consumers" standard is too open-ended and could unfairly penalize lenders with higher costs and unfairly benefit consumer litigants who pose risks greater than consumers in general.

These codifications are instructive in their almost uniform adoption of a retail price standard, but most offer less guidance on the extent of disparity necessary. They often employ the standard of "gross" disparity,<sup>232</sup> but some refer to a "substantial" excess,<sup>233</sup> and one to an "unreasonable difference."<sup>234</sup> "Gross," "substantial," and "unreasonable," each vague, will likely be interpreted similarly by courts. Both those statutes providing more concrete guidance and the case law interpreting these less specific standards indicate that the disparity ratio must exceed two to one for the claimant to succeed. For example, the 1974 UCCC comments illustrate that a price of three times the retail price is unconscionable.<sup>235</sup> Illinois' Home Repair Fraud Act provides that a repair price over four times market value is *prima facie* unconscionable.<sup>236</sup> West Virginia rent-to-own legislation proscribes charging more than 240 per-

231. FONSECA, *supra* note 157, § 4:12, at 143.

232. UNIF. CONSUMER CREDIT CODE § 5.108(4)(c), 7A U.L.A. 168 (1974) ("gross disparity"); UNIF. CONSUMER SALES PRACTICES ACT § 4(c)(2), 7A U.L.A. 241 (1971) ("grossly exceeded"); UNIF. LAND TRANS. ACT § 1-311(b)(4), 13 U.L.A. 502 (1977) ("gross disparity"); UNIF. COMMON INTEREST OWNERSHIP ACT § 1-112(b)(4), 7 U.L.A. 261 (1982) ("gross disparity"); UNIF. CONDOMINIUM ACT § 1-112(b)(4), 7 U.L.A. 451 (1980) ("gross disparity").

233. See, e.g., OHIO REV. CODE ANN. § 1345.03(B)(2) (Anderson 1993) (substituting "substantially in excess" for the Uniform Consumer Sales Practices Act's standard of "grossly exceeded"); S.C. CODE ANN. § 38-39-80(e) (Law. Co-op. Supp. 1993) (proscribing service charge rates by insurance premium service companies "substantially exceeding" the "usual and customary charge"); S.C. CODE ANN. § 37-5-108(9) (Law. Co-op. 1989) (employing the "substantial excess" standard for consumer credit charges generally).

234. See ILL. ANN. STAT. ch. 815, para. 515/3(a)(3) (Smith-Hurd 1993) (Home Repair Fraud Act) (proscribing "unreasonable difference" between value and price charged). Senate Bill 1145, introduced but defeated in the 1993-94 California legislature, would have governed fees imposed for unsecured open-end consumer credit arrangements, such as credit cards, under a standard of commercial reasonableness. Fees would have been deemed commercially reasonable when they were less than or equal to the comparable fee charged by at least one of the ten largest lenders headquartered outside California.

235. See UNIF. CONSUMER CREDIT CODE § 5.108 cmt. 4, 7A U.L.A. 170 (1974) (providing that a home solicitation sale of cookware for \$375 in an area where a set of comparable quality is available on credit in stores for \$125 or less would entitle a consumer to relief).

236. See ILL. ANN. STAT. ch. 815, para. 515/3(a)(3) (Smith-Hurd 1993) (governing home repair contracts requiring payment of at least \$4000).

cent of the good's retail price.<sup>237</sup> Courts have held five to one<sup>238</sup> and three to one<sup>239</sup> discrepancies unconscionable, and two to one discrepancies conscionable.<sup>240</sup>

4. *Statutory Unconscionability—Remedies for Unconscionable Pricing.* These newer statutes codifying unconscionability usually offer a wider range of sanctions than section 2-302: from restitution to civil penalties and loss of license. This severity indicates that unconscionable conduct is increasingly recognized as tortious or the equivalent. Most codifications permit penal remedies for unconscionable conduct, typically by providing a fixed recovery of a "consumer" penalty, or by a trebling of actual damages.<sup>241</sup>

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237. See W. VA. CODE § 46B-3-9 (Supp. 1994). Under the West Virginia statute, retail value is determined by reference to prices in the particular market area. Though almost all states now have special rent-to-own regulation, fewer than ten impose similar price controls on the transaction. See generally *Hearing, supra* note 3, at 242-43 (written testimony of Association of Progressive Rental Organizations) (stating that six states regulate the total amount a merchant may charge for an item under a rent-to-own transaction).

238. See, e.g., *Wernly v. Anapol (In re Wernly)*, 91 B.R. 702, 704 (Bankr. E.D. Pa. 1988) (holding that a check cashing fee five times the industry norm violated Pennsylvania's unfair trade practice statutes).

239. See, e.g., *Phillips v. Dukes (In re Dukes)*, 24 B.R. 404, 412-13 (Bankr. E.D. Mich. 1982) (holding that loan closing costs of three times customary costs violated the Michigan Consumer Protection Act standard of "grossly in excess").

240. See, e.g., *California Grocers Ass'n, Inc. v. Bank of Am.*, 27 Cal. Rptr. 2d 396, 403 (Ct. App. 1994) (holding that a \$3 "deposited item returned" fee including a 100% markup over the bank's processing cost was not unconscionable as the price unconscionability cases "generally involve much greater price-value disparities"); *Remco Enters., Inc. v. Houston*, 677 P.2d 567, 572-73 (Kan. Ct. App. 1984) (holding that Kansas' version of the 1974 UCCC was not violated by a 108% markup over retail price of a TV from a rent-to-own center since the consumer received benefits over a retail transaction of free repairs and the right to terminate at will). Cases under Texas' Deceptive Trade Practices Act appear to apply a more consumer favorable definition of "gross disparity," as a 28% disparity has been declared "gross." See *Mercedes-Benz of North Am. v. Dickenson*, 720 S.W.2d 844 (Tex. App.—Fort Worth 1986, no writ) (finding "gross disparity" when the buyer paid \$30,429 for a car worth approximately \$8,500 less); Greg S. Gober, Comment, *DTPA Gross Disparity: A Risky Business*, 44 BAYLOR L. REV. 133 (1992) (analyzing how much disparity is required by Texas courts).

241. See, e.g., UNIF. CONSUMER SALES PRACTICES ACT § 11(b), 7A U.L.A. 255 (1971) (allowing a consumer to recover actual damages or \$100, whichever is greater). Utah's adoption of that Act allows generous recovery of the greater of actual damages or \$2,000. See UTAH CODE ANN. § 13-11-19(2) (Supp. 1993). Texas' Deceptive Trade Practices Act allows recovery for unconscionable disparity of actual damages plus twice the actual damages that do not exceed \$1000, and uncapped treble damages for knowing violations. TEX. BUS. & COM. CODE ANN. § 17.50(b)(1) (Vernon Supp. 1994).

The National Consumer Law Center's 1970 National Consumer Act authorizes punitive damages for unconscionability, but its more moderate Model Consumer Credit Act published in 1973 does not. See generally DEUTCH, *supra* note 73, at 236-39 (noting the distinctions between the Model Consumer Credit Act and the National



Though denied by section 2-302 case law, restitution is a fixture of these more recent codifications.<sup>242</sup> Victims of excessive pricing can thus recover excessive payments made, even if they have fully paid the contract price.<sup>243</sup> Attorneys' fees for successful claimants are allowed almost uniformly.<sup>244</sup> Claimants who pursue actions they know to be groundless, however, may be compelled by statute to pay the other party's fees.<sup>245</sup> A few commentators argue that this chills private enforcement,<sup>246</sup> but it guards against claimants who might exploit the uncertainties of unconscionability to exact settlement

Consumer Act). See also *Brown v. Lyons*, 332 N.E.2d 380, 386-87 (Ohio Ct. C.P. 1974) (allowing punitive damages for unconscionability under Ohio's adoption of the Uniform Consumer Sales Practices Act).

Article 2A of the UCC authorizes "appropriate relief" for unconscionable conduct in the leasing of goods. U.C.C. § 2A-108 (2) (1990). One commentator speculated that it may be difficult or impossible for a lessee to recover punitive damages under that provision because of other limitations in the UCC. See Michael J. Herbert, *Unconscionability Under Article 2A*, 21 U. TOL. L. REV. 715, 732 (1990) (referring to § 1-106(1) which states "neither consequential or special nor penal damages may be had except as specifically provided for in this Act or by other rule of law [e.g., an independent tort claim]").

242. See, e.g., *Fleet v. United States Consumer Council, Inc. (In re Fleet)*, 95 B.R. 319 (Bankr. E.D. Pa. 1989) (finding that grossly overpriced lawyer referral services violated New Jersey unfair practices law, entitling consumers to the statutory remedy of a refund of all monies acquired by a deceptive or unconscionable practice); *Wernly v. Anapol (In re Wernly)*, 91 B.R. 702, 704 (Bankr. E.D. Pa. 1988) (awarding the return of excessive check cashing charges under Pennsylvania's unfair practices law); *Phillips v. Dukes (In re Dukes)*, 24 B.R. 404, 417 (Bankr. E.D. Mich. 1982) (concluding that the consumer was entitled to the return of excessive closing costs under Michigan's Consumer Protection Act); see also *People v. Two Wheel Corp.*, 525 N.E.2d 692, 696 (N.Y. 1988) (holding that the trial court has discretion under New York's price gouging statute to design a restitutionary fund for consumer victims).

243. This right would presumably be subject to any applicable statute of limitation.

244. See, e.g., UNIF. CONSUMER CREDIT CODE § 5.108(6), 7A U.L.A. 169 (1974) (providing that "the court shall award reasonable fees to the attorney for the consumer or debtor"); UNIF. CONSUMER SALES PRACTICES ACT § 11(e), 7A U.L.A. 255-56 (1971) (providing that "the court may award to the prevailing party a reasonable attorney's fee"); U.C.C. § 2A-108(4)(a) (1990) (providing that "the court shall award reasonable attorney's fees to the lessee").

245. See, e.g., UNIF. CONSUMER CREDIT CODE § 5.108(6), 7A U.L.A. 169 (1974); UNIF. CONSUMER SALES PRACTICES ACT § 11(e), 7A U.L.A. 255-56 (1971); U.C.C. § 2A-108(4)(b) (1990).

246. See Charles A. Heckman, *Article 2A of the Uniform Commercial Code: Government of the Lessor, by the Lessor, and for the Lessor*, 36 ST. LOUIS U. L.J. 309, 331 (1991-92) (suggesting that the provision on attorneys' fees will make consumers hesitant to litigate unconscionability claims not previously sanctioned in the jurisdiction); Donald B. King, *Major Problems with Article 2A: Unfairness, "Cutting Off" Consumer Defenses, Unfiled Interests, and Uneven Adoption*, 43 MERCER L. REV. 869, 873 (1992) (stating that Article 2A's provision defeats unconscionability claims because the term "groundless" is not well defined and places consumers who assert unconscionability at risk). Oregon and Florida are among the handful of states that didn't adopt either of Article 2A's attorneys' fees provisions. See FLA. STAT. ANN. § 680.1081 (West Supp. 1994); OR. REV. STAT. § 72A.1080 (1993).

of a groundless claim.<sup>247</sup> Moreover, civil procedure codes already impose similar constraints on such claims,<sup>248</sup> and most consumer credit contracts provide the creditor a contractual recovery of attorneys' fees for successfully defending even good faith claims.<sup>249</sup>

Most unconscionability claims present expensive problems of proof with small amounts at stake. Class actions<sup>250</sup> and administrative enforcement are two additional mechanisms employed commonly to overcome these discouraging economics. The UCCC and the Uniform Consumer Sales Practices Act authorize an administrative authority (typically the state's Attorney General)<sup>251</sup> to seek injunctive relief and actual damages for victimized consumers.<sup>252</sup> Attorneys general have employed the administrative enforcement power to gain relief from unfair pricing for consumers unlikely to pursue their claims

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247. See DEUTCH, *supra* note 73, at 235 (calling the UCCC approach a "balanced solution" that should be adopted in any future revision of § 2-302).

248. See Herbert, *supra* note 241, at 738 (noting that the Article 2A provision will likely have little real significance due to Rule 11 sanctions in the Federal Rules of Civil Procedure and the like).

249. Cf. *Credit Union One v. Stamm*, 867 P.2d 285, 291 (Kan. 1994) (holding that an attorney fee clause for a creditor authorizing fees to the extent permitted under law was contingent and therefore did not violate Kansas law prohibiting consumer credit agreements from requiring the payment by consumers of the creditor's fees).

250. Section 11 of the Uniform Consumer Sales Practices Act expressly allows class actions, but precludes recovery of damages in such actions. 7A U.L.A. 255 (1971). The National Consumer Law Center's National Consumer Act §§ 5.308, 6.111 (1970) and Model Consumer Credit Act (1973) both broadly authorize class actions for unconscionability.

Professor Leff observed that it would be "most useful" if an effective class action remedy could be conjoined with the unconscionability standard to cut down the "per-plaintiff transaction cost." Leff, *supra* note 118, at 357 n.34. Class actions to challenge unfair pricing have been pursued most notably against financial institutions charging NSF fees alleged to be unfairly excessive. See, e.g., *Perdue v. Crocker Nat'l Bank*, 702 P.2d 503, 507 (Cal. 1985) (rejecting defendant's demurrer to an unconscionability challenge to NSF fees in a class action suit); *Best v. United States Nat'l Bank*, 739 P.2d 554, 555 (Or. 1987) (affirming summary judgment in favor of defendant bank on class action unconscionability claim against the bank's NSF fees but finding genuine issues of material fact on whether the bank had breached its implied covenant of good faith in setting the fees); cf. *Fleet v. United States Consumer Council, Inc. (In re Fleet)*, 95 B.R. 319, 322-23 (Bankr. E.D. Pa. 1989) (holding that the defendant misrepresented the nature of its services and that the defendant's fees were unconscionable in light of the bankruptcy attorney referral services provided and entering judgment in favor of the plaintiff class).

251. See UNIF. CONSUMER SALES PRACTICES ACT § 2, 7A U.L.A. 235 cmt. 2 (1971) (noting in official comments that the Attorney General has substantial power with respect to consumer sales practices in some states and recommending designation of the Attorney General in those states as the "Enforcing Authority" for purpose of the Act).

252. See UNIF. CONSUMER CREDIT CODE §§ 6.111, 6.113, 7A U.L.A. 201-02, 204 (1974); UNIF. CONSUMER SALES PRACTICES ACT § 9, 7A U.L.A. 252 (1971).

individually.<sup>253</sup> Other administrative sanctions range from loss of license to civil penalties.<sup>254</sup>

5. *Statutory Unconscionability—The Consumer/Commercial Party Distinction.* Several of the recent codifications of unconscionability protect only consumers. Often this is because the unconscionability provisions are adopted as part of the state's consumer credit code or consumer deceptive practices statutes. Article 2A of the UCC, which otherwise governs both commercial and consumer leases of goods, limits some of its unconscionability protection, particularly its allowance of attorneys' fees, to consumer lessees.<sup>255</sup> It apparently presumes that commercial lessees are sophisticated enough to bargain effectively, and even if they are not, concludes policy reasons counsel against protecting them.<sup>256</sup> In contrast, the National Consumer Law Center's 1970 National Consumer Act extends its enhanced unconscionability remedies and protection to sole proprietors purchasing business equipment,<sup>257</sup> apparently presuming that small businesspersons share the bargaining disadvantages of consumers.

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253. See, e.g., *Kugler v. Romain*, 279 A.2d 640, 654 (N.J. 1971) (ruling in favor of the New Jersey Attorney General under New Jersey's Consumer Fraud Act for the benefit of all purchasers of excessively priced educational books); *State v. ITM, Inc.*, 275 N.Y.S.2d 303, 322 (Sup. Ct. 1966) (enjoining enforcement of excessively priced consumer goods in an action by the Attorney General under New York's consumer fraud statute).

254. See, e.g., GA. CODE ANN. § 7-1-707 (a)(1)(E)(i) (1994) (providing for loss of a license to cash checks as the sanction for charging unconscionable fees that "do not adequately reflect" risks and costs of operation); N.Y. GEN. BUS. LAW § 396-r (McKinney 1984) (imposing a civil penalty of up to \$5000 for "price gouging"). But see UNIF. CONSUMER CREDIT CODE § 6.113(2), 7A U.L.A. 204 (1974) (excluding "unconscionable agreements" and "unconscionable conduct" from \$5000 civil penalty for UCCC violations).

255. Subsection 2A-108(2) on the "appropriate relief" for unconscionable conduct and subsection 2A-108(4) on attorneys' fees are limited to "consumer leases," defined in § 2A-103(1)(e) as leases to individuals primarily for a personal, family or household purpose. See generally Herbert, *supra* note 241, at 750 (noting that this distinction reflects a perceived need to protect consumers who may be naive and unable to negotiate favorable terms from lessors). Additionally, U.C.C. § 2-719(3) (1990) provides that limitations on consequential damages in contracts for the sale of consumer, but not commercial, goods are *prima facie* unconscionable.

256. Cf. Herbert, *supra* note 241, at 751 (noting that providing businesses with less protection in contractual arrangements might further the goal of economic efficiency by allowing less efficient producers to go bankrupt).

257. Section 1.301(8) defines consumer as "a person other than an organization who seeks or acquires (a) business equipment for use in his business, or (b) real or personal property, services, money or credit for personal, family, household or agricultural purposes."

### C. Interest Pricing Cases—General

A surprising number of reported cases decide the conscionability of interest pricing.<sup>258</sup> In fact, the cases outnumber the pricing cases under section 2-302, and might therefore be expected to shed more light on the appropriate standard for unconscionability. Unfortunately, these cases generally suffer from the same shoddy and conclusory legal analysis as those under section 2-302.

1. *Interest Pricing Cases—The Procedural v. Substantive Debate.* Only a few interest pricing cases address the need for proof of procedural unfairness, and the results are mixed. Older cases parallel equity's standard that substantive unfairness alone is not unconscionable unless the disparity is extraordinary,<sup>259</sup> but one nineteenth century interest case demanded proof of some procedural defect without exception.<sup>260</sup> Recent case law is inconclusive—the few cases that address the issue directly are split,<sup>261</sup> and no clear factual distinction such as

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258. Usury regulation has lapsed before, and a few cases date to the nineteenth century when at times there was no usury protection. See, e.g., *Boyce v. Fisk*, 42 P. 473, 474 (Cal. 1895) (holding that the court could not interfere in a contract where \$260 was loaned at 4% monthly interest because neither fraud nor incapacity was involved); *Lamprey v. Mason*, 19 N.E. 350, 351 (Mass. 1889) (finding loans of \$62 and \$37 at \$2 per month interest and loans of \$60.75 and \$90 at \$3-4 per month interest were not unconscionable and must be enforced in the absence of fraud). These early cases typically invoked the authority of equitable courts to review contracts for their conscionability. Refer to note 84 *supra* and accompanying text. More recent interest cases are often brought under the increasing number of statutes codifying the unconscionability standard. Refer to notes 79-83 *supra* and accompanying text.

259. See, e.g., *Boyce*, 42 P. at 475-76 (noting that the general rule is that equity courts will only interfere in the most extraordinary cases except when the parties stand in a "peculiar predicament" such as expectant heirs or sailors). Refer to note 138 *supra* for a discussion of the unconscionability standard in equity.

260. See *Lamprey v. Mason*, 19 N.E. 350, 351 (Mass. 1889) (arguing that courts cannot refuse to enforce contracts with excessive interest rates in the absence of fraud, because that would constitute a finding of gross inadequacy of consideration, which does not render the contract invalid).

261. Compare *Carboni v. Arrospeide*, 2 Cal. Rptr. 2d 845, 849 (Ct. App. 1991) (requiring both procedural and substantive unconscionability before a contract or clause will be held unenforceable) and *Verson v. Hardt*, 246 N.E.2d 461, 464 (Ill. App. Ct. 1969) (holding that an extremely high rate of interest "without more" does not make a case for equitable relief) with *In re Chicago Reed & Furniture Co.*, 7 F.2d 885, 886 (7th Cir. 1925) (refusing to enforce an interest rate, including commission, in excess of 40% because it was on its face "glaringly and obviously harsh") and *Maxwell v. Fidelity Fin. Servs., Inc.*, No. 1 CA-CV 91-0485, 1993 WL 440534, at \*6 (Ariz. Ct. App. Oct. 28, 1993) (Kleinschmidt, J., dissenting) (proclaiming agreement with Professors White and Summers that substantive unconscionability alone is sufficient and noting that such a rule had been applied by Arizona courts previously).

the consumer or commercial nature of the parties readily explains the difference. As with the pricing cases under section 2-302, this issue has not been considered directly by enough higher courts to settle the dispute over the necessity of showing procedural unfairness.

2. *Procedural Unfairness in the Interest Pricing Cases.* In articulating what constitutes procedural unfairness, the interest pricing cases borrow their standards from cases decided under section 2-302.<sup>262</sup> Thus, the factors of lack of borrower sophistication, financial necessity, lender sharp practices, and lack of choice are deemed relevant in most of the interest pricing cases. As neither the section 2-302 cases nor the interest pricing cases provide a precise recipe for success, claimants should offer proof in as many of these categories as possible.<sup>263</sup> However, some conclusions can be drawn from the case law. To be found sophisticated is the borrower claimant's "kiss of death,"<sup>264</sup>

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One commentator argues that the *Carboni* court's finding of procedural unfairness is "unpersuasive" and criticizes that court's "near total reliance on the substantive aspects" as a "highly subjective method of determining unconscionability." Giedgowd, *supra* note 123, at 101. However, substantive unfairness seems less "subjective" than procedural unfairness, for which the court must gauge the borrower's sophistication and financial necessity without reference to some concrete standard such as the market rate or retail price.

262. Many cases employ the phrasing, "absence of meaningful choice," discussed *supra* at note 161. See e.g., *Greene v. Gibraltar Mortgage Inv. Corp.*, 488 F. Supp. 177, 180 (D.D.C. 1980) (finding that plaintiff lacked any meaningful alternative at the time the loan documents were executed given the overwhelming terms and the inability to review the documents before they were to be signed); *Carboni v. Arrospide*, 2 Cal. Rptr. 2d 845, 850 (Ct. App. 1991) (upholding the trial court's reduction of an interest rate from 200% to 24% due to substantive and procedural unconscionable conduct by the lender and finding procedural unconscionability by the absence of meaningful choice since the borrower was acting under emotional distress and had no alternative sources of credit); *Barnes v. Helfenbein*, 548 P.2d 1014, 1020 (Okla. 1976) (rejecting an unconscionability claim because the borrower had "viable alternatives" including selling the property for substantial profit or undergoing the foreclosure proceedings and retaining the excess); *Bekins Bar V Ranch v. Huth*, 664 P.2d 455, 461 (Utah 1983) (finding no lack of meaningful choice because the contract was formed between sophisticated business people).

263. Cf. *Equity Mortgage, Inc. v. Johnson (In re Johnson)*, 149 B.R. 284, 288 (Bankr. D. Conn. 1993) (stating that, for real estate transactions, interest price unconscionability is determined on a case-by-case basis, taking into account all pertinent facts and circumstances).

264. See *E & W Bldg. Material Co. v. American Sav. & Loan Ass'n*, 648 F. Supp. 289, 291 (M.D. Ala. 1986) (declaring a loan agreement not unconscionable since rescission of a contract for unconscionability is an "extraordinary remedy usually reserved for the protection of the unsophisticated" and in this case the borrower was "sophisticated and knowledgeable" and fully aware of the terms of the note); *Marshall v. Mercury Fin. Co.*, 550 So. 2d 1026, 1028 (Ala. Civ. App. 1989) (holding that the credit purchase of car at 29% was not unconscionable when the debtor was college educated in business management and could understand the loan documents); *Cheshire Mortgage Serv., Inc. v. Montes*, 612 A.2d 1130, 1135-36 (Conn. 1992)

though proof of egregious deception might overcome that sophistication or constitute the tort of fraud. Even sophisticated borrowers could fall victim to deception if the lender misrepresents or "buries" the true costs of the loan,<sup>265</sup> and several courts that found the borrower sophisticated noted that the lender had not engaged in deceptive practices.<sup>266</sup>

It is unclear whether financial necessity and lack of choice can override the borrower's sophistication.<sup>267</sup> Although some courts have confused the analysis, necessity and lack of choice can coincide or occur separately. For example, someone who borrows for a medical emergency may have nothing to sell to raise the money. Compare the borrower who seeks funds to avoid loss by foreclosure of valuable equity in property. The latter borrower is under financial necessity but presumably could sell the property in advance of foreclosure or reinstate and restructure the oversecured obligation in bankruptcy. Financial necessity should ordinarily be combined with a lack of choice to carry persuasive weight. Some of the interest pricing cases support this analysis.<sup>268</sup> Conversely, lack of choice

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(finding that a second mortgage taken out for the purpose of purchasing vinyl siding for the home was not unconscionable because the Puerto Rican borrowers fully understood the loan and were not illiterate in English as claimed); *Iamartino v. Avallone*, 477 A.2d 124, 128 (Conn. App. Ct. 1984) (concluding that the note was not unconscionable because the borrower was an experienced real estate speculator represented by counsel); *Barnes*, 548 P.2d at 1021 (denying relief on the ground of unconscionability when the borrower had "extensive business acumen" in real estate transactions and where the borrower's attorney explained the interest rate to the borrower); *Bekins Bar V Ranch*, 664 P.2d at 463-64 (treating a borrower as an experienced businessperson, thus rejecting a portrayal as simple-minded hay farmer and holding the contract not unconscionable); cf. *Comdisco Disaster Recovery Serv., Inc. v. Money Management Sys., Inc.*, 789 F. Supp. 48, 55 (D. Mass. 1992) (holding a default rate of 18% not unconscionable when negotiated at arms-length by a sophisticated corporate borrower). Sophistication might not be fatal if the court allows substantive unfairness alone to constitute unconscionability.

265. Several cases have held that compounding of interest contravenes public policy. See, e.g., *Kredietbank, N.V. v. Esic Capital Corp. (In re Rosner)*, 48 B.R. 538, 558 (Bankr. E.D. N.Y. 1985). One commentator explained that courts are concerned with the deceptive nature of compounding. See BROWN & KEEST, *supra* note 26, § 4.2.3.2.2, at 89.

266. See, e.g., *E & W Bldg. Material v. American Sav. & Loan Ass'n*, 648 F. Supp. 289, 291 (M.D. Ala. 1986) (finding no evidence of "trickery or deception"); *Bekins Bar V Ranch*, 664 P.2d at 464 (noting the lack of evidence to support fraud, deception, unfair surprise or exploitation).

267. Professor Ellinghaus has argued that courts should look beyond "any nominal parity of status" to situations in which "unusual pressures are being brought to bear on one of the parties," such as the prospect of impending bankruptcy. Ellinghaus, *supra* note 139, at 768. Presumably he means that even the sophisticated borrower can be unconscionably exploited.

268. See, e.g., *Barnes*, 548 P.2d at 1021 (arguing that a claimant who borrowed money at a high rate to avoid foreclosure of commercial property had the alternative of selling property before foreclosure); *Bekins Bar V Ranch*, 664 P.2d at 464 (holding

should not be relevant without financial necessity. For example, a speculator who seeks funds for a business opportunity but has no alternative to the high interest loan is acting under the artificial financial "necessity" of "nothing ventured, nothing gained." Courts requiring procedural unfairness shouldn't rescue this speculator regardless of how excessive the rate paid.<sup>269</sup>

### 3. *Substantive Unfairness in the Interest Pricing Cases.*

The interest pricing (and UCC) cases often blunder through their analysis of substantive fairness. Several do not specify the standard that makes a rate substantively excessive.<sup>270</sup> Others employ the market comparison borrowed from the UCC pricing cases under which experts testify to the rate a borrower and the collateral would fetch in the market.<sup>271</sup> That market rate comparison, however, takes too little into account. At least four elements compose a fair interest rate: (1) the lender's cost of

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that loans at 36% and 58% were not unconscionable despite financial need to save a ranch because selling a portion of the ranch would have raised the necessary funds). *Carboni v. Arrospide* involved a financially distressed borrower who sought to pay his parents' medical expenses but was unable to borrow from other sources; the lender could thus propose terms on a "take it or leave it" basis. 2 Cal. Rptr. 2d 845, 851 (Ct. App. 1991). The collateral apparently had over \$50,000 equity when the first loan of \$4000 was made, *id.* at 846, but the court didn't discuss whether the borrower could have sold that property to raise the money. Rather, the court concluded that the 200% per annum interest rate was unconscionable. *Id.*

269. See, e.g., *Shriver v. Druid Realty Co.*, 131 A. 815 (Md. 1926) (holding that a corporation borrowing to construct an additional apartment building to reduce overhead expenses was not a "necessitous borrower" deserving relief from alleged excessive interest). But see *In re White*, 88 B.R. 498, 510-11 (Bankr. D. Mass. 1988) (holding a 48% default rate unconscionable in a loan to a businessperson to purchase a nightclub).

270. See, e.g., *Greene v. Gibraltar Mortgage Inv. Corp.*, 488 F. Supp. 177 (D.D.C. 1980) (finding unconscionability when a lender was to be repaid \$7,000 for a \$2,700 loan, but not discussing whether the lender costs or borrower risks justified or did not justify that price); *Burnett v. Ala Moana Pawn Shop*, No. 90-267 (D. Haw. Mar. 3, 1992) (holding 20% per month interest on a pawn transaction without explanation "oppressive" to consumers and in violation of Hawaii's unfair trade practices statutes), *aff'd*, 3 F.3d 1261 (9th Cir. 1993).

271. See, e.g., *Carboni*, 2 Cal. Rptr. 2d at 846-49 (relying on plaintiff's own testimony, when plaintiff was a licensed real estate broker, that a 200% rate was 10 times the prevailing rate for similar loans); *Cheshire Mortgage Serv., Inc. v. Montes*, 612 A.2d 1130, 1137-38 (Conn. 1992) (referring to testimony that the rate and points charged were "in the middle of the market"); cf. *Iamartino v. Avallone*, 477 A.2d 124, 128 (Conn. App. Ct. 1984) (stating that the rate charged on the second mortgage, either 37% or 45% depending on the calculation, was in line with rates prevailing for highly speculative real estate ventures); *Mobile Am. Corp. v. Howard*, 307 So. 2d 507, 508 (Fla. Dist. Ct. App. 1975) (noting that judges are aware of "common knowledge" that an 11.75% rate is within prevailing limits for mobile home installment contracts); see also Peter J. Shedd, *Real Estate Transactions and the Principles of Unconscionability*, 13 REAL EST. L.J. 334, 351 (1985) (arguing that unconscionability can only be applied properly when the rate charged exceeds market interest by an above normal amount).

obtaining the money lent,<sup>272</sup> (2) its cost in making and administering the loan,<sup>273</sup> (3) the risk of inflation,<sup>274</sup> and (4) the risk of default.<sup>275</sup> The lender also deserves a fair return on investment over these costs and risks. The market rate standard reflects the risk of inflation, but it otherwise substitutes the marketplace experience for that of the particular lender and borrower. A lender's unique costs of operation are not relevant. A borrower's individual risk of default would likely be ignored beyond such general classifications as the existence of collateral and lien priority. The market standard may also be unfair to claimants when the market return on investment is unfairly high due to monopolies or other circumstances.<sup>276</sup>

A better approach would examine the relation of the rate charged to the four composite elements (plus profit) that determine a fair rate. This is essentially a net profit, or cost-justification, approach because it examines costs and risks for each specific transaction in relation to the rate charged. Some appellate courts appear to adopt this standard,<sup>277</sup> but the vague

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272. Benfield, *supra* note 17, at 826.

273. *Id.* at 829.

274. See Allen & Staaf, *supra* note 98, at 225 (noting that inflation is an important concern, since the money loaned today may be worth less in the future).

275. *Id.* at 224; Benfield, *supra* note 17, at 830. The risk of default includes detrimental impacts of bankruptcy, as well as the risk of nonpayment on default. Thus, factors relevant to the risk of default, such as the borrower's credit-worthiness, and factors relevant to the prospect of full payment upon default, primarily the value of any collateral, should be considered. For a general discussion of the components of interest, see Oeltjen, *supra* note 16, at 196-98.

276. See *California Grocers Ass'n v. Bank of Am.*, 27 Cal. Rptr. 2d 396, 402 (Ct. App. 1994) (recognizing that a price within the range of general market prices could be held unconscionable if the market is oligopolistic). The *Carboni* case illustrates another problem with a market rate comparison. See *Carboni v. Arrospide*, 2 Cal. Rptr. 2d 845, 849-51 (Ct. App. 1991) (holding a note that carried a 200% interest rate which ballooned to \$390,000 from \$4,000 was both procedurally and substantively unconscionable). One commentator reasoned that the borrower's inability to get a loan from other sources renders prevailing market rates irrelevant, as there was no "market" for this loan. See Giedgowd, *supra* note 123, at 101. While this logic is debatable, judging fairness separate from any market rate avoids that complaint.

277. See, e.g., *Hamm v. Taylor*, 429 A.2d 946, 948-49 (Conn. 1980) (claiming that determining whether interest rates are unconscionable should not be decided by "judicial surmise" about prevailing prime interest rates but rather by the financial circumstances of the borrower, the increased risk of a second mortgage, and the income-producing capability of the mortgaged property should be considered). The California courts, in resolving pricing challenges to banking services fees, have also employed a cost-justification standard comparing fees charged to the bank's costs in providing the service. See, e.g., *California Grocers Ass'n*, 27 Cal. Rptr. 2d at 403 (rejecting an unconscionability claim against a \$3 NSF fee when the actual cost was approximately \$1.50 and noting that while the 100% profit was generous, the cases of price unconscionability generally involve greater price-value disparities). See generally Giedgowd, *supra* note 123, at 104 (predicting that the California courts' willingness to require cost-justification of banking service fees will undoubtedly be



direction from some of them to examine the loan's commercial "risks," "purposes," and "effects"<sup>278</sup> offers little guidance to trial courts. Trial courts should at least examine the articulated composite factors in every case, whether or not they go on to consider commercial policies and the like.

Regardless of the standard employed, practical problems unique to the lending industry complicate gauging the substantive fairness of rate pricing. Lenders rarely tailor a rate to a particular borrower's credit characteristics. Instead, the lending market presents a stratified range of lenders who typically offer a single "house" rate to all qualified customers even if their credit standings merit lower rates.<sup>279</sup> The market ranges in rough order from commercial banks and credit unions to credit card financing, retail installment sales credit, finance companies, rent-to-own companies, pawnshops, and loan sharks. A consumer who desires furniture on credit may face borrowing at (say) 21 percent from a retail seller, 40 percent from a finance company, and an effective rate of 200-300 percent from a rent-

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extended to loan pricing).

278. See, e.g., *In re Elkins-Dell Mfg. Co.*, 253 F. Supp. 864, 874 (E.D. Pa. 1966) (listing the issues the judge should explore including the extent to which the rate reflects anticipated risks); *Towne Funding Co. v. Macchia*, 501 N.Y.S.2d 717, 717-18 (App. Div. 1986) (requiring a hearing, under Connecticut law, to examine the surrounding context of the loans including "their commercial setting, risks, purposes, and effects"). One commentator has observed that the *Elkins-Dell* analysis looking to risk "may be a severe limitation on the usefulness of the unconscionability doctrine to those persons who are so impoverished that they . . . could not have gotten credit elsewhere, or at least not on any better terms." Shanker & Abel, *supra* note 75, at 708. The unconscionability standard, however, does not charitably ensure low prices or low rates. Rather, it polices against unfairly excessive rates. An uncreditworthy borrower may justify a high rate.

Some courts have examined only the borrower's risk of default when deciding whether to hold a rate conscionable. See, e.g., *Harris v. Howell*, 739 F. Supp. 565, 568 (N.D. Ala. 1989) (holding a 20% rate not unconscionable given borrower's "credit status"), *aff'd*, 902 F.2d 959 (11th Cir. 1990); *Bank of New Haven v. Liner*, No. 91CV 0345165, 1994 WL 282222, at \*5 (Conn. Super. Ct. June 10, 1994) (holding an interest rate of prime plus 2% charged to claimants who were not the "most responsible and substantial" customers who receive the prime rate was not unconscionable as a matter of law); *Christiano v. Bonesteel*, No. 89 CV 0104622, 1991 WL 162160, at \*3 (Conn. Super. Ct. Aug. 16, 1991) (upholding a trial referee's finding that a 23% loan to a "shaky credit risk" was not unconscionable); see also *In re Chicago Reed & Furniture Co.*, 7 F.2d 885, 885 (7th Cir. 1925) (holding a 40% loan unconscionable where the collateral was ample given surplus obtained on foreclosure). Courts should not focus only on credit risk unless that risk alone justifies the rate agreed to by the parties. It would also be erroneous to allow a miserable credit history to justify any agreed upon rate.

279. See Oeltjen, *supra* note 16, at 225 (describing how the rise of uniform rates is due in part to the convenience of establishing a "credit package"). See generally CONSUMER CREDIT REPORT, *supra* note 48, at 113 (describing how credit grantors find it uneconomical to adjust the price of credit precisely to differences between the borrowers).

to-own dealer. If a consumer whose risk merits a rate of 50 percent can successfully challenge the 200 percent rent-to-own rate as unfair, lenders would have to adjust their business procedures. The rent-to-own dealer would be compelled to offer loan programs at (say) 75 percent, 100 percent, 125 percent and so on or risk a fairness challenge from more creditworthy borrowers. Though not necessarily a bad result, legislatures and courts should understand this effect when developing and applying an appropriate fairness standard.

A closely related problem is that some creditors, particularly rent-to-own companies, forgo the transaction costs of individual credit decisions in favor of more generalized inquiry, such as the overall default record of their past borrowers.<sup>280</sup> As a result, borrowers who in fact present a comparatively low credit risk (here fifty percent) may be charged a rate (200-300 percent) that a court would deem grossly unfair in relation to that risk, particularly when a net profit approach is employed. Courts should be aware that applying the net profit standard may force these lenders to incur (and pass on) the transaction costs of tailoring rates to each borrower. The appropriate inquiry for a lender that does not determine the credit risks of particular borrowers should focus on the risk record of its borrowers generally, rather than the predictive risk for each particular borrower.

The final practical problem in judging substantive rate fairness is the necessity that courts understand the variable costs and risks of the lending industry. If they do, the unconscionability standard should overcome the critique that usury does not take into account the costs and risks of a particular loan.<sup>281</sup> For example, courts should understand that because transactions costs are usually fixed and independent of the amount loaned, seemingly high rates for small loans may be justified.<sup>282</sup> Ghetto merchants may have higher costs of

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280. Cf. *Remco Enters., Inc. v. Houston*, 677 P.2d 567, 573 (Kan. Ct. App. 1984) (finding that a rent-to-own customer received the benefit of not having to undergo a credit check and holding a 108% markup over retail conscionable). Some consumer advocates have challenged the rent-to-own industry's assertion that it does not check credit, alleging that the industry in fact uses nationwide computer checks such as Tele-Track. See *Hearing, supra* note 3, at 244-49 (written testimony of attorney David L. Ramp) (stating that the rent-to-own industry uses nationwide computer networks to check the credit-worthiness of prospective customers). The industry responds that it typically does not check credit, and that the Tele-Track service, used by few companies, reports only those customers who have stolen merchandise from other subscribers. *Id.* at 744 (May 18, 1993 letter from Bill Keese to Rep. Henry Gonzalez).

281. Cf. Note, *supra* note 175, at 1253 n.30 (arguing that usury laws which set an inflexible rate are unreflective of the "true costs and risks" to the lender).

282. See generally Robert W. Johnson, *Conclusions for Regulation*, in THE CON-

operation than retailers generally.<sup>283</sup> The rent-to-own industry claims its special services justify higher effective rates.<sup>284</sup> Pawnshops limit their recourse to the collateral and therefore assume the risk that the collateral's value may decline.<sup>285</sup> A market price standard might force lenders to offer the same or fewer services than lenders generally. Though the net profit standard encourages specialized services, courts must be sure to give proper credit for those extra services in judging substantive rate fairness.

Determining the market rate, or as this Article advocates, the rate justified by the composite elements identified (the net profit standard), does not conclude the court's scrutiny. The next question is what degree of excess over the reference employed is tolerable. One leading case held a rate ten times the market rate unconscionable by reference to the classic UCC pricing cases that found sales of goods unconscionable when the price was three to four times their retail value.<sup>286</sup> Because the market standard already builds in a market return on investment (profit), courts using the net profit approach must be careful when borrowing any disparity formula developed in pricing cases employing the market standard. The net profit standard might justify more disparity above costs and risks because it does not initially include the built-in profit of the market rate comparator.

Rather than state a mathematical formula to adjust for this concern, the disparity necessary for unconscionability

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SUMER FINANCE INDUSTRY, ITS COSTS AND REGULATION 148 (John M. Chapman & Robert P. Shay eds., 1967) (noting that fixed costs constitute a substantial portion of the cost of the loan). The UCCC usury statutes account for this by employing a graduated rate ceiling that declines as the loan amount increases. See UNIF. CONSUMER CREDIT CODE §2.201, 7A U.L.A. 61 (1974) (requiring finance charges for non-open-end credit to not exceed the greater of 18% or the total of 36% on unpaid balances of \$300 or less, 21% on unpaid balances that exceed \$300 but not \$1000, and 15% on unpaid balances that exceed \$1000); *id.* §2.401, 7A U.L.A. 79-80 (1974) (same limitations for open-end credit); *id.* §2.201, 7 U.L.A. 643 (1974) (1968 Act) (same limitations for non-revolving charge accounts); *id.* §3.508, 7 U.L.A. 772 (1974) (1968 Act) (same limitations for so-called supervised loans).

283. See FTC REPORT, *supra* note 170, at 14-15.

284. See *Hearing*, *supra* note 3, at 53 (statement of Bill Keese, Executive Director of Association of Progressive Rental Organizations) (testifying that due to the unique nature of the rent-to-own business, labor costs, interest cost, delivery, and repair costs are greater than for other operations); *cf.* *Remco Enters., Inc. v. Houston*, 677 P.2d 567, 573 (Kan. Ct. App. 1984) (holding that a 108% markup by a rent-to-own center was not unconscionable when, among other things, the center was responsible for servicing the TV).

285. *Cf.* Jonathon King, *In Hock for Thirty Years*, SUN SENTINEL, July 11, 1993, at 21 ("[A] pawnbroker . . . will never take more [in collection] than you bring [her]. . . . [T]hat in itself may be worth a few percentage points.").

286. See *Carboni v. Arrospide*, 2 Cal. Rptr. 2d 845, 849 (Ct. App. 1991).

should be left to a court's discretion. Mathematic formulas smack of usury and may lead to unfair results. For example, if a rate of six percent covers risks and costs, a rate of eighteen percent should not automatically be unfair,<sup>287</sup> whereas a rate of sixty percent, given costs and risks justifying thirty percent, should not always be fair despite the lesser relative disparity. In determining how much profit is too much, Professor Speidel's proposal under section 2-302 to compare net profits in the marketplace is valuable if applied as a persuasive rather than controlling standard.<sup>288</sup>

4. *Remedies Under the Interest Pricing Cases.* Too few of the interest pricing cases have held challenged rates unconscionable to give a developed picture of the remedies courts will award. A recent case awarded the usual remedy of the UCC pricing cases; the excessive rate was reduced to a reasonable one.<sup>289</sup> Some authority seems to support denying all interest, but it is either dated<sup>290</sup> or involved "default" interest, which

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287. Cf. *Best v. United States Nat'l Bank of Or.*, 739 P.2d 554, 556 (Or. 1987) (observing that \$5 NSF charges were "relatively small" despite being allegedly two to three times the bank's costs).

288. See Speidel, *supra* note 169, at 373 (proposing the seller's net profit be compared under a standard of gross disparity to net profits of similarly situated sellers of similar goods). A recent California decision deciding the conscionability of NSF charges appears to employ the flexible analysis advocated, as it held the charges conscionable by reference to both the bank's actual processing costs and the prices charged by other financial institutions. See *California Grocers Ass'n v. Bank of Am.*, 27 Cal. Rptr. 2d 396, 402-03 (Ct. App. 1994). In addition to comparing profits in the similarly situated marketplace, the court should have the discretion to look at profits of other lenders or of industries generally. This may aid in determining if the market for the particular loan is a monopoly. For example, in scrutinizing a rent-to-own operation's rate of return, courts might consider statistics of rent-to-own profit margins compared to those of conventional retailers. Cf. Alix M. Freedman, *Peddling Dreams: A Marketing Giant Uses Its Sales Prowess to Profit on Poverty*, reprinted in 139 CONG. REC. H7142, at 145 (daily ed. Sept. 28, 1993) (reporting a 16% profit margin of a rent-to-own operation—a margin that is "eye-popping by retail standards").

289. *Carboni v. Arrospide*, 2 Cal. Rptr. 2d 845, 847 (Ct. App. 1991) (affirming the trial court's reduction of a 200% rate to 24%). A reviewer of *Carboni* complained that there was no mention of how the trial court determined the substitute rate, see Giedgowd, *supra* note 123, at 103, but presumably it applied testimony that the market rate for third lien loans was 18-21%, whereas the disputed loan was secured by a fourth deed of trust. See *Carboni*, 2 Cal. Rptr. at 846; see also *In re Elkins-Dell Mfg. Co.*, 253 F. Supp. 864, 875 (E.D. Pa. 1966) (allowing a bankruptcy judge to reduce interest to a reasonable rate if the rate is found unconscionable on remand); *Bridge v. Kedon*, 126 P. 149, 150 (Cal. 1912) (affirming the trial court's reduction of unconscionable rates of compounded 2½-3% per month to "reasonable and fair" amount of simple 12% per annum).

290. See, e.g., *In re Chicago Reed & Furniture Co.*, 7 F.2d 885, 885-86 (7th Cir. 1925) (affirming the bankruptcy court's refusal to allow a lender an unconscionable \$300 loan commission, though validating a 7% interest rate since the borrower

implicates liquidated damages principles and remedies.<sup>291</sup> Affirmative relief for unconscionable interest, whether restitutionary or punitive, will likely be denied—one court held that a borrower who had repaid the loan entirely could not recover unconscionable interest.<sup>292</sup> Relief might be possible, however, if either principal or interest remains due on the obligation against which past excessive payments of interest can be offset.

5. *The Consumer/Commercial Party Distinction Under the Interest Pricing Cases.* Though at least one commentator has assumed that unconscionability will not protect commercial borrowers,<sup>293</sup> the interest pricing cases have applied the same standards to consumer and commercial borrowers.<sup>294</sup> However,

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apparently challenged the commission only); *Westchester Mortgage Co. v. Grand Rapids & I.R. Co.*, 213 N.Y.S. 593, 598 (Sup. Ct. 1926) (holding that even if a loan was governed by Rhode Island law which imposed no usury limit on the loan, the rate was unconscionable and therefore void), *modified*, 219 N.Y.S. 695 (N.Y. App. Div.), *modified*, 158 N.E. 70 (N.Y. 1927).

Another remedy sometimes employed is denying foreclosure of any realty collateral. *See, e.g., Hamm v. Taylor*, 429 A.2d 946, 949 (Conn. 1980) (declaring that a court can reduce an unconscionable rate or withhold foreclosure). Presumably the lender would lose its secured position and have to proceed against the collateral as a judgment creditor, a result similar to the bankruptcy penalty of equitable subordination, discussed *supra* at note 199 and accompanying text. Setting aside the mortgage lien as a sanction for unconscionable interest has also been employed in other jurisdictions. *See, e.g., Wingold v. Horowitz*, 274 So. 2d 591 (Fla. Dist. Ct. App. 1973) (applying a Bahamas statute and finding the trial court within its authority to cancel a mortgage and indebtedness when the interest charged was unconscionable), *rev'd on other grounds*, 292 So. 2d 585 (Fla. 1974); *Milani v. Banks*, 98 D.L.R. 4th 104, 109 (Ont. 1992) (setting aside the charge, vacating the registration, revising the repayment note to \$32,000 from \$35,000, and striking the interest).

291. *See In re Hollstrom*, 133 B.R. 535, 541 (Bankr. D. Colo. 1991) (ordering recovery at a nondefault contractual rate of 12% rather than 36%); *In re White*, 88 B.R. 498 (Bankr. D. Mass. 1988) (holding a 48% default rate unconscionable and asserting that the court lacks authority to reform the note to a reasonable default rate).

292. *See Williams v. E.F. Hutton Mortgage. Corp.*, 555 So. 2d 158, 162 (Ala. 1989). The *Williams* case is one of the few reported class action cases challenging the fairness of loan interest rates. Such claims do not seem amenable to class action pursuit, as they turn on borrower-specific proof of risk, and when insisted on, procedural unfairness. One possible use of class actions, though, would be against creditors who base their rates on their experience with borrowers generally and do not investigate individual borrower risks.

293. *See Shedd, supra* note 271, at 351 n.54 (arguing that "unconscionability would not provide relief for interest rates charged in the financing of commercial real estate").

294. For examples of cases applying the unconscionability standard to commercial borrowers, see *Metal-Built Prods., Inc. v. Bornstein (In re Metal-Built Prods., Inc.)*, 3 B.R. 176, 179 (Bankr. E.D. Pa. 1980) (holding a 100% rate conscionable in a debt between commercial parties); *Bekins Bar V Ranch v. Huth*, 664 P.2d 455, 457 (Utah 1983) (holding rates of 36% and 58% conscionable).

because a finding of lack of sophistication may be required, commercial parties will prevail on rare occasions only.<sup>295</sup> Moreover, several of the cases involving commercial borrowers counsel judicial restraint because interfering with commercial loan pricing may inhibit vital high risk capital.<sup>296</sup>

#### D. Comparative Rate Regulation—General

Australia, the Bahamas, Belgium, Canada, England, Germany, Mexico, New Zealand, and Switzerland<sup>297</sup> are among the jurisdictions that regulate interest rates using an unconscionability standard. The discussion below focuses on the statutory unconscionability models of England and Germany because of England's influence on similar adoptions in other countries and the advanced development of both countries' case law and legal commentary on this issue.<sup>298</sup>

Uncertainty followed England's 1854 repeal<sup>299</sup> of its three centuries old usury standard.<sup>300</sup> Aside from the Court of Chancery's very limited jurisdiction, there was no check on

295. Refer to note 264 *supra* and accompanying text.

296. See, e.g., *In re Elkins-Dell Mfg. Co.*, 253 F. Supp. 864, 871 (E.D. Pa. 1966) (noting that important policy considerations favor promotion of availability of funds for businesses in distress even if at high rates of interest); *Bekins Bar V Ranch*, 664 P.2d at 464 (arguing that finding unconscionability "on these facts" would discourage future lenders from loaning to financially troubled businesses because of the risk that a court would not allow the cost of high risk capital); see also *Shriver v. Druid Realty Co.*, 131 A. 815, 819 (Md. 1926) (noting that relieving a corporation from an allegedly excessive rate would chill credit for "hazardous or venturesome enterprises"). Of course, the same might be said for credit to high risk consumers. Cf. *Amoco Oil Co. v. Ashcraft*, 791 F.2d 519, 522 (7th Cir. 1986) (speculating that poor borrowers may be worse off if courts do not enforce unfair bargains because merchants with knowledge of that potential may be unwilling to deal with them).

297. Interest regulation summaries for these and certain other countries can be obtained from the annual Martindale-Hubbell International Law Digest. Canada's legislation was enacted by each province rather than federally. See generally GERALD H. FRIDMAN, *THE LAW OF CONTRACT IN CANADA* 313-16 (2d ed. 1986).

298. England's Moneylenders Act of 1900, discussed *infra* in the text accompanying note 302, was adopted with some variation by, among other jurisdictions, the Canadian provinces, Australia and New Zealand. See generally K.L. Fletcher, *Review of Unconscionable Transactions*, 8 U. QUEENSLAND L.J. 45, 57-58 (1973) (tracing the Moneylenders Act's influence into the twentieth century).

299. See A.H. Angelo & E.P. Ellinger, *Unconscionable Contracts: A Comparative Study of the Approaches in England, France, Germany, and the United States*, 14 LOY. L.A. INT'L & COMP. L.J. 455, 462 (1992) (noting that English courts were slow to intervene in cases involving usurious bargains when those cases became free from legislative controls in 1854). See generally PRIDGEN, *supra* note 24, § 10.01[2], at 10-4 (discussing the history of usury in England).

300. Adopted in 1545, England's legislation allowing interest at 10% or less was repealed during the reign of Queen Mary but reenacted in 1570. See BROWN & KEEST, *supra* note 26, § 2.2.1, at 20. The 10% rate allowed was lowered to 5% by the 1713 Statute of Anne. Riley, *supra* note 20, at 201 n.9.

interest rates.<sup>301</sup> Coming in response to then widespread abuse, the 1900 Moneylenders Act articulated a flexible unconscionability standard and explicitly authorized courts to reopen "harsh and unconscionable" loan bargains.<sup>302</sup> In 1974, the Consumer Credit Act amended that standard; it now proscribes "extortionate" and "grossly exorbitant" interest pricing.<sup>303</sup>

Germany's rate regulation experience is remarkably similar to England's. German usury regulation succumbed in 1867 to free market regulation, but abuses prompted the Parliament to adopt a flexible unconscionability standard to police interest pricing fairness in the German Civil Code of 1900.<sup>304</sup>

1. *The Procedural v. Substantive Debate in Comparative Rate Regulation.* The procedural unfairness debate lurks unresolved in both England and Germany. England's Consumer Credit Act defines a credit bargain as extortionate if it "(a) requires . . . payments . . . which are grossly exorbitant, or (b)

301. See generally P.V.B., *Reforming the Moneylenders Acts*, 83 LAW Q. REV. 196, 196 (1967) (observing that no restraints on "extortionate moneylending" existed after the repeal of usury statutes in 1854 with the exception of the Court of Chancery's ability to set aside harsh and unconscionable bargains).

302. The 1900 Act provided in relevant part that when interest is "excessive" and "the transaction is harsh and unconscionable, or is otherwise such that a court of equity would give relief, the court may re-open the transaction . . . [and provide such relief] as the court, having regard to the risk and all the circumstances, may adjudge to be reasonable . . . ." Moneylenders Act, 1900, 63 & 64 Vict., ch. 51, § 1 (Eng.). For an excellent historical discussion of England's unconscionability regulation, see H.W. Wilkinson, *Extortionate Credit Bargains Under the Consumer Credit Act 1974*, 8 ANGLO-AM. L. REV. 240, 241-43 (1979).

303. Section 138 of the 1974 Act provides in relevant part that a "credit bargain is extortionate if it (a) requires the debtor . . . to make payments . . . which are grossly exorbitant, or (b) otherwise grossly contravenes ordinary principles of fair dealing." Consumer Credit Act, 1974, ch. 39, § 138 (Eng.). Debate ensued in England and the question remains open whether the new phrasing meant something different than prior law, which would limit the utility of case authority under the 1900 Act. See Lionel Bentley & Geraint G. Howells, *Judicial Treatment of Extortionate Credit Bargains*, 1989 CONV. & PROP. LAW 164, 166 (concluding that the new standard seems more lenient to creditors). But see Wilkinson, *supra* note 302, at 243 (suggesting the changes will have little effect).

304. Article 138 of the German Civil Code provides:

- (1) A legal transaction which is contrary to public policy is void.
- (2) A legal transaction is also void whereby a person exploits the distressed situation, inexperience, lack of judgmental ability or grave weakness of will of another to obtain the grant or promise of pecuniary advantages for himself or a third party which are obviously disproportionate to the performance given in return.

Angelo & Ellinger, *supra* note 299, at 483 (employing translation of 1976 amendment in ARTHUR T. VON MEHREN & JAMES R. GORDLEY, *THE CIVIL LAW SYSTEM* 1188, 1209 (2d ed. 1977)). See generally John P. Dawson, *Economic Duress and the Fair Exchange in French and German Law*, 12 TUL. L. REV. 42 (1937) (concluding that the German experience with Article 138 introduced moral and social values into the concept of usury).

otherwise grossly contravenes ordinary principles of fair dealing.<sup>305</sup> Commentators have found the phrase "or otherwise" ambiguous.<sup>306</sup> The German Civil Code is similarly uncertain. One commentator observed without citation that German courts require, in addition to substantive disparity, that the borrower's weakness be exploited,<sup>307</sup> but gross pricing disparity alone may be actionable under Germany's more general prohibition of transactions contrary to public policy.<sup>308</sup>

## 2. Procedural Unfairness in Comparative Rate Regulation.

The same factors of procedural unfairness identified in case law under the UCC appear relevant under the English and German statutes.<sup>309</sup> English courts apply the standard of sophistication as whether the borrower could understand the loan terms offered.<sup>310</sup> Having been represented by counsel in negotiating the loan is usually fatal to an English borrower's claim.<sup>311</sup>

305. Consumer Credit Act, 1974, ch. 39 § 138 (Eng.).

306. See, e.g., Bentley & Howells, *supra* note 39, at 235. It is unclear whether "otherwise" means some procedural unfairness must be shown, or whether substantive unfairness alone contravenes ordinary principles of fair dealing. See Wilkinson, *supra* note 302, at 243-44. Cases decided under the former 1900 Moneylenders Act applied that Act to redress substantive unfairness alone. See, e.g., Fortescue Ltd. v. Bradshaw, 27 T.L.R. 251 (K.B. 1911) (reducing contract rate from 220% to 50% without finding any procedural unfairness).

307. See Angelo & Ellinger, *supra* note 299, at 499.

308. See Dawson, *supra* note 304, at 71 (referring to Article 138(1) of the German Civil Code of 1900, which provides that a legal transaction that is contrary to public policy is void).

309. The debtor's "age, experience, business capacity and state of health," and the degree and nature of the debtor's "financial pressure" are detailed by the English Consumer Credit Act as relevant "in relation to the debtor" in determining whether the loan is extortionate. Consumer Credit Act, 1974, ch. 39, § 138(3) (Eng.). It also appears relevant whether the English lender employed any misrepresentation or sharp practice to disguise the actual rate paid. Presumably that would render the rate unconscionable, though this issue has been addressed in cases denying relief to a sophisticated borrower, with the court adding a conclusory statement that no deception was involved. See, e.g., Reading Trust, Ltd. v. Spero, 1 K.B. 492, 509-10 (C.A. 1930) (finding no lender misrepresentation to experienced borrower); see also Davies v. Directloans Ltd., 2 All E.R. 783, 783-87 (1986) (holding that a 25% mortgage interest rate was not extortionate because the borrowers had independent legal advice and financial pressures were not excessive and noting that the lender testified that it advised every borrower to seek a loan elsewhere because its rates exceeded those of a building society); Carringtons, Ltd. v. Smith, 1 K.B. 79, 92 (C.A. 1906) (enforcing a 75% rate for a business loan and finding no deception). German statutes void a transaction that exploits inexperience, weakness, inability to judge or distressful situations. Refer to note 304 *supra*.

310. See, e.g., Reading Trust, 1 K.B. at 510 (holding that a loan was not harsh and unconscionable when the borrower at a 80% rate understood the loan transaction thoroughly). Courts should determine whether the borrower understood that the rate substantially exceeded risks and costs, not solely whether the borrower knew it was paying a facially high rate.

311. See, e.g., Davies, 2 All E.R. at 790 (finding no unconscionability when



English courts take a strict view of what constitutes financial necessity or "pressure"; one court suggests that "penniless debtors" who are "desperate for money" would qualify as necessitous.<sup>312</sup> Borrowers for business speculation, however, are not necessitous.<sup>313</sup> English courts have refused to aid borrowers who created their own distress, or who had some viable alternative to a high rate loan such as selling their property.<sup>314</sup> This is the English equivalent of lack of choice.<sup>315</sup> German cases have drawn the same distinctions.<sup>316</sup>

3. *Substantive Unfairness in Comparative Rate Regulation.* England's Consumer Credit Act directs the court to evaluate the rate charged in relation to prevailing interest rates and the borrower's risk.<sup>317</sup> German courts have justified high interest rates by reference to comparable market transactions,<sup>318</sup> borrower risk, and the effects of inflation.<sup>319</sup> It is apparent from

"naive and trusting" consumer borrowers were advised by an independent solicitor, and holding that they could not challenge the loan due to their own business inexperience); *Parkfield Trust Ltd. v. Portman*, 81 Sol. J. 687 (1937) (holding that a loan at 177% to a borrower advised by an independent solicitor was not unconscionable).

312. See *Patel v. Patel*, (Q.B. Nov. 25, 1987) (LEXIS, Enggen library, Cases file) (holding that borrowers paying 48% interest on a loan to prepare for the religious visit of a swami were neither penniless nor forced to accept the loan).

313. See, e.g., *Reading Trust*, 1 K.B. at 509-10 (holding that an antique dealer who borrowed to finance inventory was not necessitous). But see *Shahabinia v. Giyahchi* (C.A. July 5, 1989) (LEXIS, Enggen library, Cases file) (ruling that a 45% loan to a sandwich bar business was unconscionable even without any apparent proof of lack of sophistication or financial necessity).

314. See, e.g., *Davies*, 2 All E.R. at 790 (holding a loan not unconscionable when pressure on the borrowers to borrow to avoid losing their home purchased under a unique deferred sales arrangement was the "inevitable consequence of their original decision to buy [the home]").

315. For a discussion of lack of choice refer to note 161 *supra*.

316. See *Angelo & Ellinger*, *supra* note 299, at 484 (illustrating necessity under German law as when the debtor faces economic collapse, but not for business expansion or acquisition); John P. Dawson, *Unconscionable Coercion: The German Version*, 89 HARV. L. REV. 1041, 1057-58 & n.37 (1976) (citing German court decisions in which necessity was not found when money was sought for business speculation, or if the borrower had assets that were disposable or available as security on a less expensive loan).

317. See Consumer Credit Act, 1974, ch. 39, § 138(2) (Eng.) ("In determining whether a credit bargain is extortionate, regard shall be had to . . . interest rates prevailing at the time it was made . . . [and the] creditor[s] . . . degree of risk."). This supports the author's approach of judging rates in relation to risks and costs, with the market standard employed as persuasive authority only. English courts have been criticized for looking to rates prevailing for the class of lender involved, without regard to whether the actual rate charged is excessive in relation to the risks the particular claimant presents. These courts are "accepting the nature of the lending institution as a satisfactory explanation of the high interest rate." Bentley & Howells, *supra* note 39, at 236.

318. See Dawson, *supra* note 316, at 1063 (noting that annual interest rates of 96% and 34% were upheld when similar rates were commonly charged).

319. See *Angelo & Ellinger*, *supra* note 299, at 486 (reporting that annual

English cases that almost anything goes when the debtor has a bad credit history, minimal collateral, or both. Rates of 177 percent, 120 percent, and 80 percent have been upheld in such circumstances,<sup>320</sup> as English courts struggle to ascertain a fair rate for such loans.<sup>321</sup>

The English and German statutes employ vague standards of disparity typical in America; England's statute refers to "gross exorbitance,"<sup>322</sup> Germany's to an obvious disproportion.<sup>323</sup> They both stand in contrast to the Roman doctrine of *laesio enormis* in rejecting a purely mathematical approach to disparity in favor of a flexible case-by-case standard.<sup>324</sup> *Laesio enormis*, which allowed sellers to rescind sales of land sold for less than half of true value,<sup>325</sup> was never generally accepted

interest rates of 96% were approved during periods of high inflation); Dawson, *supra* note 316, at 1063 n.52 (noting that interest rates of 10% a day were not held excessive during the 1920 to 1923 German period of inflation); see also HOMER & SYLLA, *supra* note 20, at 508 (noting that the Berlin Stock Exchange once quoted a market rate for call loans of over 10,000% per annum).

320. See *Parkfield Trust Ltd. v. Portman*, 81 Sol. J. 687 (1937) (approving 177% interest for loan secured by a speculative reversion in an insurance company loan); *Mills Conduit Inv., Ltd. v. Tattersall*, 56 T.L.R. 209, 210 (K.B. 1939) (approving 120% interest for a loan to a borrower who provided no income information and secured the loan with a postdated check); *Reading Trust, Ltd. v. Spero*, 1 K.B. 492, 510 (C.A. 1930) (approving loans at 60% and 80% to a business borrower with no security who bought stock on credit and who had bank overdraft).

321. See *Mills Conduit Inv., Ltd. v. Tattersall*, 56 T.L.R. 209, 210 (K.B. 1939) (holding that a 120% loan to a "reckless" debtor was not excessive because "[i]f ever there was a case in which the interest cannot be calculated at all except in terms of a quite ridiculous figure . . . this is that case"). English commentators suggest that the line should be drawn somewhere. See Lord Meston, *Rates of Interest in Moneylending Transactions*, 1 SOLIC. 40, 46 (1962) (suggesting that where a loan is unsecured and the borrower is irresponsible, the lender is justified in charging 80% and more, but "an astronomical rate of interest such as 400 per cent would offend against the conscience"); Wilkinson, *supra* note 302, at 252-53 (arguing that interest rates on high risk loans still have a conscionable ceiling).

322. Consumer Credit Act, 1974, ch. 39, § 138(1) (Eng.).

323. See Dawson, *supra* note 316, at 1063.

324. In 1927, England flirted with a mathematical formulation and adopted a presumption of unconscionability where loan rates exceeded 48%. The 1927 Moneylenders Act provided in relevant part that if the annual rate exceeded 48%, the court shall "unless the contrary is proved, presume for the purposes of [the 1900 Moneylenders Act] that the interest charged is excessive . . ." Moneylenders Act, 1927, 17 & 18 Geo. 5, ch. 21, § 10 (Eng.). The 1974 Act abolished this presumption, but placed on the creditor the burden of proving the loan was not extortionate, whether the interest rate was below or above 48%. Consumer Credit Act, 1974, ch. 39, § 171(7) (Eng.). See generally Bentley & Howells, *supra* note 39, at 241 (analyzing governmental reasons for rejecting a 48% rate presumption). See Dawson, *supra* note 316, at 1062-63 (noting the formula of *laesio enormis* was "emphatically rejected" by the German Civil Code drafters who employed the test of disproportion which "probably gave as much guidance as language could usefully provide once simple arithmetic had been abandoned").

325. See generally REINHARD ZIMMERMANN, *THE LAW OF OBLIGATIONS*, 259-70 (1990) (chronicling the expansion, contraction, and eventual disappearance of *laesio*

in Europe for other types of contractual exchanges<sup>326</sup> and was criticized by commentators as arbitrary and inflexible.<sup>327</sup>

4. *Comparative Rate Regulation Remedies.* English and German remedies for unfair interest rates are at least equal to and in some cases better than those allowed in America. Germany's statute declares unfair transactions "void."<sup>328</sup> Though interpreted initially to bar recovery of both principal and interest, courts now allow recovery of principal.<sup>329</sup> The lender cannot recover any interest, however, even as reduced to a fair rate.<sup>330</sup> In contrast, English courts reduce an excessive rate to a fair one.<sup>331</sup> Commentators criticize Germany's denial

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*enormis* in European law). The unconscionability doctrine, while applied typically to protect buyers rather than sellers, would in appropriate circumstances relieve sellers and lenders from unfair bargains. *Cf. In re Estate of Young*, 367 N.Y.S.2d 717, 722 (Sup. Ct. 1975) (holding that a contract for an interest-free payment obligation to an author was conscionable because of the risk assumed by the publisher).

326. See Dawson, *supra* note 138, at 276 (reviewing the limitation of *laesio enormis* to property transfers and the refusal to review adequacy of bargains generally during the ascent of consideration). *Laesio enormis* has some remaining life in the French law governing realty sales. See Angelo & Ellinger, *supra* note 299, at 474-75 (discussing *lésion* as the modern remnant of *laesio enormis* which nullifies consent for property sold at less than half its value). *Laesio enormis* also lurks in the interest rate statutes of some jurisdictions. For example, loans in France are usurious and criminal if they exceed by more than 33% the rate charged generally for loans of similar costs and risk. See MARTINDALE-HUBBELL INTERNATIONAL LAW DIGEST, FRA-17 (1993). Rates exceeding the normal market rate by 75% are punishable as crimes in Uruguay. *Id.* at URU-5. *Cf. Krock v. Midtown Mortgage & Loans Ltd.*, 52 D.L.R.3d 286, 291 (Alta. Sup. Ct. 1975) (ruling that a rate of almost twice the "going rate" is unconscionable).

327. See, e.g., 3 SYMONS, *supra* note 138, § 927, at 637 n.18 (arguing that arbitrary rules of value are unfair and preferring determination on a case-by-case basis after consideration of all circumstances); ZIMMERMANN, *supra* note 325, at 270 (advocating judicial consideration of the specific circumstances rather than rigid limitations). Both usury and the unconscionability standard (when demanding proof of substantive unfairness only) have been referred to unflatteringly as descendants of *laesio enormis*. See TEEVEN, *supra* note 138, at 318 (stating that cases finding unconscionability on the sole basis of gross inadequacy are perhaps a "loose adoption" of the *laesio enormis* theory); Leff, *supra* note 110, at 427 (arguing that usury laws are an emotional remnant of attempts to determine a "fair price" rather than inquiring into procedural unfairness).

328. Refer to note 304 *supra* for a translation of the German unconscionability statute.

329. See Angelo & Ellinger, *supra* note 299, at 486-88 (citing the German policy change in 1939 that allowed recovery of principal but not interest by a usurious lender); Dawson, *supra* note 316, at 1056 n.31 (citing the vigorous debate generated by this new policy, and the reluctance of German courts to change).

330. *Cf. Angelo & Ellinger, supra* note 299, at 487, 505 (arguing that the better system is the court's power under § 2-302 of the UCC to set a fair rate).

331. See, e.g., *Shahabinia v. Giyahchi*, (C.A. July 5, 1989) (LEXIS, Enggen library, Cases file) (modifying an interest rate on appeal to 30% after the trial court reduced it to 15% from 45%). For cases under the former Moneylenders Act of 1900, see, e.g., *Grosvenor Guarantee Trust Ltd. v. Colleano*, 1950 W.N. 501 (150% reduced

of all interest as harsh and inflexible, but those in England complain that merely reducing the rate does not deter unfair pricing, and advocate reform to render "the whole bargain unenforceable."<sup>332</sup> Neither the English nor the German statute provides penalties more punitive than the loss of all or a portion of interest.<sup>333</sup>

5. *The Consumer/Commercial Party Distinction Under Comparative Rate Regulation.* The English Act relieves "individuals" from extortionate loans.<sup>334</sup> It defines "individuals" to include partnerships but exclude corporations,<sup>335</sup> a distinction which is artificial and ill-conceived.<sup>336</sup> The Act protects individuals whether they borrow for commercial or consumer purposes.<sup>337</sup> However, proving procedural unfairness if required would pose the same formidable hurdle that American commercial borrowers face.

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to 60%); *Verner-Jeffreys v. Pinto*, 1 Ch. 401, 421 (1929) (48% reduced to 15%); *Garde v. Kerman*, 41 T.L.R. 597 (Ch. 1925) (60% reduced to 30%); *Jennings v. Seeley*, 40 T.L.R. 97 (Ch. 1923) (82½% reduced to 15%). Canadian courts also employ this remedy under Canadian statutes based on those of England. *See, e.g., Krock v. Midtown Mortgage & Loans Ltd.*, 52 D.L.R.3d 286, 292 (Alta. Sup. Ct. 1975) (reducing a 65% rate to 14% for a loan secured with mortgage insurance and held to be a no risk loan).

332. *See Bentley & Howells, supra* note 39, at 238-39. Though England's Consumer Credit Act in Section 139(2) authorizes the court to "set aside the whole or part of any obligation," which arguably allows voiding the loan agreement, that authority is given only "for the purpose of relieving the debtor . . . from payment of any sum in excess of that fairly due and reasonable." Consumer Credit Act, 1974, ch. 39, § 139(2) (Eng.). The statute therefore seems to allow relief only for the unfair portion of the bargain. The English statute does allow retroactive relief from unfair rates; courts have applied past payments of excessive interest partly to future interest at the reduced fair rate, and the rest to principal. *See, e.g., Shahabinia v. Giyahchi* (C.A. July 5, 1989) (LEXIS, Enggen library, Cases file) (applying excess interest paid to reduce "capital"). English courts would presumably allow affirmative recovery of past excessive interest paid when outstanding principal is not enough to offset that excess. Canadian courts have so construed their remedial provisions based on England's statutes. *See Churchill v. Le Barron Mortgages Ltd.*, 86 D.L.R.3d 538, 540 (Nfld. Dist. Ct. 1978) (allowing retroactive relief to a debtor whose unconscionable loan was paid off).

333. *See Consumer Credit Act*, 1974, ch. 39 § 139(2) (describing English law readjustment of extortionate debt to a fair interest rate); *Dawson, supra* note 316, at 1056 n.31 (describing German law allowing the usurious creditor to recover principal but requiring it to forfeit interest).

334. *See Consumer Credit Act*, 1974, ch. 39, § 137(2)(a) (Eng.).

335. *Id.* § 189(1).

336. Some American usury statutes make the same distinction in excluding only corporate borrowers from usury protection. Refer to note 351 *infra* and accompanying text. Whatever fairness protection given (or not given) to partnerships should be accorded corporate borrowers as well.

337. *See, e.g., Shahabinia v. Giyahchi* (C.A. July 5, 1989) (LEXIS, Enggen library, Cases file) (finding a loan to a sandwich bar owner for business purposes extortionate and readjusting the rate).

### *E. The American Usury Standard—General*

Usury restrictions persist in most states for certain loan transactions despite the ravages of state deregulation and federal preemption.<sup>338</sup> The next sections of this Article examine how usury controls can contribute to the formation of an unconscionability standard for policing rate unfairness.

1. *American Usury—The Procedural v. Substantive Debate.* The usury experience supports dispensing with proof of procedural unfairness for consumer purpose loans. Usury statutes are violated without proof that the lender exploited the borrower's necessity or lack of sophistication.<sup>339</sup> States that exclude corporate or business loans from their usury protection, however, implicitly recognize that corporate borrowers are sophisticated and likely to borrow for profit speculation.<sup>340</sup> Statutes with such exclusions thus combine a substantive component of a rate deemed per se excessive and a "procedural" component established if the loan was for consumer purposes. Consumers are treated as deserving protection as a class without borrower-specific findings of necessity or lack of sophistication.

2. *American Usury—Procedural Unfairness.* The most often cited purpose of usury statutes is to protect unsophisticated and necessitous borrowers.<sup>341</sup> Thus, if legislatures or courts insist that procedural unfairness be proven by borrowers under the unconscionability standard, the usury standard suggests proof that the borrower was unsophisticated and necessitous justifies relief.<sup>342</sup>

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338. Refer to text accompanying notes 57-71 *supra*.

339. Usury statutes have therefore been criticized as regulating without relation to morality. See William C. Prather, *Mortgage Loans and the Usury Laws*, 16 BUS. LAW 181, 182 (1960) (arguing that fixed rate ceilings are not morally responsive because they apply equally to loans to the starving and loans to the wealthy).

340. Refer to note 351 *infra* (providing the rationale for the distinction between consumer and corporate borrowers).

341. See *Scientific Prods. v. Cyto Medical Lab., Inc.*, 457 F. Supp. 1373, 1379 (D. Conn. 1978) ("The prohibition against usury is based on the principle that it is unconscionable to charge excessive interest on loans of money to those who are forced by necessity to borrow it."); Riley, *supra* note 20, at 223 (justifying usury laws to protect unsophisticated borrowers).

342. Other guidance in shaping the unconscionability standard comes from courts estopping borrowers who procured their loans by fraud from asserting usury. See, e.g., *Buck v. Dahlgren*, 100 Cal. Rptr. 462, 463-65 (Ct. App. 1972) (affirming the trial court's decision that a sophisticated developer who concealed the true value of land securing a loan was estopped from asserting usury against an inexperienced lender where the developer suggested the terms challenged as usurious). The

3. *American Usury—Substantive Unfairness.* Usury regulation evidences that rates for certain risky consumer transactions can be justifiably high. For example, several states that limit pawnbroker rates permit facially high rates of return.<sup>343</sup> Such high pawn rates reflect both the lender's need to recoup transaction costs in these typically small dollar transactions and the risk assumed by the lender in limiting its recourse to the collateral.

4. *Remedies Under the American Usury Standard.* Usury remedies are notoriously nonuniform and therefore of limited use in setting remedial standards for unconscionable interest pricing. Usury penalties historically were more severe than they are now.<sup>344</sup> Today, only a dozen or so states provide criminal penalties,<sup>345</sup> and most of those defer to private enforcement

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borrower's deception as to her risk status should typically preclude relief under the unconscionability standard despite an otherwise unconscionable loan. See *E & W Bldg. Material v. American Sav. & Loan Ass'n*, 648 F. Supp. 289, 292 (M.D. Ala. 1986) (denying equitable relief on the grounds of unconscionability to a borrower who falsely represented to a lender that his house was unencumbered).

343. See Oeltjen, *supra* note 48, at 784 n.166 (listing 11 states that statutorily allow comparatively high interest rates: Connecticut, Kansas, Nevada, Ohio, Oklahoma, Rhode Island, South Carolina, Texas, Vermont, Virginia and Washington). There are two distinct approaches to usury—setting a ceiling consistent with industry risks and costs, as a public utilities commission would do, or setting a ceiling higher than industry risks would justify, so that rates are set for the most part by competition with some outward check on abuse. See generally FONSECA, *supra* note 157, § 7:1, at 259 (analyzing the historical development of instituting rate ceilings). The UCCC is a notable example of the latter approach and is one small step removed from regulation by the unconscionability standard. That Act is described by one commentator as a "startling departure" from prior regulation for its reliance on competition to govern loan costs. Robert P. Shay, *The Uniform Consumer Credit Code: An Economist's View*, 54 CORNELL L. REV. 491, 494 (1969). If courts applying the unconscionability standard look to usury statutes effective in other states for guidance in gauging the rate justified for a particular type of loan, they should be aware which approach the statutes follow.

344. For example, the usurer forfeited his lands and chattels in eleventh century England, and in Rome was subject to twice the criminal fine as thieves. Usury was also compared in the Bible to rape, murder, and robbery. See Ackerman, *supra*, note 21, at 62.

345. See, e.g., N.Y. PENAL LAW § 190.40 (McKinney 1988) ("A person is guilty of criminal usury when, [without authorization by law] he knowingly charges . . . interest . . . at a rate exceeding twenty-five percent per annum . . ."). Federal law enacted in 1968 as title II of the Consumer Credit Protection Act made "extortionate credit transactions" a federal crime. 18 U.S.C. § 892 (1988). Rates exceeding 45%, when several other factors are present, are *prima facie* evidence of extortionate credit. 18 U.S.C. § 892(b)(2) (1988). Since the statute is concerned only with combating organized crime, it requires borrower belief of a reputation for extortionate collection methods be proven for that evidentiary rule to apply. 18 U.S.C. § 892(c) (1988). As such, except for lenders who deal in legbreaking, this Act is not implicated. See generally Walter D. Malcolm & John J. Curtin, Jr., *The New Federal Attack*

rather than employing government resources to enforce the penalties robustly. The typical usury statute still imposes punitive civil sanctions by either denying recovery of principal or interest, imposing statutory penalties, or inflicting some combination of these remedies.<sup>346</sup> Some void only the interest that exceeds the usury limit, but most levy some additional sanction to deter the usurer.<sup>347</sup> Similarly, the deterrence argument supports penalizing unconscionability beyond the reduction of excessive rates to fair ones.

Usury statutes vary on whether usurious interest already paid can be recovered.<sup>348</sup> The common law recognizes this remedy, but some usury statutes have abrogated that recovery.<sup>349</sup> Courts should employ this common law remedy by

*on the Loan Shark Problem*, 33 LAW & CONTEMP. PROBS. 765 (1968) (discussing and evaluating title II of the Consumer Credit Protection Act).

346. For example, in Arkansas the lender forfeits the principal and interest of usurious consumer loans. ARK. CONST. art. XIX, § 13 (1982). In Nebraska a lender making a usurious loan forfeits all interest but not principal. NEB. REV. STAT. § 45-105 (1988). If employed, statutory penalties are typically double or triple either the entire interest charged, the usurious portion of the interest, or some other measure. *E.g.*, COLO. REV. STAT. ANN. § 5-5-202 (West 1994); IND. CODE ANN. § 24-4.5-5-202 (Burns 1994); TEX. REV. CIV. STAT. ANN. art. 5069-1.06 (Vernon Supp. 1994). The UCCC provides a statutory penalty of \$100 to \$1,000 as determined by the court. UNIF. CONSUMER CREDIT CODE § 5.201, 7A U.L.A. 182 (1974). For a general discussion of usury remedies, see PRIDGEN, *supra* note 24, § 10.07 (describing the great variation in state usury remedies but noting that the most common remedy is disallowance of interest).

The federal Racketeer Influenced and Corrupt Organizations Act ("RICO"), with its treble damages remedy, is implicated by collection of an "unlawful debt" at a "usurious rate" at least twice the "enforceable rate." See 18 U.S.C. § 1961(6) (1988) (defining the term "unlawful debt"). Query whether an outrageous rate held unconscionable in the absence of a usury ceiling could implicate RICO.

Class actions to challenge usury have been certified when the procedural requisites for such actions are otherwise satisfied. See *Cohen v. District of Columbia Nat'l Bank*, 59 F.R.D. 84, 88-91 (D.D.C. 1972) (holding that borrowers of unsecured installment loans from a single bank that charged a usurious rate met the procedural requirements of Fed. R. Civ. P. 23(a) and were thus certified as a class). See generally PRIDGEN, *supra* note 24, § 10.07[4] (stating the elements that the plaintiff must prove to receive class certification and the difficulties inherent in achieving that status). The UCCC, however, denies recovery in class actions of its statutory penalty for usury violations. 7A U.L.A. 182 (1974) (explaining in comment 2 that the statutory penalty was designed in part as an incentive for a consumer to bring an action and consequently cannot be recovered in a class action).

347. See UNIF. CONSUMER CREDIT CODE § 5.201, cmt. 3, 7A U.L.A. 183 (1974). The UCCC statutory penalty for usury serves to deter lenders who might gamble and make usurious loans, because without the penalty they would only have to forfeit the illegally gained interest. *Id.*

348. See generally BROWN & KEEST, *supra* note 26, § 9.4.1.1.2, at 248-49 (discussing statutory and common law approaches to recovery of payments made to principal or interest prior to the lawsuit).

349. See KEEST, *supra* note 6, § 9.4.1.1.2, at 201-02 (listing cases dealing with a borrower's recovery of usurious payments).

analogy under the unconscionability standard to allow a claimant to recover past excessive interest paid when there is not enough principal left unpaid to offset that amount.

Separate from usury's influence on shaping unconscionability remedies, an unconscionable rate could trigger usury remedies in deregulated states that amended their usury statute to allow any "agreed rate."<sup>350</sup> Borrowers might argue that procedural unfairness precluded their effective "agreement" to the excessive rate, thereby invoking the jurisdiction's remaining usury sanctions.

5. *The Consumer/Commercial Party Distinction Under American Usury.* Most usury regulation treats corporate and consumer borrowers differently. Some states allow higher ceilings for corporate borrowers, but many others exempt corporate loans from usury limits altogether. The trend is to extend this "corporate exemption" to business loans generally.<sup>351</sup> Some

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350. See BROWN & KEEST, *supra* note 26, § 9.2.3, at 219-22 (discussing the ways that a usury statute can be violated in a state which has amended its usury statute to allow any agreed rate of interest).

351. See MICHAEL T. MADISON & JEFFRY R. DWYER, *THE LAW OF REAL ESTATE FINANCING*, § 5.05[4][e][i], at 5-38 (1994) (recognizing that several states have expanded their corporate exemption to other commercial borrowers). The rationale for treating corporate borrowers differently than consumers is derived from usury's policy of protecting unsophisticated and financially necessitous borrowers. As a class, corporate borrowers are perceived as having a "natural sophistication in business matters" and therefore as being able to bargain at arms length with lenders. See Note, *Stemming Abuses of Corporate Exemptions from the Usury Laws: A Legislative and Judicial Analysis*, 59 IOWA L. REV. 91, 92 (1973) (explaining that corporate entities enjoy a more equal bargaining position with lenders); see also Riley, *supra* note 20, at 208 (explaining that usury protection is aimed at "poor individual consumers" rather than corporate borrowers because corporations have both sophisticated leveraging techniques and "bargaining competence"); Melissa Stimmel, Note, *The Scope of the Corporate Exemption to State Usury Laws*, 3 ANN. REV. BANKING L. 309, 316 (1984) (arguing that corporate borrowers have more business experience, greater borrowing strength, and are not subject to the particular needs and limitations of individuals). Moreover, corporate borrowers are less susceptible to financial coercion because they seek to further profit-making activities, rather than to acquire personal necessities. See Note, *supra* at 92 (noting that corporations, as artificial entities, have been regarded as immune from the personal necessities that cause individuals to be susceptible to coercion); see also Ackerman, *supra* note 21, at 78 (noting that John Calvin recognized the oppressive nature of charging interest was absent in commercial transactions when both parties profited). Other rationales offered for the "corporate exemption" are that a corporation has better access to legal advice and that its potential loss on default does not implicate consumer necessities. See BROWN & KEEST, *supra* note 26, § 9.1.1.1, at 203. But see Hershel Shanks, *Practical Problems in the Application of Archaic Usury Statutes*, 53 VA. L. REV. 327, 347 (1967) (arguing that corporate exceptions were passed not because corporate borrowers did not need usury protection, but as a safety valve to relieve the "adverse pressure" usury laws were exerting on "legitimate commercial activities"). The "corporate exemption" rationale clearly extends to business loans generally. See Merriman & Hanks, *supra* note 122, at 15-16 (arguing that there is no reason to



commentators are concerned for the small businessperson who might have less access than other commercial borrowers to expert advice and less familiarity with commercial transactions.<sup>352</sup> A few usury statutes address this concern by limiting their corporate or business loan exemption to loans over a specified dollar amount<sup>353</sup> on the assumption that businesses obtaining larger loans are better able to protect themselves.<sup>354</sup> The 1968 UCCC protected the small businessperson by imposing usury limits on loans of \$25,000 or less to individuals for business purposes,<sup>355</sup> but the 1974 UCCC abandoned all limits on business loans.<sup>356</sup> The 1974 UCCC, the better approach, is consistent with the federal Truth in Lending Act, which excludes business loans from its loan disclosure obligations regardless of dollar amount.<sup>357</sup>

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prevent knowledgeable businesspersons from obtaining loans at high interest rates merely to protect those businesspersons with poor judgment who probably make poor decisions in other business contexts as well); Oeltjen, *supra* note 16, at 186 (arguing that "it would seem reasonable to revise the corporate exemption to make it a business exception"); Riley, *supra* note 20, at 219 (arguing that often sole proprietorships and partnerships are equally as sophisticated in business dealings as corporations).

352. See, e.g., BROWN & KEEST, *supra* note 26, § 9.1.1.1, at 203-04; Merriman & Hanks, *supra* note 122, at 10-13 (concluding that borrowers knowledgeable in commercial transactions should not be able to use the defense of usury while less experienced borrowers should have access to the usury defense).

353. E.g., MD. CODE ANN., COM. LAW. § 12-103(d)(3) (1990) (exempting loans to corporations regardless of amount and loans for commercial purposes over \$15,000 if they are not secured by residential real estate and over \$75,000 when they are so secured); see also Merriman & Hanks, *supra* note 122, at 14 (arguing that usury limits should be retained for business loans under \$10,000).

354. See BROWN & KEEST, *supra* note 26, § 9.1.1.1, at 204.

355. UNIF. CONSUMER CREDIT CODE §§ 2.602, 3.602, 7 U.L.A. 716, 778 (1974) (1968 Act). Loans of \$25,000 or less to organizations such as corporations and partnerships are protected by rate limits only when secured primarily by a one or two-family dwelling occupied by the debtor or a related person. *Id.* §§ 2.602(1)(b), 3.602(1)(b), 7 U.L.A. 716, 778 (1974) (1968 Act). See generally Benfield, *supra* note 17, at 875-85 (discussing the Uniform Consumer Credit Code).

356. See UNIF. CONSUMER CREDIT CODE § 2.601, cmt. 1, 7A U.L.A. 102-03 (1974) (noting that most business loans involve sophisticated borrowers who can effectively negotiate credit charges).

357. This is accomplished by somewhat redundant provisions that (1) impose Truth in Lending requirements only on loans to consumers, defined in 15 U.S.C. § 1602(h) (1988) as natural persons, for "personal, family, or household purposes," *id.*, and (2) specifically exclude from the Act loans for "business, commercial, or agricultural purposes." 15 U.S.C. § 1603(1) (1988); cf. Robert D. Miller Jr., Comment, *Washington's Corporate Exemption from Usury*, 12 GONZ. L. REV. 312, 327 (1977) (arguing that Washington's usury laws should be consistent with such consumer credit regulation as Truth in Lending, which exempts all business loans). Washington's statutory history is also instructive in illustrating expansion of the "corporate exemption." Its "corporate exemption," once limited to certain corporate borrowers, now exempts business loans of all types whether made to entities or individuals. WASH. REV. CODE § 19.52.080 (1992); Miller, *supra* at 326. That exemption was also once limited to business loans over \$100,000, but was later modified to

The "corporate exemption" trend supports repeal of state usury ceilings on business loans generally, whether the borrower is a corporation, partnership, limited liability company, or sole proprietorship. The question is indeed whether business borrowers deserve any fairness protection. Though the "corporate exemption" might be understood to support freedom of contract without the variable fairness check of unconscionability, this interpretation misreads the purpose of such exemptions. Corporate exemptions reflect the greater sophistication and lesser financial necessity of business borrowers as a class.<sup>358</sup> That does not mean businesses are always sophisticated borrowers seeking funds for speculative purposes. The unconscionability standard provides a defensible safety net for those rare situations when financial necessity and lack of sophistication coincide to cause a business borrower to strike a substantively unfair bargain. Small business borrowers will be more successful than others in satisfying this standard, but the unconscionability standard on its face should give all business borrowers an equal opportunity to demonstrate the requisite unfairness.<sup>359</sup>

Two related questions in formulating the unconscionability standard can be answered by reference to usury regulation—whether agricultural loans and large dollar consumer loans should be treated as business loans in applying the unconscionability standard. The 1968 and 1974 UCCC treat loans to individuals for agricultural purposes as consumer loans,<sup>360</sup>

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exempt loans over \$50,000 and finally amended in 1981 to abandon any dollar threshold for the exclusion of business loans from usury protection. WASH. REV. CODE. § 19.52.080 (1992); Miller, *supra* at 315-16.

358. Refer to note 351 *supra* for a discussion of the rationale of the "corporate exemption."

359. Cf. Benfield, *supra* note 17, at 883 (arguing that even though the 1968 UCCC excludes large business loans from its usury protection, it is likely that courts will apply unconscionability concepts to set aside or lower interest payments "in the unusual case in which the lender has unjustifiably overcharged"). Courts have often reviewed the conscionability of loans falling under the state's "corporate exemption." See, e.g., *In re Chicago Reed & Furniture Co.*, 7 F.2d 885 (7th Cir. 1925) (holding that interest of 40% was harsh and oppressive regardless of the fact that the borrower was a corporation). Small businesses seeking working capital constitute a healthy market for loan sharks. See Oeltjen, *supra* note 16, at 219-20 (discussing the process by which loan sharks infiltrate a legitimate business with illegally gained money and often, by "milking the business of funds," force it into bankruptcy). The thriving loan shark market for small commercial loans supports the idea of providing some fairness protection to commercial borrowers.

360. See UNIF. CONSUMER CREDIT CODE § 1.301(14), 7A U.L.A. 43 (1974) (defining "consumer loan" for purposes of usury to mean loans "primarily for a personal, family, or agricultural purpose"); UNIF. CONSUMER CREDIT CODE § 3.104(1)(b), 7 U.L.A. 723 (1974) (1968 Act) (same definition). However, because both the 1968 and 1974 Acts in these sections exclude organizational debtors from their definitions of "consumer loan," agricultural loans would be protected only when made to

but Truth in Lending disclosure law, which once applied the same approach, now exempts agricultural loans<sup>361</sup> because they are "essentially commercial in nature."<sup>362</sup> The Truth in Lending approach is more persuasive. Thus, if different standards of unconscionability are applied by statutes or courts to business loans, loans primarily for agricultural purposes should be treated as business loans.

Some usury statutes, apparently seeing a correlation between loan amount and borrower sophistication, exempt consumer loans above a specified dollar amount. These dollar limits are often so high, however, that they are meaningless.<sup>363</sup> The UCCC in contrast exempts consumer loans over \$25,000 unless secured by realty,<sup>364</sup> as does Truth in Lending.<sup>365</sup> Though the Truth in Lending and UCCC approach of employing a lesser dollar amount with a realty collateral exception could be carried over in some way to the unconscionability standard, the dollar limit chosen is necessarily arbitrary and quickly outdated.<sup>366</sup> The unconscionability standard should therefore ap-

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individuals. See UNIF. CONSUMER CREDIT CODE § 1.301 (15), 7 U.L.A. 43 (1974); UNIF. CONSUMER CREDIT CODE § 3.104(1)(a), 7 U.L.A. 723 (1974) (1968 Act).

361. 15 U.S.C. § 1603(1) (1988).

362. S. REP. NO. 96-368, 96th Cong., 1st Sess. 24 (1979) (excluding agricultural credit from Truth in Lending's coverage because of the Senate Banking Committee's belief that agricultural credit "is essentially commercial in nature").

363. See, e.g., DEL. CODE ANN. tit. 6, § 2301 (1993) ("[T]here shall be no limitation on the rate of interest which may be charged for the loan or use of money, where the amount of money loaned or used exceeds \$100,000, and where repayment thereof is not secured by a mortgage against the principal residence of any borrower."); N.Y. GEN. OBLIG. LAW § 5-501(6)(a) (McKinney 1989) ("No law regulating the maximum rate of interest . . . shall apply to any loan . . . in the amount of two hundred fifty thousand dollars or more, other than a loan of forbearance secured primarily by an interest in real property improved by a one or two family residence."); OHIO REV. CODE ANN. § 1343.01(B)(1) (Anderson 1993) ("Any party may agree to pay a rate of interest in excess of the maximum rate . . . when . . . [t]he original amount of principal indebtedness . . . exceeds one hundred thousand dollars . . ."). See generally Riley, *supra* note 20, at 228 n.137 (suggesting that a \$10,000 standard is sufficient to protect poor, high risk borrowers who are most deserving of usury protection).

364. See UNIF. CONSUMER CREDIT CODE § 3.104, 7 U.L.A. 722 (1974) (1968 Act); UNIF. CONSUMER CREDIT CODE § 1.301(15)(a)(iv), 7A U.L.A. 43 (1974) (additionally excluding loans over \$25,000 for an agricultural purpose even if secured by land). However, the 1970 National Consumer Act does not impose any dollar limit on its protection for consumer loans. Section 2A-103 of the UCC used to exclude leases whose total payments exceeded \$25,000 from the special unconscionability protections in that Article, but as amended in 1990 provides the individual state should decide whether there should be a dollar limit and its amount. U.C.C. § 2A-103 cmt. e (1990).

365. 15 U.S.C. § 1603(3) (1988).

366. Truth in Lending, for example, has employed its \$25,000 limit since its enactment, and routine family car financings in the 1990s are sometimes outside that Act. The legislature could address this problem in part by employing some

ply equally to all consumer loans without regard to their amount.

*F. Commercial Loans—Summary of Proposed Standards*

Usury limits on business loans should be repealed and replaced by the judicial standard of unconscionability. This standard should apply equally to loans to individuals and business associations regardless of amount. Both procedural and substantive unfairness should be proven for a business loan to be unconscionable. Requiring proof of procedural unfairness is consistent with the rationale of the corporate or business loan exemption from usury which assumes business borrowers are sophisticated and understand the rate agreed to.<sup>367</sup> Such proof protects against commercial borrowers exploiting the uncertainties of the substantive standard and pursuing a claim groundless in fact. Unlike consumers, business borrowers who agreed to a substantively excessive rate do not deserve a conclusive presumption that they were knowingly taken advantage of by the lender.

The factors relevant in proving procedural unfairness are the commercial borrower's inability to understand that the agreed upon rate is unfairly high, the lender's deception in hiding the rate charged, the borrower's financial necessity, and the lack of some readily available alternative to the high rate loan. Certainly, a coincidence of all these factors in the business borrower's favor should satisfy the procedural component. What suffices short of that combination should be left for case-by-case review, though this author suggests the following guidelines: (1) egregious lender deception without more may justify relief from an excessive rate, even if short of common law fraud, (2) borrowing for the artificial "necessity" of pursuing some speculative opportunity for profit should not justify relief,<sup>368</sup> (3) even true financial necessity should not be relevant

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adjustment procedure tied to inflation, as do both the 1968 and 1974 UCCC. See UNIF. CONSUMER CREDIT CODE § 1.106, 7A U.L.A. 28 (1974) (using the Consumer Price Index and guidelines to determine a rate); UNIF. CONSUMER CREDIT CODE § 1.106, 7 U.L.A. 610 (1974) (1968 Act) (same).

367. Refer to note 351 *supra* for a discussion of the "corporate exemption" from usury laws.

368. The author would decide differently the case of *In re White*, 88 B.R. 498 (Bankr. D. Mass. 1988). That court refused to enforce substantively excessive default interest payable by a businessperson borrowing to purchase a nightclub and thus gave relief when the loan was for a speculative profit-seeking venture. Since the court cited both parties' greed, 88 B.R. at 510, it therefore should have left both commercial parties alone. Cf. MINDY CHEN-WISHART, UNCONSCIONABLE BARGAINS 43

unless combined with the lack of a reasonable alternative, such as selling property with sufficient equity, to raise the funds needed, and (4) financial necessity and lack of sophistication should coincide to justify relief.

Substantive unfairness should be proven by testimony that the rate charged grossly exceeded a reasonable profit over the risks of default and inflation, the lender's cost of funds, and the costs of making and administering the loan. Courts should decide the requisite amount of excess in their discretion, though section 2-302 case law and other unconscionability codifications suggest there be at least a two to one disparity by reference to the standard chosen. If that standard is the market rate charged similar borrowers by similar lenders, rather than the net profit approach advocated, the court should identify the unique costs of a lender that may justify a rate higher than market, and also make sure the market rate itself is not unfair.

Courts should ordinarily employ the usual remedy under the UCC, the interest pricing cases, and English rate regulation to reduce the excessive rate to a fair one without further sanction. The court might have the ability under common law to refuse to enforce the interest term of the agreement, which it might employ in egregious cases of procedural unfairness.<sup>369</sup> Allowance of attorneys' fees to either side should be left to the parties' loan agreement, itself subject to constraints of conscionability.

#### *G. Consumer Loans—The Need for Legislation and a Proposed Statute*

Three reasons support codification of the unconscionability standard for consumer loans: (1) to confirm that courts have authority to review interest pricing for its conscionability, (2) to enhance remedies, and (3) to resolve the need for proof of any procedural unfairness. Unconscionability has entered the mainstream of contract law and no recent court decision has disclaimed authority to hold a rate unconscionable, but a rogue court might do so. For example, a court could conclude that legislation deregulating usury was intended to remove any fairness control on interest pricing.<sup>370</sup> Codifying the

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(1989) (noting that under common-law comparative unconscionability decisions the complainant's need for money "must usually be accompanied by the threat of insolvency, business collapse or a forfeiture of mortgage").

369. Refer to notes 290-91 *supra* and accompanying text for a discussion of cases in which the court refused to enforce the interest term.

370. Refer to note 79 *supra* and accompanying text for a discussion of legislative

unconscionability standard would dispel any doubt that courts are authorized to review interest rates for fairness. England codified its unconscionability standard in the 1900 Money-lenders Act in part for this reason.<sup>371</sup>

Unconscionability should be codified to enhance existing remedies. Restitution for excessive interest paid has been denied under section 2-302 and its allowance at common law is questionable.<sup>372</sup> Because there is no reason to deny retroactive relief from excessive interest, subject to some reasonable statute of limitation, this remedy should be codified to ensure its availability. Most importantly, the consumer loan statute can entitle successful consumers to attorneys' fees, as have most codifications of unconscionability more recent than section 2-302.<sup>373</sup>

To counter the trend of court authority demanding procedural proof,<sup>374</sup> statutes should codify that proof of substantive unfairness by consumer borrowers is alone sufficient. This is consistent with usury's historical regulation of interest pricing, which generally takes no account of procedural defects.<sup>375</sup> It is also consistent with opinion that consumers as a class are not bargaining equals with lenders, generally do not understand the nature of the credit transaction, and are typically desperate for

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changes to usury laws that might undermine application of the unconscionability doctrine to interest pricing.

371. Refer to the text accompanying notes 299-302 *supra*. The argument that codifying unconscionability expressly authorizes courts to review interest rates may extend to commercial loans, which is not objectionable, but the other reasons for codifying the unconscionability standard are more applicable to consumer loans. Although there is little question courts are authorized to apply the unconscionability standard to interest pricing, refer to notes 79-86 *supra* and accompanying text, litigants seemingly need some judicial or statutory "green light" to challenge rates as unconscionable. Most of the recent cases applying the unconscionability standard to interest pricing were brought in jurisdictions in which courts have signaled claimants that they will review challenged rates under the unconscionability standard. For example, numerous challenges to rates have been pursued in Connecticut since its highest court held in 1980 that courts will review rates for their conscionability. See *Hamm v. Taylor*, 429 A.2d 946, 947-49 (Conn. 1980) (affirming that a trial court has the discretion in a foreclosure proceeding to withhold foreclosure or reduce the amount of indebtedness upon a finding that terms in a mortgage loan such as the rate of interest are unconscionable).

372. Refer to note 185 *supra* and accompanying text for a discussion of relevant § 2-302 case law. Cf. *California Grocers Ass'n, Inc., v. Bank of Am.*, 27 Cal. Rptr. 2d 396, 403-04 (Ct. App. 1994) (observing that affirmative relief for unconscionability, while not available historically, could be provided by statute).

373. Refer to note 244 *supra* and accompanying text (discussing attorneys' fees under the Uniform Consumer Credit Code, the Uniform Consumer Sales Practices Act, and the Uniform Commercial Code).

374. Refer to note 136 *supra* and accompanying text.

375. Refer to Part II(E)(1) *supra*.

money.<sup>376</sup> Finally, it conserves judicial resources because procedural and substantive unfairness almost always coincide in consumer transactions.<sup>377</sup>

A threshold question is whether codification should be accomplished by Congress or the states. Some commentators have urged the federal government to abrogate patchwork state usury laws and assume regulation of consumer credit contracts,<sup>378</sup> but historically, unconscionability and usury have been administered by the states. Rate unconscionability is probably codified best at the state level as well.<sup>379</sup> The statute proposed below vests enforcement power in a state administrator, usually the same authority who enforces the state's unlawful trade practices regulation.<sup>380</sup> Enforcement of unconscionable loans could

376. BROWN & KEEST, *supra* note 26, § 2.4.1, at 37.

377. Refer to notes 147-51 *supra* and accompanying text. It may appear needless to abandon proof of procedural unfairness if consumer loans almost always involve such circumstances. Because the standard for proving procedural unfairness is somewhat nebulous, however, some unsympathetic court might proclaim that a consumer had "meaningful choice" or the like and deny the claim.

As for whether the court or legislature is best suited to decide the need for procedural fairness, see Riley, *supra* note 20, at 223 (arguing that the issue of whether proof of procedural unfairness should be required is better suited for the legislature than for the judiciary because it involves fundamental social policy questions).

378. *E.g.*, Davis, *supra* note 55, at 1353.

379. One uncertainty in codifying the unconscionability standard, particularly by states, is the effect on existing federal preemption. For example, the Depository Institutions Deregulation and Monetary Control Act first lien regulation preempts the "laws of any State expressly limiting the rate or amount of interest." 12 U.S.C. § 1735f-7a(a)(1) (1988). The author believes the unconscionability standard does not "expressly limit" interest, *see supra* note 86, though codifying unconscionability may change that result. Whether unconscionability is codified or not, if a decision ever holds that standard preempted, Congress should move to allow the variable fairness standard of unconscionability to be employed, as distinct from the fixed fairness standard of usury that Congress intended to preempt.

A similar uncertainty exists for lenders entitled to "export" favorable state rates under the Federal National Bank Act. *See generally* KEEST, *supra* note 6, § 3.2.1.4, at 24-28 (discussing the extent to which national banks can export their home states' most favored lender rates to other states). Query the result when a national bank exports a credit card rate into a state with a more restrictive standard of unconscionability than the bank's home state. Moreover, what if a particular state court or legislature rejects authority to review the conscionability of rates? Could outrageous national bank rates issue from that state to others with impunity? Congress should consider such possible abuses in the ongoing debate as to whether it should abolish rate exportation under the National Banking Act.

380. There are too many gaps in coverage and remedies to rely on existing state unlawful trade practice statutes to regulate interest pricing effectively. Most states' trade practice statutes do not expressly proscribe unconscionable conduct. *Cf.* JONATHAN SHELDON & CAROLYN L. CARTER, NATIONAL CONSUMER LAW CENTER, UNFAIR AND DECEPTIVE ACTS AND PRACTICES § 4.4.1, at 136 (3d ed. 1991) (noting that Unfair and Deceptive Acts and Practices statutes in 12 states and the District of Columbia prohibit unconscionable practices explicitly: Alabama, Idaho, Kansas, Kentucky, Michigan, Nebraska, New Jersey, New Mexico, New York, Ohio, Texas, and

alternatively be accomplished by some federal authority such as the Federal Trade Commission.<sup>381</sup>

In codifying unconscionability, legislators must decide who will determine fairness—an administrative body acting prospectively, or courts adjudicating borrower challenges *ex post*.<sup>382</sup> The administrative model is deceptively attractive because it would assure fairness in advance. It answers the charge that consumers rarely pursue unconscionability claims in the courts and usually do so only as a defense when sued rather than as a sword to affirmatively challenge unfair agreements.<sup>383</sup>

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Utah). Even if unconscionable conduct is proscribed implicitly as an unfair or deceptive practice, some trade practice statutes may not encompass realty secured or unsecured loans. *See, e.g.,* UNIF. CONSUMER SALES PRACTICES ACT § 2, 7A U.L.A. 234 (1971) (defining the threshold “consumer transaction” as involving a sale or lease of goods or services, which would presumably govern credit purchases or leases of goods, but arguably not other financing); *Barber v. National Bank*, 815 P.2d 857, 861 (Alaska 1991) (holding that a mortgage loan was not a good or service under Alaska’s unfair trade practices act); *Lamm v. Amfac Mtge. Corp.*, 605 P.2d 730, 731 (Or. Ct. App. 1980) (concluding that loans do not come under Oregon’s Unfair Trade Practices Act). *See generally* James R. Cox, *State Consumer Protection or Deceptive Trade Practices Statutes: Their Application to Extensions of Credit and Other Banking Activities*, 105 BANKING L.J. 214 (1988) (surveying several states’ approaches to deceptive trade practices). Moreover, existing unfair trade practice regulation may not authorize equitable relief or provide for mandatory (or even permissive) recovery of the successful consumer’s attorneys’ fees. *See* SHELDON & CARTER, *supra* note 380, § 5.7.4.2A, at 83 (Supp. 1993) (noting that unfair and deceptive acts and practices statutes may not mandate or even allow recovery of attorney fees). Private enforcement is questionable under a few of these statutes. *See id.* § 8.2.1, at 415 (1991) (listing Arkansas, Iowa, and North Dakota as states that may not have private damage remedies for unfair or deceptive practices). In 1991, North Dakota adopted a private remedy by statute. N.D. CENT. CODE § 51-15-09 (Supp. 1993); *cf.* OR. REV. STAT. § 646.607 (1993) (proscribing unconscionable conduct separate from unfair or deceptive trade practices but providing no private remedy).

State consumer credit codes do not usually proscribe unconscionability outside of consumer credit sales and leases. *E.g.,* UNIF. CONSUMER CREDIT CODE § 5.108(4)(c), 7A U.L.A. 168 (1974) (referring to the relevance in a “consumer credit sale” or “consumer lease” of gross price to value disparity). South Carolina’s adoption of that UCCC subsection does refer more broadly to “a consumer credit sale, consumer lease, consumer rental-purchase agreement [rent-to-own], or consumer loan.” S.C. CODE ANN. § 37-5-108(4)(c) (Law. Co-op. 1989).

Instead of adopting a statute specific to unconscionable interest pricing, states could reform their trade practice or consumer credit codes to address the above concerns. The model statute proposed in this Article would nonetheless be relevant in such reform, particularly in proposing standards and remedies unique to loan transactions.

381. The Federal Trade Commission could invoke its rulemaking authority to deem unconscionable loans by entities it regulates, such as finance companies, as an unfair trade practice.

382. Two other arbiters of rate fairness, the legislature and the parties themselves, have been rejected in this Article. It would be unworkable for legislatures to approve each loan transaction, so they have instead specified approved rates in advance to govern a class of loans. That approach, of course, is the usury standard. The alternative of the parties themselves determining a fair rate is the freedom of contract model also rejected in favor of some fairness standard.

383. *See* DEUTCH, *supra* note 73, at 243 (recognizing that consumers rarely chal-



Advance review of each individual rate by an administrative body would assure fairness for all loan transactions, but appears inefficient and impractical. Administrative agencies, delegated the task of setting fair interest rates, have therefore functioned necessarily as legislatures have by imposing usury standards on loans as a class.<sup>384</sup> Lenders in Israel do have the option to seek individual advance administrative review and approval of certain contractual terms for their fairness,<sup>385</sup> but they have been predictably "indifferent"<sup>386</sup> because of the transaction costs of seeking that validation. Individual review

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lenge their contracts for unconscionability because of the expense, the time required, and the uncertainty of litigation).

384. For example, rates for small consumer loans in Virginia are set by the Commissioner of Financial Institutions agency under the legislative directive to fix "fair and reasonable" rates. See VA. CODE ANN. § 6.1-271 (Michie 1993). Such rates apply equally to all small loan licensees, so that a lender's unique costs of operation and a borrower's particular credit risk are not taken into account. Presumably, however, this administrative agency can react more quickly than a legislature to changes in inflationary risks, or other risks and costs.

Rates for federally chartered credit unions are set in a similar manner by the National Credit Union Administration Board, which is authorized under the National Credit Union Act to substitute rates higher than those prescribed by statute if economic conditions so compel. See 12 U.S.C. § 1757(5)(A)(vi)(I) (1988) (setting an interest rate ceiling at 15% but allowing the rate to exceed the ceiling if the Board determines that prevailing rates threaten the soundness of individual credit unions).

North Carolina employs a system closer to the unconscionability standard for income tax refund anticipation loans. Each lender must file a fee schedule with an administrative agency that determines if the schedule is conscionable. See N.C. GEN. STAT. § 53-249 (Supp. 1993). Presumably each lender is allowed to justify its unique costs of operation. This approach would be more efficient than judicial fairness review for lenders such as pawnshops that do not evaluate the individual credit risk of borrowers. Cf. Oeltjen, *supra* note 48, at 780-83 (discussing the pros and cons of regulating pawnbrokers under the public utility model of regulation). For general criticism of using the public utility model to regulate the credit industry, see Oeltjen, *supra* note 16, at 221-22 (concluding that an attempt to regulate credit as a public utility would be undesirable); see also CONSUMER CREDIT REPORT, *supra* note 48, at 102-03 (concluding that the public utility model for regulation of consumer credit grantors is unsound because of the lender's ability to manipulate administrative regulation by denying loans to riskier borrowers); Richard Craswell, *Property Rules and Liability Rules in Unconscionability and Related Doctrines*, 60 U. CHI. L. REV. 1, 20 n.36 (1993) (observing that public utility commissions have not performed well in trying to set reasonable rates). Lenders' manipulation of a regulation to deny riskier borrowers loans would not be a concern, however, when the administrative model is applied to only those lenders who don't evaluate individual credit risk.

385. For a discussion of this Israeli law, see generally DEUTCH, *supra* note 73, at 245-50.

386. *Id.* at 247-66, 247 n.224 (noting that only one company had applied for prior approval of credit terms between the years 1964 and 1969, and concluding that voluntary submission of contracts for administrative review had been a failure). An English commentator suggested creditors be allowed to seek advance court approval of the interest rate, but that approach would surely gather the same dust as Israel's administrative opportunity. See Bentley and Howells, *supra* note 39, at 238 (suggesting that reform of English credit laws include the opportunity for the lender to safeguard its position by seeking prior court approval of the credit terms).

could be mandated, but this fixed expense, perhaps justifiable for larger loans, would be unsuitable for small ones.<sup>387</sup> One commentator thus observed that, "despite all its deficiencies," reliance on judicial action "is the most effective way to battle unfair contracts."<sup>388</sup>

Any statute enacted to codify the unconscionability standard for consumer loans should at minimum (1) define its scope broadly to include transactions such as rent-to-own that have eluded usury regulation but are functionally equivalent to loans, (2) govern charges related to interest such as points and origination fees, (3) allocate the burden of proving unfairness, (4) specify whether proof of procedural unfairness is required, and if so, what would suffice, (5) specify some benchmark by which substantive fairness should be judged, (6) authorize courts to grant flexible remedies, including forfeiture of some or all interest charged<sup>389</sup> and recovery of past excessive interest paid, and (7) award attorneys' fees to encourage private enforcement of good faith claims. The following model statute addresses these concerns:

#### Section 1. Unconscionable Consumer Credit Charges.

1.1 Except as provided in this Section or other applicable state law, the parties to a consumer credit transaction may agree to any charges. If the court as a matter of law finds all or any part of the charges for a consumer credit transaction to be unconscionable at the time the agreement was made, the court may do one or more of the following: refuse to enforce collection of all or any part of any charges, order the creditor to repay all or any part of any charges<sup>390</sup> in an action brought no later than [ ] year[s] after the date of final payment on the consumer credit transaction,<sup>391</sup> and award such equitable relief as it deems necessary or proper.<sup>392</sup>

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387. See Deutch, *supra* note 73, at 249 (suggesting that mandated review of all contracts may be applied to a particular area of law, but is impossible generally).

388. *Id.* at 248.

389. See Ounce, *supra* note 39, at 110 (arguing for a penalty stiffer than forfeiture of just the unconscionable interest, but cautioning the penalty be discretionary to avoid deterring the court from finding the rate unconscionable).

390. This remedy is based on § 139(2) of England's 1974 Consumer Credit Act. Refer to note 332 *supra*.

391. Existing or repealed usury statutes provide an analogous limitation period which typically varies from one to three years after accrual of the usury action, usually the date of final payment. See BROWN & KEEST, *supra* note 26, § 9.3.5.5, at 243.

392. For example, the court might nullify any collateral securing the loan, a remedy employed on occasion in the common law interest unconscionability cases. Refer to note 290 *supra*. In codifying remedies, the jurisdiction should address

1.2 In determining unconscionability, the creditor shall bear the burden of proving that the charges were not unreasonably excessive<sup>393</sup> in relation to the costs and risks incurred or assumed by the creditor in the consumer credit transaction. Both parties shall be afforded a reasonable opportunity to present evidence to aid the court in making its determination. The court may, but is not required to, consider the charges in relation to those for which similar credit could be obtained by like borrowers at the time the consumer credit transaction was entered into.

1.3 The court shall not require the borrower to prove the existence of such circumstances as lack of sophistication, deceptive creditor practices, financial necessity, or lack of other alternatives to the consumer credit transaction, but such proof, in the court's discretion, may support a finding of unconscionability upon a lesser degree of substantive unfairness than the court might otherwise require.

#### Section 2. Attorneys' Fees.<sup>394</sup>

2.1 In the event the court finds any portion of the charges unconscionable, the court shall award reasonable fees to the borrower's attorney. In determining reasonable fees, the amount of relief or recovery on behalf of the borrower is not controlling. If the court does not find any part of the charges unconscionable and the borrower brought or maintained an action the borrower knew to be groundless, the court shall award reasonable fees to the creditor's attorney.

#### Section 3. Enforcement by the Administrator.<sup>395</sup>

3.1 The Administrator may bring a civil action to restrain a creditor from collecting any unconscionable charge under a consumer credit transaction. The same standards and burden of proof for determining unconscionability in an action by or against the borrower shall apply in an action by the Administrator. The Administrator shall also have authority on behalf of

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whether it authorizes or denies punitive damages for abusive interest. UCC authority denies such recovery. *See, e.g., Pearson v. National Budgeting Sys., Inc.*, 297 N.Y.S.2d 59 (App. Div. 1969) (denying punitive damages because the UCC provides no damage recovery in an unconscionable contract case). However, several state unfair trade practice statutes award some form of punitive damage recovery. Refer to note 241 *supra*. This issue will likely be resolved differently by states depending on their standards for allowing punitive damages for claims in general.

393. Imposing the burden on the creditor is based on England's 1974 Consumer Credit Act § 171(7). Refer to note 324 *supra* and accompanying text.

394. This section is based on § 5.108(6) of the 1974 UCCC. Refer to notes 244-48 *supra* and accompanying text.

395. For state adoptions, the administrator would typically be the enforcement authority for the state's unlawful trade practices act, and would be identified in the enabling legislation. Refer to notes 252-53 *supra* and accompanying text.

any aggrieved borrower to seek the relief available under Sections 1 and 2, including recovery of the Administrator's reasonable attorneys' fees.

#### Section 4. Definitions.

4.1 Charges. For purposes of this Act, "charges" means any cost, fee, charge, discount, commission, compensation, or the like, whether denominated as "interest," "principal," "points," "time price differential" or otherwise, whether paid to the lender or some third party, and whether paid in cash or otherwise, incurred or to be incurred by the borrower in connection with any consumer credit transaction, but does not include registration fees, filing fees, or the like, to the extent paid to any governmental authority.<sup>396</sup>

4.2 Consumer Credit Transaction. For purposes of this Act, "consumer credit transaction" means any transaction involving the extension of credit to an individual primarily for personal, family, or household purposes.<sup>397</sup> For purposes of this Act, an extension of credit includes any transaction that is the substantial equivalent of a credit transaction,<sup>398</sup> including without limitation, rent-to-own and pawn transactions, and assignments of income tax refunds.

#### Section 5. Remedies Supplementary.

5.1 The remedies in this Act are in addition to all other remedies existing at common law or under the laws of this state.<sup>399</sup>

### *H. The Unconscionability Standard as a Partial Solution—Proposals for Further Reform*

The unconscionability standard is not a complete cure for the persistent problem of excessive interest rates. It is the best compromise between the usury and free market standards, but

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396. Canadian statutes properly exclude from review registration or filing fees paid to the government in connection with the loan. See, e.g., Unconscionable Transactions Act, R.S.A., ch. 377, §2(a) (1970) (Can.) (excluding registration or filing fees prescribed by any statute).

397. Truth in Lending so defines "consumer" credit. See 15 U.S.C. § 1602(h) (1988).

398. Ontario's Unconscionable Transactions Relief Act subjects to unconscionability review "any transaction that, whatever its form may be, is substantially one of money-lending . . ." Unconscionable Transactions Relief Act, R.S.O., ch. 514 (1980) (Can.).

399. See, e.g., U.C.C. § 2-302(1) (governing credit sales of goods); *id.* § 2A-108 (perhaps governing rent-to-own transactions); see SHELTON & CARTER, *supra* note 380, § 5.7.4.2A (Supp. 1993) (discussing the advantages of U.C.C. § 2A-108 for consumers challenging rent-to-own transactions). There may also be a consumer penalty recoverable under the state's unfair trade practices act if it governs credit transactions. Refer to note 380 *supra*.

it has several shortcomings. Rates that are, in fact, excessive, but are not "grossly" so, may survive substantive scrutiny as conscionable.<sup>400</sup> The unconscionability standard should not be rejected for this reason, however, as usury tolerates the same unfairness whenever the usury ceiling exceeds a fair rate for a particular loan transaction.<sup>401</sup> A second problem, unique to unconscionability, is the cost of ensuring fair rates through case-by-case adjudication.<sup>402</sup> Finally, unconscionability may not serve the "paternalistic" function of usury<sup>403</sup> by keeping credit-risky borrowers from obtaining credit.

These problems, rather than compelling rejection of the unconscionability standard, argue for widespread multi-institutional reform to combat excessive interest pricing. The unconscionability standard should exist only as an ex post safety check on instances of unfair bargaining. Market perfection reforms designed to promote competition and equality in bargaining should be pursued to reduce the need for such market control.

Necessary reforms include consumer education to enable consumers to understand the composition of a fair interest rate.<sup>404</sup> Car purchasers, for example, can readily obtain third-

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400. Both the classic UCC price cases and those under more recent codifications of unconscionability seem to demand at least a two to one disparity compared to value, however determined. Refer to notes 178, 239-40 *supra* and accompanying text. The interest pricing cases follow the same standard. For example, a home improvement loan at 33% was held conscionable despite its exceeding a fair rate. See *Cheshire Mortgage Serv., Inc. v. Montes*, 612 A.2d 1130, 1135, 1150 (Conn. 1992) (holding conscionable two second mortgage loans made to one family that had a combined financing cost of more than 33% because the borrowers were not oppressed or unfairly surprised); see also *Unrau v. Modern Fin. Ltd.*, 12 D.L.R.3d 366, 377 (B.C. Ct. App. 1970) (holding that a home loan made to an elderly couple at 24% was excessive but not so grossly excessive as to be unconscionable); cf. *Johnson*, *supra* note 37, at 90 (discussing the inefficiency of rate ceilings that produce a sub-optimal result, but noting that without them there is no law, absent proof of fraud, that will protect a consumer paying \$500 for a television worth \$300, less than a two to one disparity). It may nonetheless be possible to attack such loans under the "sliding scale" approach. Refer to note 137 *supra* and accompanying text.

401. Refer to note 37 *supra* and accompanying text.

402. Cf. Alan Schwartz, *Unconscionability and Imperfect Information: A Research Agenda*, 19 CAN. BUS. L.J. 437, 440 (1991) (observing that courts are poor social institutions for identifying market imperfections for consumers because so little money is involved in consumer protection cases that few reach the courtroom).

403. Refer to notes 101-03 *supra* and accompanying text.

404. See DAVID CAPLOVITZ, *THE POOR PAY MORE* 192 (1967) (concluding that consumer education of low income families is one of the limited number of solutions available short of eradicating poverty itself); CONSUMER CREDIT REPORT, *supra* note 48, at 197-98 (discussing several existing adult education programs and suggesting improvements in and expansion of the programs); see also Riley, *supra* note 20, at 224 (proposing counseling and educating borrowers to increase comprehension of available information). Consumer education could address the problem of high risk

party information on the dealer's cost for a vehicle and assess intelligently whether the dealer's price is excessive.<sup>405</sup> In contrast, most borrowers have little understanding of the risk and cost factors that determine a fair interest rate.<sup>406</sup> Consumers also need to be educated about the existence of other financing sources and alternatives to high rate loans, such as reorganization of existing loans in bankruptcy.

Disclosure reform, another market perfecting strategy, should be studied and pursued. Reforms might include increased bilingual disclosures and enactment of uniform (federal) disclosure legislation for transactions not currently covered by disclosure regulation.<sup>407</sup> Studies should examine how to better provide disclosure before the loan is consummated, and how to remedy so-called information overload under current disclosure statutes.<sup>408</sup> Reforming disclosure to address problems of timing and content, however, will not help consumers who, despite consumer education efforts, lack the evaluative skills necessary to use the information disclosed.<sup>409</sup> One approach worth exploring is the feasibility of a public or private information agency for consumer loans. A few commentators have proposed that the government compile and distribute pricing information for goods.<sup>410</sup> A similar program for interest pricing,<sup>411</sup> which

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borrowers getting credit doomed to fail by educating them on budgeting and the appropriate uses of credit, instead of the usury standard being employed to deny them credit for both luxuries and necessities.

405. But see Ian Ayres & F. Clayton Miller, "I'll Sell it to You at Cost:" *Legal Methods to Promote Retail Markup Disclosure*, 84 NW. U. L. REV. 1047, 1055 n.35 (1990) (noting anecdotal evidence that suggests fewer than 50% of car purchasers obtained such third-party information on dealer cost).

406. Refer to note 433 *infra*.

407. For example, rent-to-own transactions presently elude the scope of Truth in Lending and other federal disclosure regulation. Cf. EDWARD L. WINN, III, RTO LEGAL REFERENCE INDEX 33-66 (1991), reprinted in *Hearing, supra* note 3, at 547, 580-613 (discussing twenty-nine state RTO statutes, all requiring certain contractual disclosures and most requiring advertising disclosures).

408. For a discussion of the shortcomings of current disclosure legislation, see Davis, *supra* note 55, at 1344-48. In 1994, Congress enacted legislation to require that disclosures in certain home equity loan transactions be delivered to the consumer at least three days before consummation of the loan. See Pub. L. No. 103-325, § 129.

409. See Lary Lawrence, *Toward a More Efficient and Just Economy: An Argument for Limited Enforcement of Consumer Promises*, 48 OHIO ST. L.J. 815, 845 (1987) (concluding that mandatory disclosures would limit the number of consumer mistakes by educating most consumers even if some remain unable to evaluate the required disclosures).

410. *Id.* at 843; see Kornhauser, *supra* note 151, at 1176 ("One can imagine the government acquiring the information from all firms [merchants] and posting the prices of the firms at some easily accessible spot.").

411. Some progress has been made to develop government informational intermediaries to disclose interest pricing. Every six months the Federal Reserve Board

need not be government run, could augment the evaluative skills of borrowers by matching the cheapest available loan programs to the credit profiles of individual consumers much as travel agencies match passengers to flights.<sup>412</sup> Economic incentives among lenders would shift from efforts to lure the unwary consumer into an expensive rate (so-called sucker pricing) to operational cost reforms.

Stratification of the credit industry means few categories of lenders offer loan programs to risky borrowers.<sup>413</sup> Eliminating usury controls that mandate different ceilings for different types of lenders may allow commercial banks to compete for high risk borrowers whose options are currently limited to finance and rent-to-own companies and the like.<sup>414</sup> Lenders might also offer more rate programs to better target the particular creditworthiness of each borrower, something the credit card industry has begun to do.<sup>415</sup>

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publishes APR and other pricing information for credit cards. See 15 U.S.C. § 1646 (1988) ("The Board shall collect, publish, and disseminate to the public . . . the annual percentage rates charged for . . . nonsale credit by creditors in such areas."). The Illinois Commissioner of Banks and Trust Companies discloses comparative information on credit card rates and fees. See ILL. ANN. STAT. ch. 815, § 140/6 (Smith-Hurd 1993):

Each credit card solicitation, application and periodic billing statement . . . mailed or otherwise presented to Illinois residents shall contain the following statement, verbatim, in bold face type: "Residents of Illinois may contact the Illinois Commissioner of Banks and Trust Companies for comparative information on interest rates, charges, fees and grace periods."

Legislation introduced in Congress in 1993 would direct the Board of Governors of the Federal Reserve System to establish and publicize a toll-free number for consumers to obtain free information on the "availability" of low interest rate credit cards. H.R. 1842, 103d Cong., 1st Sess. 7 (1993).

412. This would overcome the psychological problem of consumers pursuing no more than one prospective lender for fear of being denied credit because their only contact would be the rate broker. Refer to note 55 *supra* and accompanying text. The author echoes the advice of Professor Schwartz that "[u]nderstanding how informational intermediaries work is an important but unsolved problem" of consumer protection that should be explored. See Schwartz, *supra* note 402, at 444 (discussing the concept of informational intermediaries that would sell market pricing information to remedy the problem of costly searches or comparison shopping).

413. Refer to text accompanying note 279 *supra*.

414. See Oeltjen, *supra* note 16, at 225-26 (arguing for a uniform statutory rate ceiling for all types of financial institutions to encourage competition); see also CONSUMER CREDIT REPORT, *supra* note 48, at 136-39 (encouraging lenders to compete for high risk borrowers through policy changes to allow banks to compete with licensed finance companies for high risk loans and to allow easier entry into this market segment); cf. Bentley and Howells, *supra* note 39, at 242 (concluding that English law should remove arbitrary restrictions on mainstream lenders to encourage more reputable and efficient lenders to move into the higher risk market).

415. The credit card industry now often offers alternate rates dependent on credit history. See generally Fincher, *supra* note 87, at 508-09 (discussing alternative credit card interest rate programs). Instead of a single rate at (say) 16%, rates might be offered at 20%, 16%, and 12% depending on the consumer's performance

Finally, some commentators have suggested that the credit needs of those most vulnerable to unfair loan pricing—the poor—be addressed by government loan programs or subsidies.<sup>416</sup> The better approach, though, is to achieve fair rates by pursuing these market perfecting reforms, combined with the unconscionability standard as a safety net.

Most of the above reforms have been suggested before, but the problem of unfair rates persists. It may be necessary to pursue intense spot treatment of abusive rates in situations that do not respond to deterrence from the unconscionability standard or to increased competition and bargaining equality from renewed attention to these reforms. In these problem areas, “equity concerns may override concerns for efficient functioning of the market.”<sup>417</sup> Spot treatment might employ usury against the entire consumer small loan industry,<sup>418</sup> or just for areas of specific abuse such as auto pawn and rent-to-own transactions.<sup>419</sup> The best approach would employ administra-

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record with that lender. At the single rate of 16%, customers with payment records worthy of a 12% rate subsidize those bad risks deserving of a 20% rate.

416. See, e.g., ROSS CRANSTON, *CONSUMERS AND THE LAW* 202 (1978) (suggesting that government-supported loan schemes may provide better service to low income consumers); Bentley & Howells, *supra* note 39, at 242 (proposing that government provide “cheap” loans); Hasson, *supra* note 176, at 394 (suggesting that one approach to the problem of unconscionable price would be to replace or supplement the private-sector credit industry, where “high-risk” borrowers are concerned, with a government consumer loan program in the form of direct government loans, by public subsidization of loans, or by guarantee of private loans); Johnson, *supra*, note 37, at 104 (arguing for subsidies); Riley, *supra* note 20, at 229 n.140 (discussing four alternatives for providing credit to high risk borrowers, which include creating a pool of high risk borrowers, guaranteeing high risk loans from general tax revenues, forming a credit union underwritten by the government, and providing tax incentives to lenders who extend high risk credit); see also CONSUMER CREDIT REPORT, *supra* note 48, at 159 (recommending that Congress establish a pilot consumer loan fund and an experimental loan agency for those families whose incomes are at or below the Federal Guideline for Poverty Income Levels); Steven Savner et al., Note, *An Alternative to the UCCC: Publicly Subsidized Consumer Loans*, 4 *GOLDEN GATE U.L. REV.* 239, 274 (1974) (proposing a Federal government subsidized loan program to make low cost credit available to those who use credit to purchase basic needs).

417. Kornhauser, *supra* note 151, at 1183. Employing usury as a safety net for markets in which unconscionability fails to deter abuse differs from the approach suggested by Professor Oeltjen that unconscionability be the last defense against abuse in the free market. See Oeltjen, *supra* note 16, at 235.

418. See Riley, *supra* note 20, at 227-28 (proposing usury for consumer loans of less than \$10,000).

419. The proposed federal Rent-to-Own Reform Act of 1993, introduced in September 1993 by Rep. Henry Gonzalez, is an example of such spot treatment. See H.R. 3136, 103d Cong., 1st Sess. (1993). That legislation would classify rent-to-own transactions as credit or retail installment sales under state law, thereby invoking existing usury limits in many states for such sales. *Id.* at 6-7. The legislation would also apply Truth in Lending’s disclosure regulation to rent-to-own transactions. *Id.* at 9. Refer to note 237 *supra* and accompanying text for a discussion of existing state



tive rate-setting for these isolated, abusive industries, as North Carolina has done for tax refund anticipation lenders.<sup>420</sup> This improves on the legislative usury standard by setting rates based on detailed fact finding of industry costs and risks, and responds better to changes over time in those costs and risks.<sup>421</sup> Instead of usury controls on individual transactions, the government might consider taxing excess profit in abusive industries.<sup>422</sup>

Spot treatment aimed at an abusive industry could involve innovative use of unconscionability and existing consumer statutes. For example, charging minority homeowners twenty-five percent rates for home improvement loans may not be held substantively unfair when fifteen percent is a fair rate.<sup>423</sup> Unfair loan programs targeted at minority homeowners might implicate those codifications of unconscionability which provide that procedural unfairness alone is unconscionable,<sup>424</sup> or may violate federal and state laws such as the Equal Credit Opportunity Act<sup>425</sup> and the Fair Housing Act.<sup>426</sup> Fraudulent

statutes which impose price controls directly on rent-to-own transactions. In 1992, Georgia imposed usury limits on auto pawn transactions. See GA. CODE ANN. § 44-12-131 (1994) ("[A] pawnbroker may charge for each 30 day period interest and pawnshop charges which together equal no more than 25 percent of the principal amount advanced, with a minimum charge of up to \$10.00 per 30 day period.").

420. Refer to note 384 *supra*.

421. For example, Virginia's regulation of consumer finance companies through administrative rate setting, discussed at note 384 *supra*, requires the agency to consider costs of operations and the cost of equity capital in setting rates. VA. CODE ANN. § 6.1-271.1 (Michie 1993).

422. One commentator once proposed as a solution to excessive prices that instead of regulating individual prices, the average profits of entire industries should be controlled through payments to the government of excess profits. See W. David Slawson, *Price Controls for a Peacetime Economy*, 84 HARV. L. REV. 1090, 1095-96 (1971).

423. Refer to note 400 *supra* and accompanying text for a discussion of the shortcomings of unconscionability. Well-documented abuses have occurred in the home equity loan industry, particularly those lenders targeting minority homeowners with rates and loan amounts consumer advocates claim will lead to certain default and loss of equity in the home. See generally Daniel A. Edelman, *Second Mortgage Frauds*, in NATIONAL CONSUMER RIGHTS LITIGATION CONFERENCE (Materials) 67-108 (National Consumer Law Center 1992) (noting controversies involving "second mortgage scandals" pursued by the Massachusetts Attorney General which resulted in settlements with three major Boston banks); Dwight Golann, *Consumer Financial Services Litigation: Major Judgments and ADR Responses*, 48 BUS. LAW. 1141, 1146-49 (1993) (discussing second mortgage fraud by unfair or deceptive inducement of home improvement financing targeted at those poor homeowners who have relatively high home equity).

424. See, e.g., U.C.C. § 2A-108(2) (1990); *Besta v. Beneficial Loan Co.*, 855 F.2d 532, 535 (8th Cir. 1988) (holding a six-year loan unconscionable under the Iowa Consumer Credit Code because of the procedural unfairness involved in failing to disclose that the loan could be repaid with lower monthly payments in half the time).

425. 15 U.S.C. §§ 1691-1691f (1988 & Supp. V 1993); cf. *United States v.*

representations by the lender (e.g., "This is the lowest rate you'll find in town") may be redressed under the state's unfair trade practices act, if applicable to loans, or as common law fraud.<sup>427</sup>

Aggressive administrative attention may help deter rate abuses. The Attorney General in Massachusetts is alerted to high rate loans (over twenty percent) through a statutory notification procedure.<sup>428</sup> Though high rates are not always unfair, this reporting requirement facilitates careful scrutiny.<sup>429</sup> State administrators might obtain the injunction of extreme rate unfairness as a public nuisance.<sup>430</sup> Finally, the Federal Reserve

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Landmark Fin. Serv., Inc., 612 F. Supp. 623, 626 (D. Md. 1985) (holding that the Equal Credit Opportunity Act allows the Attorney General to bring an action for alleged discrimination against elderly credit applicants to seek civil penalties, consumer redress and injunctive relief).

426. 42 U.S.C. §§ 3601-3631 (1988 & Supp. IV 1992); see *Fleet Finance Settles Two More Rounds*, NCLC REP. CONSUMER CREDIT & USURY EDITION (Nat'l Consumer Law Ctr., Boston, Mass.), Nov/Dec. 1993, at 33 (describing multi-million dollar settlements by Fleet Finance for second lending practices targeting African-Americans for high rate loans allegedly in violation of Georgia's Fair Housing Act and other state law); see also *Evans v. First Fed. Sav. Bank*, 669 F. Supp. 915, 924 (N.D. Ind. 1987) (holding that although the Fair Housing Act applies to an equity loan on an already-owned home, it did not apply to plaintiffs in this case who were seeking the loan for an automobile and an education).

427. Cf. *Smith v. First Family Fin. Serv., Inc.*, 626 So. 2d 1266, 1272-73 (Ala. 1993) (holding that summary judgment for the lender was improper on a claim that the lender defrauded the borrower by concealing that the loan fees charged exceeded the statutory maximum); *Kish v. Van Note*, 692 S.W.2d 463, 466 (Tex. 1985) (holding that plaintiffs were entitled to recover a statutory penalty from a pool contractor under the Consumer Credit Code in addition to recovering damages under the Deceptive Trade Practices Act for failing to disclose that credit life insurance was at a premium or rate not fixed or approved by the State Board of Insurance).

428.

The provisions of paragraph (a) . . . , [which provides that a person who "knowingly contracts for, charges, takes or receives, directly or indirectly, interest and expenses the aggregate of which exceeds an amount greater than twenty per centum per annum. . . . shall be guilty of criminal usury"], shall not apply to any person who notifies the attorney general of his intent to engage in a transaction or transactions which, but for the provisions of this paragraph, would be proscribed under the provisions of paragraph (a) . . . .

MASS. GEN. L. ch. 271, § 49(d) (1990 & Supp. 1994).

429. It is questionable whether the Massachusetts approach in practice aids the prevention of egregious abuses. Massachusetts' Attorney General responded to criticism in 1991 that his office ignored "red flags" of abusive lending in the second mortgage industry by noting that the sheer volume of high rate lending notifications his office received (80-100 monthly) precluded investigation. See Steve Marantz, *Shannon Says Frequency of Loans at High Interest Precluded Probe*, BOSTON GLOBE, May 10, 1991 (Metro), at 20.

430. See, e.g., *Larson v. State*, 97 So. 2d 776, 780-91 (Ala. 1957) (holding that interest rates up to 700% charged to unsophisticated borrowers are a public nuisance, entitling the attorney general to injunctive relief denying collection of any interest, the penalty under the state's then 6% usury legislation); *State v. Hooker*,

Board recently rejected an acquisition bid by a lender in questionable compliance with the federal Equal Credit Opportunity Act.<sup>431</sup> Such tactics could penalize and deter egregious rate abusers.

More radical disclosure reforms targeted at isolated pockets of severe abuse should also be examined. Lenders typically have no statutory obligation to inform borrowers that better competitor rates exist. Borrowers are presumed able to determine that for themselves by comparison shopping. The unconscionability standard is poised to impose enhanced disclosure responsibilities on lenders. The Eighth Circuit has held it procedurally unfair for a lender to fail to disclose that another loan plan it offered was more advantageous to the borrower.<sup>432</sup> The unconscionability standard might be taken as the next step to compel lenders to disclose more advantageous rates offered in the marketplace generally.<sup>433</sup>

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87 N.W.2d 337, 343 (N.D. 1957) (holding that charging interest rates of 149% to 278% to more than 400 borrowers was sufficient to constitute a public nuisance, and allowing the state to enjoin operation of defendants' business). See generally Comment, *Commercial Nuisance: A Theory of Consumer Protection*, 33 U. CHI. L. REV. 590 (1966) (arguing for the concept of commercial nuisance as a solution to inadequate legal representation of the poor).

431. *Shawmut National Corporation, Hartford, Connecticut, and Boston, Massachusetts; Shawmut New Hampshire Corporation, Manchester, New Hampshire*, 80 FED. RESERVE BULL. 47, 48 (1994) (disapproving acquisition of a bank and formation of a bank holding company). This application was reconsidered and subsequently approved in June 1994. *Id.* at 545 (approving the bid application upon reconsideration after Shawmut filed information addressing the Board members' concerns about its mortgage lending record under the Equal Credit Opportunity Act).

432. See *Besta v. Beneficial Loan Co.*, 855 F.2d 532, 535 (8th Cir. 1988) (holding that under the Iowa Consumer Credit Code it was procedurally unconscionable for the finance company to write a six-year loan without disclosing that the loan balance could have been repaid with lower monthly payments in half the time); see also *In re Milbourne*, 108 B.R. 522, 524 (Bankr. E.D. Pa. 1989) (holding that the lender's failure to disclose to the debtor the detriment of refinancing loans as opposed to making new loans violated the Pennsylvania Unfair Trade Practices and Consumer Protection Law). See generally Dwight Golann, *Beyond Truth in Lending: The Duty of Affirmative Disclosure*, 46 BUS. LAW. 1307 (1991) (discussing the *Besta* and *In re Milbourne* holdings). A bill introduced in April 1993 in Congress would amend Truth in Lending to require lenders to post their rates for each category of loans they offer consumers. H.R. 1610, 103d Cong., 1st Sess. (1993) ("A creditor shall post a sign at each place of business where he extends credit to consumers which—(1) shall state in clear and conspicuous language the current rates of interest he charges for each category of loan he makes to consumers . . .").

433. One commentator observed "[u]nconscionability as to price is best thought of as a seller's failure to fulfill an emerging legal obligation to inform a customer of any terms that depart from common expectations—in these [classic price] cases the expectancy of being charged a price competitive with other freezers, books, or other consumer products." Stedronsky, *supra* note 118, at 83. Such failure to disclose could be held to constitute procedural unfairness if required, or support a finding of unconscionability on less substantive excess under a "sliding scale" approach.

As proposed in 1993, the federal Home Equity Protection Act would have

### III. CONCLUSION

Outrageous episodes of lender abuse in the 1990s have buoyed a consumer protection movement that had languished since its heady successes in the late 1960s and early 1970s. Consumer advocates (and legislators), however, should resist reaching for the blunt instrument of usury to restore contractual order in the marketplace. The true evil is abusive profits, not facially high rates. Scrutinized under the cost justification standard of unconscionability, the high rates of rent-to-own centers, pawnshops, and other lenders will stand if risks and costs justify such rates, but fall if they don't.

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required home equity lenders exceeding a specified rate to disclose that "this is a high cost mortgage. You may be able to obtain a less expensive loan." H.R. 3153, 103d Cong., 1st Sess. (1993). That disclosure would apply if the rate exceeded the yield on one-year Treasury notes by 10% or the loan fees exceeded the greater of 8% of the loan or \$400. This disclosure, however, would be buried in a statement with other disclosures and does not tell consumers how to comparison search for the cheaper rate to which they may be entitled. Professor Wallace once proposed and rejected a similar disclosure scheme by which lenders would disclose their willingness to lend to high risk borrowers, but recommend they do not borrow. See Wallace, *supra* note 40, at 494-95 (analyzing alternatives to lowered ceiling for protective purposes). This could be as ineffective as cigarette labeling, but such disclosures addressed to the problem of high rate lending are worth exploring further. Congress ultimately enacted various home equity loan reforms as part of the Riegle Community Development and Regulatory Improvement Act of 1994, but failed to include the proposed "high cost mortgage" disclosure. See Pub. L. No. 103-325.

The complex elements that compose interest pricing, discussed at notes 272-75 *supra* and accompanying text, make such disclosure reforms problematic. Compare the potential for reform of the new car market. Retailers could be compelled to disclose their own markup over cost, see Ayers and Miller, *supra* note 405 at 1076-78, or the existence of cheaper asking prices by other dealers for the same automobile. Applied to loan pricing, "lender's cost" would likely be the lender's cost of funds. Automobile purchasers aware of the markup could decide if the dealer's operational costs justified that amount, but loan customers would struggle with quantifying the added risks of inflation and their credit standing. Disclosing the lender's cost of funds would therefore be of little utility to the borrower. Requiring lenders to disclose their total costs and risks is troublesome because that involves much more subjective evaluations than the cost of funds.

Requiring disclosure that competitors offer cheaper rates is also of questionable merit for loans of money. A competitor may offer cheaper rates because it employs stricter standards for approving an applicant's creditworthiness. Such disclosure reform might therefore be employed properly only in lending industries that do not check their customer's credit, or disclosure could be manipulated too easily.

