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California Consumer Loans Exempt from Usury May Be Deemed "Unconscionable"

by Stephen Ornstein

In a little-noticed development with significant ramifications, the California Supreme Court ruled in *De La Torre v. CashCall Inc.,* S. Cal. 5th 966 (2018), that the interest rate on consumer loans of $2,500 or more may render the loans "unconscionable" under the California Financial Code—even though the loan is not usurious under California law. The financial product that is subject to the litigation is an unsecured $2,600 loan, payable over a 42-month term, with an annual percentage rate of up to 135%, which is typically made to subprime borrowers.

The product is not subject to California's interest rate caps that apply only to consumer loans of less than $2,500. Nevertheless, the plaintiffs contended that CashCall violated California's Unfair Competition Law, Cal. Bus. & Prof. Code 17200, because the loans are "unconscionable." The Northern District of California certified the plaintiffs' lawsuit as a class action and then granted CashCall's motion for summary judgment. On appeal, the Ninth Circuit certified to the California Supreme Court the question of whether the interest rate on consumer loans of $2,500 or more can render the loans "unconscionable" under California law. In this significant ruling, the California Supreme Court responded to the Ninth Circuit's question in the affirmative.

In rendering this decision, the California Supreme Court did not reach the merits of whether the particular loan product in question—or its interest rate—is itself "unconscionable," but it set forth criteria that a court should evaluate in ultimately determining whether such a financial product— or a particular provision in the contract—is "unconscionable."

As a threshold matter, the court asserted that a loan that is not subject to the California usury cap is not shielded from an "unconscionability" determination. The court noted that the unconscionability doctrine predates the California statutory interest rate limits and is concerned with "unreasonably and unexpectedly harsh terms having to do with price and other central aspects of the transaction." The court, in reviewing the statutory codification of the unconscionability doctrine, observed that a court may find unconscionable "the contract or any clause of the contract and so refuse enforcement."

According to the California Supreme Court, "unconscionability is a flexible doctrine … meant to ensure that in circumstances indicating an absence of meaningful choice, contracts do not specify terms that are 'overly harsh,' 'unduly oppressive,' or 'so one-sided as to shock the conscience.'" The court added that unconscionability "requires oppression or surprise … along with … overly harsh or one-sided results," noting that "unconscionability has both a 'procedural' and a 'substantive element,' the former focusing on 'oppression' or 'surprise' due to unequal bargaining power, the latter on 'overly harsh' or 'one-sided' results," *both* of which must be present for a court to "exercise its discretion to refuse to enforce a contract or clause under the doctrine."

The court observed that in assessing the presence of substantive unconscionability, a court may need to consider context. For example, "when a price term is alleged to be substantively unconscionable … it is not sufficient for a court to consider only whether 'the price exceeds cost or fair value,' … the court must also 'look to the basis and justification for the price.'" Interestingly, the court noted that "when a contract term is salient to purchasers, the market can be trusted to provide an efficient version of the term and price is probably salient to nearly all buyers. If, for example, the interest rate [of a financial product] is high because the borrowers of the loan are credit-impaired or default-prone," a finding of substantive unconscionability is less likely.

Alston & Bird Observations

Again, the court did not decide whether CashCall's loans in question are unconscionable, but it dismissed the notion that an unconscionability claim cannot be asserted merely because a loan product technically is not subject to a rate cap in California. Nonetheless, it is our observation that given the factors that a California court must consider in order to render a contract—or certain provisions of the contract—"unconscionable," there must be extreme circumstances taking into account the bargaining process of the parties and prevailing market conditions. The court emphasized that a particular term in question must be "overly harsh," "unduly oppressive," or "so one-sided as to shock the conscience."

In light of these guideposts, the actual rate of interest for the financial product may not attract scrutiny by itself, especially for a subprime consumer loan, but certain terms that the borrower may not be able to bargain for, such as high up-front fees that are financed by the lender, higher delinquency-related fees imposed upon the borrower (i.e., exorbitant default interest rates that accrue on the outstanding principle balance), and mandatory arbitration clauses that unduly favor the lender or holder, may, under certain circumstances, warrant a finding of "unconscionability." In light of this California Supreme Court decision, providers of financial consumer products in California would be well advised to review their contracts to eliminate unduly harsh provisions that could give rise to the assertion of an unconscionability claim.

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