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be resolved in continual litigation. Some more practical solution should be sought through legislation supported by the Treasury Department.[37]

PURCHASE OF NOTE CONSTITUTES USURIOUS LOAN

Defendant applied for a loan to an investment broker to whom he gave a mortgage and a promissory note payable to, and subsequently endorsed in blank by, a third party. The broker, whose name appeared on neither instrument, then sold the 6,000 dollar note at a six per cent discount to plaintiff after deducting a commission of 890 dollars. Defendant received only 4,750 dollars for his note. Plaintiff did not know that his money constituted the original consideration for the note, which bore ten per cent annual interest. After defendant's default, plaintiff brought this action to foreclose the mortgage. The trial court concluded that the transaction was in substance a usurious loan and sustained the defense of usury. On appeal, the Washington Supreme Court affirmed in a five-four decision. *Held:* The defense of usury is available to the maker of a note for which no value has previously been given if it is discounted at a rate which, when added to stated interest, exceeds the statutory maximum, even though plaintiff holder did not know that he furnished the original consideration. *Baske v. Russell,* 67 Wash. Dec. 2d 264, 407 P.2d 434 (1965).

The Washington usury statute, limited in application to loans and forbearances,[1] does not affect the sale and purchase of negotiable

litigation. Balter, *supra* note 5, at 20. The strict burden of proof rule has also been defended on the ground that the Tax Court itself is not equipped to investigate and present factual evidence. Morrisdale Coal Mining Co., 19 T.C. 208 (1952); Producers Crop Improvement Ass'n, 7 T.C. 562 (1946). See 9 MERTENS, *op. cit. supra* note 4, § 50.62; Balter, *supra* note 5.

[37] See articles cited note 8 *supra,* for possible legislative and administrative solutions to the taxpayer's burden of proof problem in dependency cases. See also Kaminsky, *The Case for Discovery Procedure in the Tax Court,* 36 TAXES 498 (1958). The problems illustrated by the principal case often could be avoided by providing in the alimony decree at the time of divorce that child support be incorporated within alimony payments. The wife would get the dependency exemption, but the husband would be able to deduct the entire alimony payment. See Commissioner v. Lester, 366 U.S. 299 (1961).

[1] WASH. REV. CODE § 19.52.020 (1957):

> Any rate of interest not exceeding twelve percent per annum agreed to in writing by the parties to the contract, shall be legal, and no person shall directly or indirectly take or receive in money, goods or thing in action, or in any other way, any

paper, which may be discounted at any rate.[2] However, a court must often scrutinize a transaction to determine whether what was, in form, a sale and purchase of negotiable paper was, in substance, a usurious loan.[3]

The court in the principal case adopted the rule that if a commercial instrument is (1) sold or otherwise transferred at a discount exceeding the lawful interest rate,[4] and is (2) either (a) received directly from the maker,[5] or (b) transferred without having been previously negotiated for value, the transaction is in legal effect a usurious loan.[6] The court reasoned that plaintiff's lack of knowledge that the note had not been previously negotiated for value did not exempt him from this rule because: "If knowledge on the part of the lender is made a condition of liability, collusion is invited and the purpose of the statute is defeated."[7]

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greater interest, sum or value for the loan or forbearance of any money, goods or things in action than twelve percent per annum.

[2] "A sale of commercial paper or other chose in action cannot be construed as usurious, regardless of the profit made ...." 67 Wash. Dec. 2d at 267, 407 P.2d at 436. See also Acme Finance Co. v. Zapffe, 161 Wash. 312, 296 Pac. 1050 (1931); Finance & Ins. Agency v. Herren, 139 Wash. 499, 247 Pac. 948 (1926).

[3] "To determine whether all these essential elements [of usury] are present, the courts will look through the form of the transaction and consider its substance." Hafer v. Spaeth, 22 Wn. 2d 378, 383, 156 P.2d 408, 410 (1945). For the elements of usury, see note 9 *infra*. See Milana v. Credit Discount Co., 27 Cal. 2d 335, 163 P.2d 869, 871 (1945):

> [L]enders, intent on collecting compensation for the use of money in excess of the lawful rate, seek to avoid transacting their business in the form of loans. The courts have been alert to pierce the veil of any plan designed to evade the usury law and in doing so to disregard the form and consider the substance.

See also Annot., *Usury as predicable upon transaction in form a sale or exchange of commercial paper or other choses in action*, 165 A.L.R. 626, 631-32 (1946), and cases cited therein.

[4] The maximum lawful interest in Washington is twelve per cent per annum. WASH. REV. CODE § 19.52.020 (1957). The broker's commission was not included in the court's calculation. The court found usury by adding plaintiff's six per cent discount to the stated interest of ten per cent, concluding:

> If this 6 per cent were spread over the three years in which the note was to be paid, the annual interest would be 12 per cent—a rate not in excess of that provided by statute; however, when it is considered that the interest is paid on a declining balance, whereas the 6 per cent was deducted from the full amount of the loan, it becomes apparent that the statutory maximum would be exceeded. 67 Wash. Dec. 2d at 267, 407 P.2d at 436.

[5] It is curious that the court did not at this point cite a parallel provision contained in WASH. REV. CODE § 19.52.010 (1957): "The discounting of commercial paper, where the borrower makes himself liable as maker, guarantor or indorser, shall be considered as a loan for the purposes of this act."

[6] 67 Wash. Dec. 2d at 268, 407 P.2d at 436.

[7] 67 Wash. Dec. 2d at 269, 407 P.2d at 437. Whatever validity "possible collusion" may have as grounds for rendering immaterial a holder's lack of knowledge that the note he purchased had not been previously negotiated for value, it is difficult to discern any possibility of collusion on the part of plaintiff in the principal case. The majority opinion stated three times that plaintiff was un-

According to the general rule adopted by the court, the transaction whereby plaintiff unwittingly furnished the original consideration for defendant's note and mortgage constituted an usurious loan.[8] It should be noted, however, that this transaction did not contain all the elements essential to usury in Washington, for plaintiff neither made a loan nor intended to exact usurious interest.[9] A loan is:

> an advancement of money or other personal property to a person, under a contract or stipulation, express or implied, whereby the person to whom the advancement is made binds himself to repay it at some future time, together with such other sum as may be agreed upon for the use of the money or the thing advanced.[10]

The Washington court has stated that a cardinal rule in the doctrine of usury is that "to constitute usury, there must be a loan in contemplation by the parties . . . ."[11] Plaintiff thought he was purchasing a note. The court did not find that he intended to make a loan; nor was there any indication that he had entered into a "contract or stipulation, express or implied," to lend money to defendant. The court was similarly silent about plaintiff's intent to exact usurious interest.[12] If, as he thought, plaintiff was purchasing a note which

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aware that the money he was advancing was to be the original consideration for the note. 67 Wash. Dec. 2d at 267-68, 407 P.2d at 435-36. From the majority's description of the facts, the only collusion which appeared likely was between the broker and defendant. Both defendant and his third party payee cooperated in the broker's scheme, the final result being that the broker received a "commission" of $890 and defendant was enriched by $2,392. 67 Wash. Dec. 2d at 273, 407 P.2d at 439 (dissenting opinion). Due to deduction of penalties under the usury statute, quoted in note 20 *infra*, plaintiff received judgment of only $1808.01 on his plea for $5,751.66, the amount due on the note. *Id.* at 270, 407 P.2d at 437-38.

[8] See note 6 *supra* and accompanying text.

[9] In addition to (1) a loan or forbearance, express or implied, and (2) an intent to exact more than the legal maximum for the loan or forbearance, the essential elements of usury are: (3) money or its equivalent constituting the subject matter of the loan or forbearance, (4) an understanding between the parties that the principal shall be repayable absolutely, and (5) the exaction of something in excess of what is allowed by law for the use of the money loaned or for the benefit of the forbearance. Colagrossi v. Hendrickson, 50 Wn. 2d 266, 310 P.2d 1072 (1957); Hafer v. Spaeth, 22 Wn. 2d 378, 156 P.2d 408 (1945).

[10] Hafer v. Spaeth, 22 Wn. 2d 378, 384, 156 P.2d 408, 411 (1945).

[11] *Id.* at 383, 156 P.2d at 411, quoting with approval from Nichols v. Fearson, 32 U.S. 103, 108 (1833).

[12] Such intent is not an intent to violate the statute as such, but is merely an intent to do what is forbidden by statute. Intentional imposition of more than twelve per cent annual interest will raise a presumption of intent to charge usury. Washington Fire Insurance Co. v. Maple Valley Lumber Co., 77 Wash. 686, 138 Pac. 553 (1914).

It has been held, however, that "a contract was not usurious unless, upon reasonable construction of the terms in view of the dealings of the parties, it is manifest that the parties intended to engage in a usury transaction." Tacoma Hotel, Inc. v. Morrison & Co., 193 Wash. 134, 141, 74 P.2d 1003, 1005 (1938), citing Simpson v. The C.P. Cox Corp., 167 Wash. 34, 8 P.2d 424 (1932). If plaintiff had intended

had already been negotiated for value, the discount could not be added to the stated interest in determining the interest rate.[13]

The effect of this decision, which ignored plaintiff's status as a holder in due course,[14] is to carve an exception out of Washington's negotiable instruments law by subjecting a holder in due course to the defense of usury, heretofore a personal defense in Washington.[15] A holder in due course, by definition, has acquired a negotiable in-

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to make a loan, therefore, an intent to exact usurious interest could have been presumed from the fact that he discounted at six per cent a note bearing ten per cent interest. But he could not be presumed to have intended to exact usurious interest when he did not even intend to make a loan.

[13] The majority opinion explicitly conceded: "We hold that a note for which value has once been given can be discounted at any rate. . . ." 67 Wash. Dec. 2d at 269, 407 P.2d at 437.

See note 2 *supra*.

[14] WASH. REV. CODE § 62.01.052 (1955):

> A holder in due course is a holder who has taken the instrument under the following conditions:
>
> (1) That it is complete and regular upon its face;
>
> (2) That he became holder of it before it was overdue, and without notice that it had been previously dishonored, if such was the fact;
>
> (3) *That he took it in good faith and for value;*
>
> (4) *That at the time it was negotiated to him he had no notice of any infirmity in the instrument or defect in the title of the person negotiating it.* [Emphasis added.]

From the court's description of the facts, it is clear that plaintiff took the instrument under these conditions.

If the court had accepted the trial court's finding that the broker was plaintiff's agent in this transaction (Brief for Appellants, p. 3) and its conclusion of law that plaintiff was chargeable with the broker's knowledge of the true nature of the transaction (Brief for Appellants, p. 4), plaintiff's imputed knowledge would have prevented him from being a holder in due course. Keene v. Behan, 40 Wash. 505, 82 Pac. 884 (1905). *But see* Fry v. Knouse, 142 Wash. 500, 505, 253 Pac. 802, 804 (1927), which held that a broker who had made a usurious loan without plaintiff's knowledge and later sold the note to plaintiff was plaintiff's agent, but that his knowledge was not chargeable to plaintiff, for "it was essential to the agent's purpose that he should conceal the real facts from his principal." See also Ridgway v. Davenport, 37 Wash. 134, 79 Pac. 606 (1905); WASH. REV. CODE § 19.52.030 (1957):

> [T]he acts and dealings of an agent in loaning money shall bind the principal, and in all cases where there is illegal interest contracted for by the transaction of any agent the principal shall be held thereby to the same extent as though he had acted in person. And where the same person acts as agent of the borrower and lender, he shall be deemed the agent of the lender for the purposes of this act.

The court in the principal case apparently did not accept the trial court's finding of agency nor did it base its decision on this finding, and nowhere did it imply that the broker was plaintiff's agent or that plaintiff was chargeable with broker's knowledge of the true nature of the transaction.

[15] American Sav. Bank & Trust Co. v. Helgesen, 64 Wash. 54, 116 Pac. 837 (1911); WASH. REV. CODE § 62.01.057 (1955):

> A holder in due course holds the instrument free from any defect of title of prior parties, and free from defenses available to prior parties among themselves, and may enforce payment of the instrument for the full amount thereof against all parties liable thereon.

"Usury, a matter on which there is great variation in state policy, has been held to be a personal defense in Washington." Cosway, *Negotiable Instruments—A Comparison of Washington Law and Uniform Commercial Code Article 3*, 40 WASH. L. REV. 281, 312 n.162 (1965).

strument without knowledge of facts indicating, *inter alia,* that the transaction was in substance a loan, for if he had such knowledge, a purchaser would not be a holder in due course. Even though an innocent purchaser is a holder in due course, he may nevertheless be deemed a usurious lender if knowledge or intent is not necessary to make a loan.

Availability of usury as a defense against a holder in due course is dependent upon provisions of the usury statute of each jurisdiction. In some states usury statutes explicitly exempt a holder in due course from the defense of usury.[16] Absent such provision, it is generally held that usury is a defense against a holder in due course to the extent that a state's usury statute renders void either the entire usurious contract[17] or the interest or excess of interest over the lawful maximum.[18] But where the statute merely provides a penalty without voiding the instrument, it is generally held that the defense of usury is not available against a holder in due course:[19] this is the rule in Washington.[20]

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[16] *E.g.,* KAN. GEN. STAT. 16-203 (Supp. 1961) provides in part:

> [N]o bona fide endorsee of negotiable paper purchased before due shall be affected by any usury exacted by any former holder of such paper unless he shall have actual notice of the usury previous to his purchase.

[17] Hare v. General Contract Purchase Corp., 220 Ark. 601, 249 S.W.2d 973 (1952), held that the defense of usury was available against a bona fide holder for value and without notice for the reason that the Arkansas constitution voids usurious contracts. Sabine v. Paine, 233 N.Y. 401, 119 N.E. 849 (1918), held that the New York usury statute, voiding usurious contracts, was not impliedly repealed or modified by the subsequently enacted New York negotiable instruments law (providing that a holder in due course holds the instrument free from any defect of title in prior parties and free from defenses available to prior parties among themselves), and that therefore a note void in its inception for usury could not be enforced even by a holder in due course.

[18] Whitaker v. Smith, 255 Ky. 339, 73 S.W.2d 1105 (1934), held that because the Kentucky statute rendered void the obligation to pay interest in excess of the lawful maximum, in a suit brought by a holder in due course, defendant maker was entitled to credit on the note in the amount of the usurious interest he had paid. A similar rule was followed in National Bond & Investment Co. v Atkinson, 254 S.W.2d 885, 887-88 (Tex. Civ. App. 1952): "Since usurious interest in the hands of the original payee is void, it logically follows that it continues to be usurious and void even if the note is in the hands of a bona fide holder."

[19] Because the Virginia usury statute did not void usurious contracts, the defense of usury was held not available against plaintiff holder in due course in Moore v. Potomac Sav. Bank, 160 Va. 597, 169 S.E. 922 (1933).

[20] WASH. REV. CODE § 19.52.030 (1957):

> If a greater rate of interest than is hereinbefore allowed shall be contracted for or received or reserved, the contract shall not, therefore, be void; but if in any action on such contract proof be made that greater rate of interest has been directly or indirectly contracted for or taken or reserved, the plaintiff shall only recover the principal, less the amount of interest accruing thereon at the rate contracted for, and the defendant shall recover costs; and if interest shall have been paid, judgment shall be for the principal less twice the amount of the interest paid, and less the amount of all accrued and unpaid interest....

The relationship between a state's usury statute and its negotiable instruments law is recognized by the Uniform Commercial Code, which becomes effective in Washington on July 1, 1967. The Code provides that a holder in due course takes the instrument free from all defenses of any party to the instrument with whom he has not dealt, except such illegality as renders void the obligation of that party.[21] By rejecting this relationship,[22] the Washington court has rendered uncertain the favored status which a holder in due course heretofore has enjoyed, and which he would have been expected to enjoy under the Uniform Commercial Code. Close examination of a negotiable instrument's history will be required prior to its purchase to ascertain whether it has previously been negotiated for value. Good faith and lack of knowledge may no longer protect the holder in due course from the defense of usury.

American Sav. Bank & Trust Co. v. Helgesen, 64 Wash. 54, 61, 116 Pac. 837, 839 (1911):

> Since the contracting for a greater rate of interest than is allowed by law does not render the notes void . . . it seems clear that the defense of usury is not available to the maker against a holder acquiring the notes in good faith for value before maturity.

[21] UNIFORM COMMERCIAL CODE § 3-305 (2) (b). Comment 6 adds:

> Illegality is most frequently a matter of gaming or usury, but may arise in many other forms under a great variety of statutes. The statutes differ greatly in their provisions and the interpretations given them. They are primarily a matter of local concern and local policy. All such matters are therefore left to the local law. If under that law the effect of the duress or the illegality is to make the obligation entirely null and void, the defense may be asserted against a holder in due course. Otherwise it is cut off.

Prior to the principal case, the effect of § 3-305(2) (b) in Washington, where usurious contracts are not void by statute, would have been that the defense of usury could not be raised against a holder in due course. This result is no longer safely predictable, for under the reasoning of the principal case the possibility of collusion has replaced voidness of usurious contracts as ground for subjecting a holder in due course to the defense of usury.

[22] "Our statute does not make the contract void but simply imposes penalties. However, we do not think that a distinction based upon the severity of the sanctions imposed by a statute is necessarily valid." 67 Wash. Dec. 2d at 269, 407 P.2d at 437.