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## Judicially Imposed Usury Penalties in the Absence of Statutory Penalties: Can Freedom of Contract Co-Exist with Public Policy After *Merritt v. Knox*?

Since 1741 the North Carolina General Assembly and judiciary have provided and enforced penalties against lenders who attempt to exact interest at usurious<sup>1</sup> rates from borrowers.<sup>2</sup> North Carolina's usury penalties are subject to a two-year statute of limitations,<sup>3</sup> however, and thus force borrowers to seek judicial relief within this period or risk losing the protections afforded under the law.<sup>4</sup> Usurious lenders face no other statutory penalty for usury once the limitations period has expired.<sup>5</sup>

Economists and legal commentators are critical of usury laws for unnecessarily restricting parties' freedom of contract and exerting a restraining influence on the commercial marketplace.<sup>6</sup> Proponents of usury laws staunchly support these laws and the public policy behind their enactment of protecting unsophisti-

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1. It is well-settled that to establish a transaction as usurious, the borrower must affirmatively plead and prove: (1) there was a loan, (2) there was an understanding that the borrower would return the money lent, (3) the lender charged a greater rate of interest for the loan than allowed by law, and (4) there was corrupt intent to take more than the legal rate for the use of money. *Bagri v. Desai*, 83 N.C. App. 150, 151, 349 S.E.2d 309, 310 (1986) (citing *Kessing v. National Mortgage Corp.*, 278 N.C. 523, 530, 180 S.E.2d 823, 827 (1971)), *cert. denied*, 319 N.C. 102, 353 S.E.2d 103 (1987); *see, e.g.*, *Western Auto Supply Co. v. Vick*, 303 N.C. 30, 37, 277 S.E.2d 360, 366, *aff'd on rehearing*, 304 N.C. 191, 283 S.E.2d 101 (1981); *Henderson v. Security Mortgage & Fin. Co.*, 273 N.C. 253, 263, 160 S.E.2d 39, 46 (1968); *Carolina Indus. Bank v. Merrimon*, 260 N.C. 335, 338, 132 S.E.2d 692, 693-94 (1963); *Preyer v. Parker*, 257 N.C. 440, 444, 125 S.E.2d 916, 918-19 (1962); *Perry v. Doub*, 249 N.C. 322, 327, 106 S.E.2d 582, 587 (1959); *Bailey v. Inman*, 224 N.C. 571, 573, 31 S.E.2d 769, 770 (1944); *Doster v. English*, 152 N.C. 339, 341, 67 S.E. 754, 755 (1910). The element of corrupt intent is "simply the intentional charging of more for money lent than the law allows." *Kessing*, 278 N.C. at 530, 180 S.E.2d at 827 (citing *Associated Stores, Inc. v. Industrial Loan & Inv. Co.*, 202 F. Supp. 251 (E.D.N.C. 1962), *aff'd*, 326 F.2d 756 (4th Cir. 1964), *cert. denied*, 379 U.S. 830 (1964)). Courts will imply corrupt intent when the first three elements are apparent on the face of the contract. *See id.* ("Where the lender intentionally charges the borrower a greater rate of interest than the law allows and his purpose is clearly revealed on the face of the instrument, a corrupt intent to violate the usury law on the part of the lender is shown."); *Planter's Nat'l Bank v. Wyson & Miles Co.*, 177 N.C. 380, 386, 99 S.E. 199, 202-03 (1919); *MacRackan v. Bank of Columbus*, 164 N.C. 24, 26, 80 S.E. 184, 185 (1913); *Charles A. Riley & Co. v. W.T. Sears & Co.*, 154 N.C. 509, 520-21, 70 S.E. 997, 1001 (1911); Comment, *Usury Law in North Carolina*, 47 N.C.L. REV. 761, 773 (1969). Treatise writers developed the four components of a usurious transaction and courts widely accept them as the essential elements of usury. *See* Comment, *supra* at 772 n.62.

2. North Carolina's first usury statute was the Act of 1741. Act of 1741, ch. 28, Potter's Revision of 1819, (repealed 1837). For a discussion of the historical development of North Carolina's usury statutes, *see infra* note 47.

3. N.C. GEN. STAT. § 1-53(2), (3) (1983). The statute of limitations runs from the date of payment for the double-recovery remedy and from the date of the contract for the forfeiture remedy. *Merritt v. Knox*, 94 N.C. App. 340, 342, 380 S.E.2d 160, 162 (1989) (citing *Haanebrink v. Meyer*, 47 N.C. App. 646, 648-49, 267 S.E.2d 598, 599-600 (1980)).

4. *See Henderson v. Security Mortgage & Fin. Co.*, 273 N.C. 253, 264, 160 S.E.2d 39, 47 (1968); *Woody v. Prudential Life Ins. Co.*, 209 N.C. 364, 365, 183 S.E. 296, 297 (1936) (*per curiam*); *Ghormley v. Hyatt*, 208 N.C. 478, 482, 181 S.E. 242, 245 (1935); *Smith v. Finance Co. of Am.*, 207 N.C. 367, 369, 177 S.E. 183, 183 (1934); *Farmer's Bank & Trust Co. v. Redwine*, 204 N.C. 125, 128, 167 S.E. 687, 689 (1933); *Patterson v. DAC Corp.*, 66 N.C. App. 110, 115, 310 S.E.2d 783, 786 (1984); *Haanebrink v. Meyer*, 47 N.C. App. 646, 648, 267 S.E.2d 598, 599 (1980).

5. *See* cases cited *supra* note 4.

6. For a discussion of these criticisms, *see infra* text accompanying notes 54-58.

cated borrowers by penalizing lenders who charge exorbitant interest rates.<sup>7</sup> Given the tension between public policy and freedom of contract in commercial transactions, one unresolved issue is whether courts should refuse to extend usury laws and enforce the original contract rate when subsequent amendments to usury laws bring the original bargained-for rate within the legal limit, or if not, what interest rate, if any, the lender should be allowed to recover. The North Carolina Court of Appeals recently considered this issue in *Merritt v. Knox*<sup>8</sup> and concluded that it could not enforce the once-usurious, originally contracted-for interest rate.<sup>9</sup> As a result, the court held the borrower liable for interest at the legal judgment rate.<sup>10</sup> The *Merritt* court, in effect, created and imposed a judicial penalty on lenders and provided relief for borrowers in the absence of statutory penalties.

This Note discusses the inherent tension between the public policies underlying usury laws and the restraining influences that interest-rate ceilings exert over economic progress and parties' freedom to strike mutually advantageous bargains.<sup>11</sup> The Note examines the court's decision in *Merritt* to determine its consistency with the public policy and historical underpinnings of North Carolina's usury laws and its probable effect on future loan transactions.<sup>12</sup> This Note analyzes other jurisdictions' constructions of usury statutes and compares them to the approach taken by the *Merritt* court.<sup>13</sup> The Note contends that, had the court's analysis balanced the public policy considerations with the negative effect that usury laws have on parties' freedom of contract, the court would have concluded that in some cases the contracted-for interest rate should be enforced.<sup>14</sup> This Note proposes an analysis that balances these interests against each other to create a rebuttable presumption that, absent unconscionability, contracts should be enforced at their bargained-for rates in the absence of statutory penalties.<sup>15</sup>

On December 14, 1977, James and Louise Knox obtained a 20,000 dollar loan from O.C. Merritt for commercial development of property.<sup>16</sup> The Knoxes executed a promissory note secured by a second deed of trust on the undeveloped property.<sup>17</sup> The note provided for interest at twelve percent per annum

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7. See Note, *Usury Legislation—Its Effects on the Economy and a Proposal for Reform*, 33 VAND. L. REV. 199, 209-211 (1980) (modern arguments supporting usury laws are based on protection of the consumer and ensuring fair credit prices); see also Oeltjen, *Usury: Utilitarian or Useless?*, 3 FLA. ST. U.L. REV. 167, 206-07 (1975) ("Today's arguments [in favor of usury laws] are phrased in such terms as 'economics,' 'unconscionability,' and 'bargaining disparity.'"). For a discussion of the public policy underlying North Carolina's usury laws, see *infra* text accompanying notes 49-52.

8. 94 N.C. App. 340, 380 S.E.2d 160 (1989).

9. *Id.* at 342, 380 S.E.2d at 162.

10. *Id.* at 342-43, 380 S.E.2d at 162-63.

11. See *infra* text accompanying notes 49-59.

12. See *infra* text accompanying notes 92-93.

13. See *infra* text accompanying notes 60-81.

14. See *infra* text accompanying notes 94-95.

15. See *infra* text accompanying notes 106-13.

16. *Merritt*, 94 N.C. App. at 341, 380 S.E.2d at 161.

17. *Id.*

from the date of execution until paid<sup>18</sup> and for attorney's fees in the amount of fifteen percent of the balance due in an action to enforce the holder's rights in the event of the borrowers' default.<sup>19</sup> The principal was due and payable one year from the date of execution.<sup>20</sup> After the Knoxes defaulted, O.C. Merritt filed suit on November 18, 1987 to collect the balance due on the promissory note.<sup>21</sup>

Under the usury statute in effect at the time of the execution of the note, the twelve percent interest rate charged by Merritt exceeded the maximum legal interest rate of ten percent per annum.<sup>22</sup> Notwithstanding the fact that the promissory note's original interest rate was usurious,<sup>23</sup> the trial court granted the plaintiff recovery of the unpaid principal plus the contract rate of twelve percent interest until judgment<sup>24</sup> and eight percent interest thereafter until paid.<sup>25</sup>

The defendants appealed, contending that the trial court erred in ordering payment of interest at the contract rate and in calculating the attorney's fee award upon that amount.<sup>26</sup> The plaintiff conceded that the court could not enforce the twelve percent contract rate in his favor.<sup>27</sup> Both parties argued that the balance due and attorney's fees should be based on the maximum legal rate allowed by the statute (ten percent) at the time of the note's execution.<sup>28</sup>

The North Carolina Court of Appeals held that the contracted-for rate was

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18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.*

22. N.C. GEN. STAT. § 24-1.1 (Supp. 1977) (amended 1985).

Except as otherwise provided in this chapter or other applicable law, the parties to a loan, purchase money loan, advance, commitment for a loan or forbearance may contract in writing for the payment of interest not in excess of: . . . (2) Ten percent (10%) per annum where the principal amount is one hundred thousand dollars (\$100,000) or less and is a business property loan.

The statute defines a "business property loan" as:

[A] loan . . . secured by real property of the borrower which is held or acquired for sale, lease or use in connection with the borrower's trade, business or profession . . . and the proceeds of which are to be used for the purpose of either acquiring, refinancing or improving such real property or in connection with such trade, business or profession of the borrower.

*Id.* The Knoxes planned to build houses on the property. Defendant-Appellants' Brief at 3, *Merritt*, 94 N.C. App. 340, 380 S.E.2d 160 (1989) (No. 8810SC815).

23. See *supra* note 22.

24. *Merritt*, 94 N.C. App. at 341, 380 S.E.2d at 161.

25. Defendant-Appellants' Brief at 2, *Merritt*, 94 N.C. App. 340, 380 S.E.2d 160 (1989) (No. 8810SC815). As it is today, the legal judgment rate at the time of the judgment in *Merritt* was eight percent. N.C. GEN. STAT. § 24-1 (1986). The trial court also awarded the plaintiff attorney's fees in the amount of 15% of the outstanding balance due. *Merritt*, 94 N.C. App. at 341, 380 S.E.2d at 161.

26. *Merritt*, 94 N.C. App. at 340, 380 S.E.2d at 161.

27. Plaintiff-Appellees' Brief at 5, *Merritt*, 94 N.C. App. 340, 380 S.E.2d 160 (1989) (No. 8810SC815) ("[I]t would be contrary to the public policy of North Carolina to permit an excessive rate to be charged on the promissory note in question."). But see *infra* text accompanying notes 94-95 and 106-13 (proposing that contract rates be enforced in the absence of unconscionable circumstances).

28. *Merritt*, 94 N.C. App. at 341, 380 S.E. 2d at 161; see Defendant-Appellants' Brief at 9-11, *Merritt*, 94 N.C. App. 340, 380 S.E.2d 160 (1989) (No. 8810SC815); Plaintiff-Appellees' Brief at 5, *Merritt*, 94 N.C. App. 340, 380 S.E.2d 160 (1989) (No. 8810SC815).

void and unenforceable.<sup>29</sup> The court reasoned that the contract rate was contrary to public policy as reflected by the usury statute in effect at execution.<sup>30</sup> Although the court recognized that the lender was entitled to recover some interest because the statute of limitations barred the penalty of forfeiture,<sup>31</sup> it rejected the parties' arguments for applying the maximum legal rate.<sup>32</sup> Instead the court treated the note as if the parties had not specified an interest rate and, relying on the Uniform Commercial Code sections governing ambiguous terms,<sup>33</sup> substituted the legal judgment rate<sup>34</sup> for the twelve percent bargained-for rate.<sup>35</sup>

The legislature raised the interest rate ceiling applicable to the type of loan at issue in *Merritt* by statutory amendment in 1981.<sup>36</sup> The amendment provides that for loans with a principal amount of \$25,000 or less, the maximum interest rate is the greater of sixteen percent or the six month Treasury Bill plus six percent rounded upward or downward to the nearest one-half of one percent.<sup>37</sup> At the time the *Merritt* plaintiff filed suit in 1987, the amended interest rate ceiling had been in effect for more than six years.<sup>38</sup> Thus, under the subsequent 1981 statutory amendment, the twelve percent interest rate provided in the promissory note was no longer usurious. The court rejected the proposition, however, that the subsequent amendment to the usury law could validate the interest provision.<sup>39</sup>

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29. "While the underlying debt is not affected, usury invalidates the provisions of a note which provide for the payment of interest." *Merritt*, 94 N.C. App. at 342, 380 S.E.2d at 162 (citing *In re Castillian Apartments*, 281 N.C. 709, 712, 190 S.E.2d 161, 162 (1972)).

30. See *infra* note 83 and accompanying text.

31. *Merritt*, 94 N.C. App. at 342, 380 S.E.2d at 162.

32. *Id.*

33. N.C. GEN. STAT. §§ 25-3-118(d), -122(4) (1986). For a full discussion of these sections, see *infra* notes 86-87.

34. N.C. GEN. STAT. § 24-1 (1986) sets forth the legal judgment rate. See *infra* note 35.

35. See *infra* text accompanying notes 85-89. The legal rate in effect at the time of execution was six percent. N.C. GEN. STAT. § 24-1 (1965) (amended 1980). An amendment to § 24-1 raising the legal rate to eight percent became effective on July 1, 1980. Act of July 1, 1980, ch. 1157, § 1, 1979 N.C. Sess. Laws, 90, 90-91 (codified at N.C. GEN. STAT. § 24-1 (1986)). Because the legal judgment rate had changed after the time of the note's execution, the case also presented the question of which legal judgment rate to apply. *Merritt*, 94 N.C. App. at 342-43, 380 S.E.2d at 162. The court concluded that the legal judgment rate in effect at the time of execution governed until the effective date of the amendment changing the legal judgment rate; from the effective date onward, the amended legal judgment rate was applicable. *Id.* at 343, 380 S.E.2d at 163.

36. Act of May 28, 1981, ch. 465, § 1, 1981 N.C. Sess. Laws 730, 730-31 (codified as amended at N.C. GEN. STAT. § 24-1.1 (1986)). The legislature further amended the statute in 1985 to provide that the maximum interest rate could vary during the term of variable rate loans. Act of July 9, 1985, ch. 465, § 1, 1981 N.C. Sess. Laws 730, 730-31 (codified at N.C. GEN. STAT. § 24-1.1 (1986)).

37. *Id.*

38. The amendment took effect 10 days after the date of ratification of May 28, 1981, and *Merritt* filed suit on November 18, 1987.

39. *Merritt*, 94 N.C. App. at 341, 380 S.E.2d at 162. Other jurisdictions also have refused to apply subsequent amendments to usury statutes retroactively. See, e.g., *Mapes v. Palo Alto Town and Country Village, Inc.*, 584 F. Supp. 508, 509-10 (D. Nev. 1984) (mem.) (construing Nevada law); *U.S. Life Title Ins. Co. v. Brents*, 676 S.W.2d 839, 841 (Mo. Ct. App. 1984); *Hazen v. Cook*, 55 Or. App. 66, 72, 637 P.2d 195, 199 (1981), *rev'd on other grounds*, 293 Or. 232, 646 P.2d 33 (1982); *Hockley County Seed & Delinting, Inc. v. Southwestern Inv. Co.*, 476 S.W.2d 38, 40-41 (Tex. Civ. App. 1971).

The court in *Merritt* relied on *Pond v. Horne*,<sup>40</sup> an early decision of the North Carolina Supreme Court, which held that a usurious interest rate in a contract made under a statute which declared such agreements "wholly void" was not revived by the subsequent repeal of the statute.<sup>41</sup> The plaintiff<sup>42</sup> in *Pond* brought suit against the borrower for payment of a bond that called for a usurious rate of interest under the statute in effect at execution.<sup>43</sup> The borrower contended that the usurious interest rate provision rendered the contract void.<sup>44</sup> The plaintiff argued that he had a right to recover because the usury statute subsequently had been repealed.<sup>45</sup> The court reasoned that the statute rendered the contract void at its inception, and thus, the subsequent repeal of the statute could not validate the contract.<sup>46</sup>

The North Carolina General Assembly has restricted significantly the breadth and scope of usury statutes over the years.<sup>47</sup> Unlike the usury statute in effect when *Pond* was decided, the current usury laws do not render usurious contracts void. Two penalties for usury are available under the current statute: forfeiture of the entire amount of interest due to the lender and recovery of twice the amount of interest actually paid by the borrower.<sup>48</sup> Thus, the *Merritt* court

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40. 65 N.C. 84 (1871) (per curiam).

41. *Id.* at 87.

42. The plaintiff brought suit to enforce payment of a bond executed by the defendant-borrower to the plaintiff's intestate. *Id.* at 84.

43. *Id.*

44. *Id.*

45. *Id.*

46. *Id.* at 86. The court stated that "the contract as alleged in the plea of usury by force of the statute 'was and is wholly void in law,' and the subsequent repeal of the statute does not give vitality to that which was dead, for . . . the effect of the statute is 'passed and closed.'" *Id.* at 87.

47. North Carolina's first usury statute, the Act of 1741, rendered "utterly void 'all bonds, contracts, and assurances whatsoever, . . . for the payment of any principal or money to be lent, or covenanted to be performed, upon or for any usury, whereupon or whereby there shall be reserved or taken' interest in excess of the legal rate prescribed." *Commercial Credit Corp. v. Robeson Motors, Inc.*, 243 N.C. 326, 330, 90 S.E.2d 886, 889 (1956) (quoting Act of 1741, ch. 28, Potter's Revisal of 1819 (repealed 1837)). For a history of usury laws generally, see F. RYAN, *USURY AND USURY LAWS* (1924); Special Project, *Interest Rates and the Law: A History of Usury*, 1981 ARIZ. ST. L.J. 61 (1981). For a history of usury laws in North Carolina generally, see *Commercial Credit*, 243 N.C. at 330-33, 90 S.E.2d at 889-91; Comment, *supra* note 1, at 762-63. Early usury laws in North Carolina prohibited any lawsuits by lenders based upon a usurious agreement. See, e.g., Act of 1741, ch. 28, Potter's Revisal of 1819 (repealed 1837); Revised Statutes of 1837, ch. 117 (repealed 1854); Revised Code of 1854, ch. 114 (repealed 1875); Act of Feb. 22, 1875, ch. 84, Laws of 1874-75 87 (repealed 1877). Under the Act of 1874-75, a lender who was a party to a usurious contract lost his right to recover the money loaned. See *Commercial Credit*, 243 N.C. at 331, 90 S.E.2d at 889-90. If the lender did recover, he was subject to a penalty of twice the amount of the recovery in a lawsuit brought by any person. Act of Feb. 22, 1875, ch. 84, § 2, Laws of 1874-75 87, 87-88 (repealed 1877). The prior statutes, with the exception of the Act of 1866, provided that the plaintiff in such a suit was entitled to only one-half of the recovered amount; the other one-half went to the state. *Commercial Credit*, 243 N.C. at 331, 90 S.E.2d at 889-90. Moreover, a violation of the Act of 1874-75 was a misdemeanor. Act of Feb. 22, 1875, ch. 84, § 3, Laws of 1874-75 87, 88 (repealed 1877). The Act of 1876-77 superceded the Act of 1874-75 and comprises a substantial part of the present North Carolina usury statute. Act of Feb. 12, 1877, ch. 91, Laws of 1876-77 147 (repealed 1907); see N.C. GEN. STAT. § 24-2 (1986).

48. N.C. GEN. STAT. § 24-2. The statute provides:

The taking, receiving, reserving or charging a greater rate of interest than permitted by this chapter or other applicable law, either before or after the interest may accrue, when knowingly done, shall be a forfeiture of the entire interest which the note or other evidence of debt carries with it, or which has been agreed to be paid thereon. And in case a greater

faced a different statutory interpretation issue when it determined the effect that subsequent amendments to usury laws should have in modifying previously usurious interest rates.

The North Carolina Supreme Court articulated the public policy underlying the state's usury laws in *Pinnix v. Maryland Casualty Co.*<sup>49</sup>:

The policy of the Legislature in adopting statutes of usury is the protection of borrowers against the oppressive exactions of lenders. . . . So long as the inclination to profit from man's adversity or necessity exists, a law limiting the rate of interest that the lender may charge the borrower for the use of money will continue to be wholesome and beneficial to society.<sup>50</sup>

In *Carolina Industrial Bank v. Merrimon*<sup>51</sup> the court characterized borrowers as "needy . . . victim[s] of . . . rapacious lender[s]."<sup>52</sup> This paternalistic concern for borrowers has led the North Carolina courts to interpret usury statutes broadly.<sup>53</sup>

Despite the altruistic purposes underlying interest rate limitations in usury statutes,<sup>54</sup> economists and legal scholars frequently have criticized these laws for failing to achieve their aim of protecting borrowers<sup>55</sup> and for the restraining influence that they exert over commercial economic progress.<sup>56</sup> Moreover, interest rate ceilings conflict with the principle of freedom of contract because these

rate of interest has been paid, the person or his legal representatives or corporation by whom it has been paid, may recover back twice the amount of interest paid in an action in the nature of action for debt. In any action . . . to recover upon any such note or other evidence or debt, it is lawful for the party against whom the action is brought to plead as a counterclaim the penalty above provided for, to wit, twice the amount of interest paid as aforesaid, and also the forfeiture of the entire interest.

*Id.*

49. 214 N.C. 760, 200 S.E. 874 (1939).

50. *Id.* at 768, 200 S.E. at 879.

51. 260 N.C. 335, 132 S.E.2d 692 (1963).

52. *Id.* at 340, 132 S.E.2d at 695 (quoting *General Motors Acceptance Corp. v. Weinrich*, 218 Mo. App. 68, 70, 262 S.W. 425, 428 (1924)).

53. Examples of this approach are found in cases which adhere to the view that the substance rather than the form of transactions controls, allowing courts to hold that such transactions are usurious, regardless of what label the excessive charges bear. See, e.g., *Western Auto Supply Co. v. Vick*, 303 N.C. 30, 277 S.E.2d 360, *aff'd on rehearing*, 304 N.C. 191, 283 S.E.2d 101 (1981); *Sherrill v. Hood*, 208 N.C. 472, 181 S.E. 330 (1935); *Polikoff v. Finance Serv. Co.*, 205 N.C. 631, 172 S.E. 356 (1934); *Jonas v. Home Mortgage Co.*, 205 N.C. 89, 170 S.E. 127 (1933); *Bundy v. Commercial Credit Co.*, 200 N.C. 511, 157 S.E. 860 (1931).

54. See Note, *supra* note 7, at 211 ("[L]egislative objectives for usury laws, protecting the consumer and providing credit for public consumption at a fixed reasonable rate, are valid and commendable public purposes and proper subjects for government regulation.").

55. See Shanks, *Practical Problems in the Application of Archaic Usury Statutes*, 53 VA. L. REV. 327, 328-30 (1967) (characterizing usury statutes as "blunt instruments of social control"); Long, *Trends in Usury Legislation—Current Interest Overdue*, 34 U. MIAMI L. REV. 325, 330 (1980) ("any benefits of lower interest rates are offset by decreased availability of funds for lending, with the result that would-be borrowers at the higher-risk end of the credit spectrum, typically those lower-income persons whom the laws are intended to protect, are denied credit"); Note, *supra* note 7, at 217-18 ("[I]ronically, the class most likely to resort to the illegal market includes the poor and uneducated borrowers that present usury legislation attempts to protect.").

56. See Note, *supra* note 7, at 201-02 (noting the "almost uniform criticism of general [interest] ceilings by economists"); J. BENTHAM, *Defence of Usury*, in *WORKS OF JEREMY BENTHAM* (1843); F. RYAN, *supra* note 47, at 60-62.

ceilings restrict contracting parties from making a mutually advantageous bargain if it is in violation of the legislatively imposed rate.<sup>57</sup> These concerns have led commentators to generate numerous alternate proposals to traditional usury statutes.<sup>58</sup> Legislative response to these criticisms has taken the form of statutory exemptions to the legal rate for certain types of transactions and positive grants of corporate power to various classes of lenders.<sup>59</sup>

In view of the criticism leveled at interest rate ceilings<sup>60</sup> and in the interest of promoting freedom of contract, other jurisdictions have sought to interpret usury penalties narrowly.<sup>61</sup> As one court noted, "the historical aversion to usury has given way to an aversion to harsh penalty statutes for usury being invoked by borrowers seeking to avoid payment of their bargained-for debts."<sup>62</sup> One approach courts have taken is to apply amendments to usury statutes retroactively so as to preclude a defense or claim of usury. A subsequent statutory amendment that repeals or modifies a usury law and is held to apply retroactively is similar in result to the statute of limitations that barred the claim of usury in *Merritt*. Both situations require the judiciary to determine what interest rate should be enforced in the absence of express legislative direction.

The United States Supreme Court applied an amendment to the usury laws retroactively in the landmark case of *Ewell v. Daggs*.<sup>63</sup> In *Ewell*, a lender brought suit to foreclose a mortgage securing a note that under Texas law contained a usurious interest rate when executed.<sup>64</sup> After the lender made the loan but before he initiated the suit, the Texas Legislature enacted an amendment repealing all usury laws.<sup>65</sup> The Texas Legislature did not make the amendment expressly retroactive.<sup>66</sup> The borrower asserted usury as a defense, contending that the law in effect when the parties made the loan should govern and that the

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57. See *Sweeney v. Citicorp Person-To-Person Fin. Center, Inc.*, 157 Ill. App. 3d 47, 54, 510 N.E.2d 93, 98, *appeal denied*, 116 Ill. 2d 576, 515 N.E.2d 127 (1987) ("[a]ll usury statutes are in derogation of the common law and are a restriction upon the freedom of contract") (citation omitted). Bentham, an economist arguing against interest rate ceilings, stated:

[N]o man of ripe years and of sound mind, acting freely, and with his eyes open, ought to be hindered, with a view to his advantage, from making such bargain, in the way of obtaining money, as he thinks fit: nor (what is a necessary consequence) anybody hindered from supplying him, upon any terms he thinks proper to accede to.

3 THE WORKS OF JEREMY BENTHAM 3 (J. Bowring ed. 1962).

58. See, e.g., Oeltjen, *supra* note 7, at 216-33 (discussing five proposals: "organized inaction," "loan sharking plus," "public utility," "free market system," and a "compromise" model); Note, *supra* note 7, at 227-30 (proposing a modified free market approach); Note, *An Ounce of Discretion for a Pound of Flesh: A Suggested Reform for Usury Laws*, 65 YALE L.J. 105, 107-10 (1955) (suggesting replacement of statutory fixed rate interest ceilings with a codified unconscionability standard which would enable courts to declare usurious those loans found to be harsh and unconscionable).

59. See Comment, *supra* note 1, at 764-71 (discussing statutory exceptions applicable to certain institutional lenders, residential loans, small loans, corporate borrowers, various credit unions, and loans insured by the Federal Housing Administration or the Veterans Administration).

60. For a discussion of these criticisms, see *supra* text accompanying notes 55-58.

61. See, e.g., cases cited *infra* note 75.

62. *Ward v. Hudco Loan Co.*, 254 Ga. 294, 296, 328 S.E.2d 729, 730 (1985).

63. 108 U.S. 143 (1883).

64. *Id.* at 144-45.

65. *Id.* at 148.

66. *Id.*



repeal of the usury laws should not be applied retroactively.<sup>67</sup>

The Supreme Court held that usury laws are penal in nature and that the repeal of such laws without a savings clause operates retrospectively, cutting off the defense of usury in all future actions, even for contracts previously made.<sup>68</sup> The Court rejected an argument that courts should give retroactive effect to an amendment only when the prior usury law had made usurious transactions voidable as distinguished from void.<sup>69</sup> The Court determined that giving the amendment retroactive effect neither deprived the parties of vested rights nor impaired the obligation of contract.<sup>70</sup> The Court reasoned:

[T]he right of a [borrower] to avoid his contract is given to him by statute, for purposes of its own, and not because it affects the merits of his obligation; and that whatever the statute gives, under such circumstances, as long as it remains *in fieri*, and not realized by having passed into a completed transaction, may, by a subsequent statute, be taken away. It is a privilege that belongs to the remedy, and forms no element in the rights that inhere in the contract. The benefit which he has received as the consideration of the contract, which, contrary to law, he actually made, is just ground for imposing upon him, by subsequent legislation, the liability which he intended to incur.<sup>71</sup>

Thus, under the principles the Supreme Court announced in *Ewell*, a borrower has a mere privilege, granted and sustained by the legislature, to avoid his contractual obligation.<sup>72</sup> Upon suspension of this privilege by the repeal or modification of the usury statute, the borrower must stand by his original bargain.<sup>73</sup>

A significant number of jurisdictions have relied on the reasoning of the *Ewell* court to give retroactive effect to amendments of usury statutes;<sup>74</sup> thus they enforce interest rates in contracts that, although usurious when made, are rendered nonusurious by a later amendment.<sup>75</sup> These holdings reflect the purely

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67. *Id.*

68. *Id.* at 150.

69. *Id.* at 148-49. Compare *American Sav. Life Ins. Co. v. Financial Affairs Management Co.*, 20 Ariz. App. 479, 484, 513 P.2d 1362, 1367 (1973) (emphasizing that the statute in effect at the time the loan was executed did not make usurious contracts void) with *United Realty Trust v. Property Dev. and Research Co.*, 269 N.W.2d 737, 743 n.11 (Minn. 1978) (attaching no significance to the distinction between previously void or previously voidable agreements under the repealed statute).

70. *Ewell*, 108 U.S. at 150-51.

71. *Id.* at 151.

72. See *American*, 20 Ariz. App. at 484, 513 P.2d at 1367 ("the statute creates a privilege in the borrower, that privilege being the ability to avoid paying the interest he has previously agreed to pay").

73. "The modification of the statute removes the previously existing privilege to the extent of the modification. The privilege ends when that which creates it ends. It can hardly be contended that a borrower has a vested right in this privilege to avoid obligations he has previously voluntarily assumed." *Id.*

74. In *American Savings Life Insurance Co. v. Financial Affairs Management Co.*, the Arizona Court of Appeals rejected the characterization of its holding as "giving retrospective or retroactive effect to the modified statute." *Id.* The court instead reasoned that "[t]he remedy or privilege given by the prior statute dies with the prior statute—the new or modified statute acts '*in praesentia*', applying to presently pending actions which have not proceeded to final judgment." *Id.*

75. See, e.g., *American Sav. Life Ins. Co. v. Financial Affairs Management Co.*, 20 Ariz. App. 479, 513 P.2d 1362 (1973); *Orden v. Crawshaw Mortgage & Inv. Co.*, 109 Cal. App. 3d 141, 167 Cal.

statutory nature of usury claims and defenses and their inherent conflict with the notion of freedom of contract.<sup>76</sup> Enforcing the contract according to its terms, rather than permitting a borrower to avoid or alter performance based on a defunct statute, prevents a borrower from obtaining a windfall at the expense of the lender.<sup>77</sup>

Clearly, when jurisdictions construe usury statutes narrowly and determine the right to a remedy by the law in effect at the time the parties file suit, courts decide the obligations of the parties to the contract primarily by their bargain. As the United States Supreme Court stated in *McNair v. Knott*:<sup>78</sup>

Placing the stamp of legality on a contract voluntarily and fairly entered into by parties for their mutual advantage takes nothing away from either of them. No party who has made an illegal contract has a right to insist that it remain permanently illegal. Public policy cannot be made static by those who, for reasons of their own, make contracts beyond their legal powers. No person has a vested right to be permitted to evade contracts which he has illegally made.<sup>79</sup>

This approach also comports with the modern view disfavoring forfeitures<sup>80</sup> and the criticism leveled at usury statutes from an economic perspective.<sup>81</sup>

Against this background of seemingly irreconcilable tension between public policy and economic reality, the *Merritt* court faced an interstice in the usury

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Rptr. 62 (1980); *Tel. Serv. Co. v. General Capital Corp.*, 227 So. 2d 667 (Fla. 1969); *Coe v. Muller*, 74 Fla. 399, 77 So. 88 (1917); *Sweeney v. Citicorp Person-To-Person Fin. Center, Inc.*, 157 Ill. App. 3d 47, 510 N.E.2d 93, *appeal denied*, 116 Ill. 2d 576, 515 N.E.2d 127 (1987); *Iowa Sav. & Loan Assoc. v. Heidt*, 107 Iowa 297, 77 N.W. 1050 (1899); *United Realty Trust v. Property Dev. & Research Co.*, 269 N.W.2d 737 (Minn. 1978); *Deposit Guar. Bank & Trust Co. v. Williams*, 193 Miss. 432, 9 So. 2d 638 (1942); *Farmland Enter., Inc. v. Schueman*, 212 Neb. 342, 322 N.W.2d 665 (1982); *Bokum v. First Nat'l Bank*, 106 N.M. 143, 740 P.2d 693 (1987).

76. The *Sweeney* court, recognizing this tension, stated:

All usury statutes are in derogation of the common law and are a restriction upon the freedom of contract. Thus, there is no usury in the absence of a law limiting the rate of interest, and a particular rate of interest is illegal only if it exceeds the statutory limit applicable in the particular case. There is also no constitutionally vested right to the defense of usury, and its repeal merely allows what was the original obligation of the parties to be enforced.

*Sweeney*, 157 Ill. App. 3d at 54, 510 N.E.2d at 98 (citation omitted). See also *Williams*, 193 Miss. 432, 439, 9 So. 2d 638, 640 ("Rights of action or defenses on account of usury are not a part of the common law. They are solely the creations of statute, and such statutes are in the nature of regulations in the public interest.").

77. See *Sweeney*, 157 Ill. App. 3d at 55, 510 N.E.2d at 98 ("The plaintiff here does not seek protection from a usurious loan, but rather seeks only a windfall, authorized by the penalty section of the statute. This hardly seems to be the type of situation intended to be covered by the usury law.").

78. 302 U.S. 369 (1937).

79. *Id.* at 373 (footnote omitted).

80. See *United Realty Trust v. Property Dev. & Research Co.*, 269 N.W.2d 737, 743 (Minn. 1978); *Ward v. Hudco Loan Co.*, 254 Ga. 294, 296, 328 S.E.2d 729, 730 (1985) ("Forfeitures and penalties are not favored. Courts should construe statutes relieving against forfeitures and penalties liberally so as to afford maximum relief.") (quoting *Southern Discount Co. v. Ector*, 246 Ga. 30, 30, 268 S.E.2d 621, 622 (1980) (per curiam)).

81. See generally *Shanks*, *supra* note 55, at 329-34 (criticizing usury laws for their ineffectiveness and negative effect on economic development); Note, *supra* note 7, at 212-18 (examining the detrimental impact usury laws have on the cost and availability of credit).

statute. The *Merritt* court correctly decided not to enforce a penalty barred by the statute of limitations.<sup>82</sup> The court faced a more difficult issue, however, in deciding whether to apply the amendment retroactively. Resolution of this issue entailed balancing two conflicting interests: (1) preservation of the public policy behind usury laws by penalizing lenders who charge exorbitant rates to protect unwary borrowers—versus (2) limiting the negative side-effects of usury laws, which include restricting parties' freedom to contract.

The *Merritt* court held that the contract provision specifying a twelve percent interest rate was contrary to public policy and therefore void and unenforceable because it violated the usury statute in effect at the time of execution.<sup>83</sup> Yet recognizing that the borrower was not entitled to complete relief from paying interest because the statute of limitations barred the penalty of forfeiture,<sup>84</sup> the court treated the note as if the parties had not specified any interest rate.<sup>85</sup> The court, relying on Uniform Commercial Code provisions addressing ambiguous terms,<sup>86</sup> substituted the legal judgment rate<sup>87</sup> for the twelve percent interest rate.<sup>88</sup> The court concluded that "where the debtor of a usurious loan is not entitled to the benefit of the statutory penalties, he is liable for interest at the legal rate."<sup>89</sup> The effect of this holding was to create and impose a judicial penalty upon the lender equal to the difference between the amount he expected to realize under the terms of the note and the legal judgment rate.<sup>90</sup> Correspondingly, the court relieved the borrower of his obligation to repay the loan as promised, allowing the borrower a windfall to the extent the legal judgment rate of interest was less than the contract rate.<sup>91</sup>

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82. See N.C. GEN. STAT. § 1-53(2), (3) (1983).

83. *Merritt*, 94 N.C. App. at 342, 380 S.E.2d at 162. See *Kessing v. National Mortgage Corp.*, 278 N.C. 523, 536, 180 S.E.2d 823, 831 (1971) (holding that an agreement made in contravention of a usury statute was void); see also *Gore v. George J. Ball, Inc.*, 279 N.C. 192, 203, 182 S.E.2d 389, 395 (1971) ("A provision in a contract which is against public policy will not be enforced."); *Glover v. Rowan Mut. Fire Ins. Co.*, 228 N.C. 195, 198, 45 S.E.2d 45, 47 (1947) ("[A]greements are against public policy when they tend to the violation of a statute."); *Cable v. Trexler*, 227 N.C. 307, 311, 42 S.E.2d 77, 80 (1947) ("The purpose of the statute becomes a public policy.").

84. *Merritt*, 94 N.C. App. at 342, 380 S.E.2d at 162.

85. *Id.*

86. *Id.* at 342-43, 380 S.E.2d at 162. The court cited N.C. GEN. STAT. § 25-3-118(d) (1986) ("Unless otherwise specified a provision for interest means interest at the judgment rate at the place of payment from the date of the instrument, or if it is undated from the date of issue."); N.C. GEN. STAT. § 25-3-122(4) (1986) ("Unless an instrument provides otherwise, interest runs at the rate provided by law for a judgment.").

87. N.C. GEN. STAT. § 24-1 (1986) sets forth the legal judgment rate. Neither of the Uniform Commercial Code sections cited in note 86 nor their respective official comments speaks directly to contract terms voided by judicial decision. The North Carolina comment to N.C. GEN. STAT. § 25-3-122(4) (1986) provides that "GS 25-3-118(d) is a construction section regarding an instrument which provides for interest, but states no rate or time" and "GS 25-3-122(4) is a procedural section regarding interest on non-interest-bearing obligations."

88. *Merritt*, 94 N.C. App. at 342, 380 S.E.2d at 162.

89. *Id.*

90. In *Merritt* this penalty was six percent of the unpaid balance from December 14, 1977, the date of execution, until the date the legal judgment rate was raised, July 1, 1980. From July 1, 1980, the penalty amount was four percent. These percentages reflect the difference between what the lender contracted for under the terms of the loan agreement and the amount the court allowed him to recover after applying the legal judgment rate. Further, the court lessened proportionally the lender's attorney's fee award.

91. See *supra* note 90.

The approach taken by the *Merritt* court, in providing judicial relief to borrowers by declaring contract rates void when they violate usury statutes in effect at the time of execution and replacing them with the legal judgment rate, has several advantages. The *Merritt* holding provides a bright-line test for determining whether a contracted-for interest rate is unenforceable and supplies a predictable remedy. Lower courts will find the *Merritt* approach simple to administer and contracting parties are assured certain results under similar contracts. Moreover, the *Merritt* holding accords with the public policy underlying usury statutes by protecting unwary, unsophisticated borrowers against unscrupulous, overreaching lenders.<sup>92</sup> The court's assertion that "the law would be treacherous to itself if it were to allow the enforcement of the forbidden usurious contracts because no penalty was attached" reflects this concern for the borrower.<sup>93</sup> Finally, under the remedy structured by the *Merritt* court, as between the innocent borrower and the culpable lender, the windfall of a lower rate goes to the borrower.

Although there exist some slight advantages from voiding the original contract rate and not applying usury amendments retroactively, the better analysis would be to presume that, in the absence of the usury ceiling at the time of execution, the parties would have bargained for the contract rate. The court, therefore, presumptively should enforce the contract as written absent some other principle of law for acting to the contrary. If the court views the contract as unconscionable, then it should not enforce the contract rate but should apply the legal judgment rate instead.

The facts in *Merritt* involved a sophisticated borrower, a commercial transaction, and a loan rate only two percent above the legal maximum, all of which indicates no lack of equal bargaining power. The *Merritt* court, therefore, could have enforced the contract rate while remaining consistent with the public policy of protecting unwary borrowers. Had the *Merritt* court applied this analysis instead of creating a bright-line rule, it could have minimized the negative impact usury laws have on parties' freedom of contract while continuing to permit judicial relief for borrowers in unconscionable bargains. The weakness in the *Merritt* court's decision was determining that the contracted-for interest rate was void and contrary to public policy without taking into consideration how economic circumstances and public policy standards had changed between the time the parties entered into the loan and when the court adjudicated the suit.<sup>94</sup> Instead of taking the opportunity to examine the contract for oppressive and unfair terms, the circumstances of the bargain itself, and the necessity of protecting this particular borrower, the *Merritt* court automatically concluded that the contracted-for interest rate was void and unenforceable and that the borrower

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92. For a discussion of the public policy considerations supporting North Carolina's usury laws, see *supra* text accompanying notes 49-52.

93. *Hughes v. Boone*, 102 N.C. 137, 164, 9 S.E. 286, 293 (1889).

94. For a discussion of the statutory amendment to N.C. GEN. STAT. § 24-1.1 increasing the interest rate ceiling, see *supra* text accompanying notes 36-37. Such an increase arguably reflects a change in the economic market and indicates that interest rates previously considered excessive may no longer impose a hardship on debtors.

should be granted relief.<sup>95</sup> In short, the court viewed protection of the borrower as completely inconsistent with freedom of contract.

The court in *Merritt* summarily disposed of the retroactivity issue in one sentence, citing *Pond v. Horne* as authority.<sup>96</sup> The *Merritt* court's automatic reliance on the holding in *Pond*<sup>97</sup> deserves closer scrutiny in light of the fundamental differences between the usury statutes in effect when the court decided *Pond* in 1871 and those in effect today. The usury statutes at issue in *Pond* rendered usurious contracts completely void whereas current usury statutes do not make the underlying loan obligation unenforceable.<sup>98</sup> The *Pond* court based its reasoning on the fact that the repealed usury statute made the usurious transactions void.<sup>99</sup> Thus, the court in *Merritt* faced an entirely different statutory construction issue.

Furthermore, the language of the legislature arguably does not support the court's refusal retroactively to apply the 1981 statutory amendment to the previously executed loan.<sup>100</sup> But even if interpreted to bar the application of the amendment to a previously executed agreement,<sup>101</sup> the amendment at least indicates the level at which lender "rapaciousness"<sup>102</sup> becomes intolerable and at what point public policy must protect borrowers.<sup>103</sup> Thus, amendments to usury statutes, although they may not directly apply to previously executed contracts, should serve as guidelines for courts in determining what interest rates are unreasonably excessive under current economic conditions.

Had the *Merritt* court construed the usury statute narrowly, as did the *Ewell* court and its successors,<sup>104</sup> automatically to preclude the borrower from presenting his case for equitable relief, the holding would have contradicted courts' traditional antipathy for usurious contracts. Construing usury statutes narrowly, by applying modifications to usury statutes retroactively or by denying borrowers relief past the statute of limitations period and thereby validating contracts according to their terms, fails to protect uninformed borrowers from overreaching lenders.<sup>105</sup> Moreover, a narrow construction does not take into account the relative bargaining power of the parties. In short, a narrow construction approach based on the freedom to contract in the absence of statutory

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95. See *Merritt*, 94 N.C. App at 342, 380 S.E.2d at 162.

96. *Id.* at 341, 380 S.E.2d at 162 (citing *Pond v. Horne*, 65 N.C. 84 (1871) (per curiam)) ("Subsequent changes in the law regarding interest rates could not validate the interest provision.").

97. For a full discussion of *Pond*, see *supra* text accompanying notes 40-46.

98. See Comment, *supra* note 1, at 762 ("No longer is a usurious contract wholly void.").

99. *Pond v. Horne*, 65 N.C. 84, 86 (1871) (per curiam).

100. Compare Act of May 28, 1981, ch. 465, § 3, 1981 N.C. Sess. Laws 730, 730 (codified as amended as N.C. GEN. STAT. § 24-1.1 (1986)) ("[T]his act shall become effective 10 days after ratification") with Act of July 9, 1985, ch. 465, § 3, 1985 N.C. Sess. Laws 849, 850 (codified at N.C. GEN. STAT. § 24-1.1 (1986)) ("This act is effective upon ratification [July 9, 1985] and shall apply to loans made after that date.") (emphasis added).

101. See *supra* note 100.

102. See *supra* text accompanying notes 51-52.

103. See *supra* text accompanying notes 49-53.

104. See *supra* text accompanying notes 63-77.

105. See Note, *supra* note 58, at 108 (arguing that repeal of usury statutes would "leave the borrower without effective protection from usurious loan contracts").

limitations does not serve the protective functions of the public policy approach. Courts can remedy these disadvantages, however, by superimposing an unconscionability<sup>106</sup> standard upon all interest rates provided for by contract.<sup>107</sup> In effect, this unconscionability standard would act as a "safety net" in the event a borrower obtained an unjust result because the running of the statute of limitations or a subsequent modification or repeal of the usury law abridged the statutory penalties.<sup>108</sup> Such an unconscionability standard is supported by the traditional common-law doctrine that courts will not enforce an unconscionable contract.<sup>109</sup>

Under the combined freedom of contract/unconscionability approach, the court would undertake a two-level analysis, balancing the need to protect the borrower who is denied statutory relief with the economic consequences inherent in enforcing the contract as written. The first level would employ the reasoning of *Ewell* and its progeny<sup>110</sup> to create a rebuttable presumption that the court should enforce the contract according to its terms in the absence of a present statutorily granted claim or defense of usury. The second level would allow the trier of fact to assess the equitable principles involved in enforcing the contract as written. At this level, the inquiry would focus on the "arms' length" nature of the transaction,<sup>111</sup> the nature and amount of the loan,<sup>112</sup> and the interest rate itself. The threshold of unconscionability would be lower in transactions that involve parties of unequal bargaining power or sophistication, personal loans (as compared to business loans), or contracts with exorbitant rates of interest.

In view of the adverse economic consequences that attend the imposition of interest rate ceilings and the restrictions such ceilings place on the freedom of

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106. In *Hume v. United States*, 132 U.S. 406 (1889), the Supreme Court defined an "unconscionable" contract as: "Such as no man in his senses and not under delusion would make on the one hand, and as no honest and fair man would accept on the other." *Id.* at 411.

107. One commentator, proposing an unregulated credit market, suggests that states implementing this system use a "streamlined unconscionability standard." Note, *supra* note 7, at 223. "Unconscionability" would be defined as "a rate of interest above the market rate procured through overreaching." *Id.*

108. One commentator has advocated replacing fixed interest rate ceilings with an unconscionability standard that would enable courts to declare any loan transaction usurious if the contract rate is excessive and the loan, taken as a whole, is harsh and unconscionable. Note, *supra* note 58, at 108. Commentators have praised this approach as providing an "appealing compromise between freedom of contract, an unrestricted credit marketplace, and provisions for consumer protection." Note, *supra* note 7, at 221-22. Potential problems with this scheme include high administrative costs and the "uncertainty inherent in the unconscionability standard." *Id.* at 222.

109. See Long, *supra* note 55, at 337 (contending that even if no legal interest rates are set "[b]orrowers are protected . . . by the common law principle that equity will not enforce an unconscionable contract"). Similarly, the Uniform Commercial Code codifies this principle for sales contracts. U.C.C. § 2-302 (1977).

110. See *supra* text accompanying notes 63-77.

111. See *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445, 449 (D.C. Cir. 1965) (The court, discussing unconscionability in the context of contracts for the sale of goods, stated that unconscionability included: "[A]n absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party.').

112. See Note, *supra* note 7, at 227-28 (identifying individuals who borrow small amounts of money for personal consumption as the class of borrowers that is most often subject to abuses by unscrupulous lenders because of the needy circumstances, lack of sophistication, and poor bargaining ability of such borrowers).

parties to strike a mutually advantageous bargain, the *Merritt* court's automatic substitution of the legal judgment rate of interest for the contract rate without considering the equitable factors involved creates a perilous precedent. When faced with loan transactions in which no statutory penalty exists for usury and a rate no longer deemed usurious under the law in effect at the time suit was filed, the court should create a rebuttable presumption that borrowers are bound according to their contracted-for obligations. A judicial determination of unconscionability, as evidenced by the parties' unequal bargaining power, the nature and amount of the loan, and the interest rate itself, could overcome this presumption. This two-step inquiry would allow North Carolina courts the flexibility to provide judicial relief<sup>113</sup> when necessary to protect vulnerable borrowers, thus effectuating the public policy against usury, while promoting the economic development and freedom of contract essential to a free market system.

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113. The *Merritt* holding would provide a guideline for such relief. For a discussion of the relief provided in *Merritt*, see *supra* text accompanying notes 83-89.