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## Cagle vs. Boyle Mortgage Co.

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## NOTE: CAGLE v. BOYLE MORTGAGE CO.

Plaintiff, Boyle Mortgage Co., sued to foreclose a mortgage given by defendant Cagle to secure a construction note. The note for \$28,000 recited a face value of 10% interest per annum. Cagle asserted the defense of usury on the grounds that the computerized monthly statements sent to him from Boyle's home office showed that the interest had been compounded monthly and yielded an effective interest rate of 10.471% per annum. In addition to this, the computerized statement showed that Boyle had computed the daily interest factor based on a 360-day year for 365 days of charging. The use of a daily interest factor based on a 365/360 computation yielded a 10.139% effective interest rate. The use of both methods produced a simple interest rate of 10.623529% per annum. Boyle argued that the transaction was free of usury because there had been a mistake of fact in the calculation of the interest, and there was no intent to exact an illegal rate of interest. The chancellor found the transaction free of usury. The Arkansas Supreme Court reversed and held that the transaction was usurious. The note and mortgage were cancelled. *Cagle v. Boyle Mortgage Co.*, 261 Ark. 437, 549 S.W.2d 474 (1977).

The Arkansas constitution states that "[a]ll contracts<sup>1</sup> for a greater rate of interest than ten per cent per annum shall be void, as to principal and interest, and the General Assembly shall prohibit the same by law; but when no rate of interest is agreed upon, the rate shall be six percent per annum."<sup>2</sup> This provision is com-

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1. "All contracts include bonds, bills, notes and all other contracts, verbal or written, whereby a rate of interest greater than ten per centum per annum is reserved, taken or secured, or agreed to be taken or reserved, as fully and completely as if they had been severally and particularly enumerated in the constitution and declared void." *German Bank v. DeShon*, 41 Ark. 331, 341 (1883).

2. Ark. Const. art. 19, § 13. All contracts that are found to be usurious are void as to the principal and interest. The title to property used to secure a usurious contract is absolute in the borrower. *Sloan v. Sears, Roebuck & Co.*, 228 Ark. 464, 473-74, 308 S.W.2d 802, 808 (1958). If the borrower voluntarily pays the entire contract price, however, he may only recover the excess interest he paid. *Harris v. McCann*, 229 Ark. 972, 983, 319 S.W.2d 832, 838 (1959). One cannot purge a usurious contract by a retroactive correction or a subsequent disclaimer. *First Nat'l Bank v. Thompson*, 249 Ark. 972, 977, 463 S.W.2d 87, 89 (1971); *Holland v. C.T. Doan Buick Co.*, 228 Ark. 340, 342, 307 S.W.2d 538, 539 (1957). However, the taint of usury may be removed where the lender made a mistake of fact. *Davidson v. Commercial Credit Equip. Corp.*, 255 Ark. 127, 129, 499 S.W.2d 68, 69 (1973).

monly referred to as a usury law. The term "usury" is ordinarily defined as an excessive charge for the loan or forbearance of money.<sup>3</sup>

It has been stated by the Arkansas Supreme Court in dictum that the facts and circumstances existing at the instant the contract is consummated determine whether the contract is usurious;<sup>4</sup> however, this statement has mainly been used to discredit a lender's attempt to purge the contract of usury after it has been discovered by the borrower.<sup>5</sup> All attendant circumstances germane to the transaction in question will be considered by the court,<sup>6</sup> and the substance, rather than the form, of the transaction is scrutinized.<sup>7</sup> The test for usury is a comparison of the amount the borrower is required to pay with the total amount he could be required to pay at a maximum rate of interest for the term, using the statutory system of applying payments first to interest and the excess to the principal.<sup>8</sup>

In order for a contract to be usurious, there must be an intention to take or reserve more than 10% interest per annum for the loan or forbearance of money;<sup>9</sup> there need not be an actual intent to violate the statute or constitution.<sup>10</sup> The Arkansas Supreme Court has held that the statutory offense of usury neither requires that there be a corrupt bargain<sup>11</sup> nor does it require that there be a concurrence of intent by the parties.<sup>12</sup>

In order for one to determine whether a contract is usurious, one must understand the term "interest." Interest may be defined as the difference between the principal of the loan and the face amount of the contract.<sup>13</sup> It is an amount of money charged for the forbearance or extension of time for the payment of the principal balance of the loan.<sup>14</sup> The nominal interest rate recited in the contract may not be

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3. *Mid-State Homes, Inc. v. Knight*, 237 Ark. 802, 803, 376 S.W.2d 556, 557 (1964).

4. *Sloan v. Sears, Roebuck & Co.*, 228 Ark. 464, 469, 308 S.W.2d 802, 806 (1958). *But see Harris v. McCann*, 229 Ark. 972, 976, 319 S.W.2d 832, 836 (1959).

5. *Gen. Contract Corp. v. Duke*, 223 Ark. 938, 941, 270 S.W.2d 918, 919-20 (1954).

6. *Textron, Inc. v. Whitener*, 249 Ark. 57, 59, 458 S.W.2d 367, 368 (1970).

7. *Hare v. Gen. Contract Purchase Corp.*, 220 Ark. 601, 249 S.W.2d 973 (1952); *Armstrong v. McCluskey*, 188 Ark. 406, 65 S.W.2d 558 (1933).

8. Ark. Stat. Ann. § 68-606 (Repl. 1957). *See Davidson v. Commercial Credit Equip. Corp.*, 255 Ark. 127, 131, 499 S.W.2d 68, 70 (1973).

9. *Garvin v. Linton*, 62 Ark. 370, 376, 35 S.W. 430, 432 (1896). *See also Siebert v. Hall*, 63 F.2d 517, 522 (8th Cir. 1933).

10. *Holland v. C.T. Doan Buick Co.*, 228 Ark. 340, 343, 307 S.W.2d 538, 540 (1957).

11. *Garvin v. Linton*, 62 Ark. 370, 378, 35 S.W. 430, 432 (1896).

12. *Id.* at 376, 35 S.W. at 432. *But see Commercial Credit Plan, Inc. v. Chandler*, 328 Ark. 966, 971, 239 S.W.2d 1009, 1012 (1951); *Armstrong v. McCluskey*, 188 Ark. 406, 410, 65 S.W.2d 558, 559 (1933) (dictum).

13. *Andrews v. Martin*, 245 Ark. 1010, 1012, 436 S.W.2d 285, 288 (1969).

14. *Pacific Indus., Inc. v. Mountain Inn, Inc.*, 232 F. Supp. 801, 806 (W.D. Ark. 1964).

the effective rate which a borrower actually pays. Some lenders calculate interest by the use of a 360/360 daily interest factor computation.<sup>15</sup> When this method is used, the lender is assuming that there are thirty days in each month, twelve months in a year, and 360 days in a year.<sup>16</sup> In determining the daily interest factor, the total annual percent interest charged is divided by 360.<sup>17</sup> The monthly factor is determined by multiplying the daily factor by thirty, regardless of how many actual days there are in that particular month;<sup>18</sup> therefore, the monthly interest factor is the same for each month in the year. The effect of using a 360/360 computation is that the effective annual rate of interest is the same as that which is recited by the contract;<sup>19</sup> however, the interest charged for a particular month such as February may be greater than that which would be charged if the lender were using a 365/365 computation.<sup>20</sup> When one uses a 365/360 computation to determine the daily interest factor, the annual percentage rate being charged is divided by 360 to determine the daily interest rate.<sup>21</sup> The daily factor is then multiplied by the *exact* number of days in the month to determine the amount of interest to be charged for that month.<sup>22</sup>

The term "compound interest" refers to a method whereby the unpaid accrued interest on the balance due is added to the principal amount of the obligation and thus becomes part of the total amount on which interest for the next payment is calculated.<sup>23</sup> The use of compound interest may render a contract usurious if such compounding effectively raises the annual interest rate above 10%.<sup>24</sup> However, it has been held that parties may lawfully agree that the unpaid interest on a note calling for 10% annual interest, payable in twelve monthly installments, shall become part of the principal at the end of the year and bear the same rate of interest thereon.<sup>25</sup>

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15. *Silverstein v. Shadow Lawn Sav. & Loan Ass'n*, 51 N.J. 30, —, 237 A.2d 474, 477 (1968).

16. *Id.*

17. *Id.*

18. *Id.*

19. *Id.*

20. The monthly factor on a note calling for 10% interest as calculated by the 360/360 method would be .008331 for all months, including February. A monthly factor determined by the 365/365 method for the month of February would be .0076692 on a 10% note. This factor is multiplied by the unpaid principal balance to determine the interest charge for the month.

21. *Silverstein v. Shadow Lawn Sav. & Loan Ass'n*, 51 N.J. 30, —, 237 A.2d 474, 477 (1968).

22. *Id.*

23. *Grider v. Driver*, 46 Ark. 50, 51 (1885).

24. *Id.* (dictum).

25. *Carney v. Matthewson*, 86 Ark. 25, 27, 109 S.W. 1024 (1908). *See also* Phipps-

Another method of calculating interest used by lenders to exact interest in excess of that recited by the contract is called discounting. This method may be illustrated by a lender who contracts to loan to a borrower \$1000 at 10% per annum interest. Instead of giving the borrower \$1000, he may discount the note by reserving \$100 (10%) at the outset. Borrower receives \$900 and when the note falls due, he pays the full \$1000. He has thus paid \$100 for the use of \$900 for a year. The true or effective rate of interest is 11.1% per annum.<sup>26</sup>

Another method of interest calculation in which a difference between the nominal rate and the effective rate arises is the addition of interest to the principal amount of an obligation to be repaid in installments. When the "add-on" method is used, the lender calculates the dollar amount of interest to be exacted over the entire life of the loan. The interest is then added to the principal amount of the debt and becomes part of the principal obligation. The amount of each installment is determined by dividing the total amount to be paid by the total number of installments.<sup>27</sup> The borrower is required to pay interest over the entire life of the loan on the total amount of the obligation even though he is reducing the principal with each installment paid.<sup>28</sup> For example, a \$2000 loan payable in thirty-six monthly installments at 8% annual interest, would be evidenced by a note for \$2480.<sup>29</sup> If the note were paid according to its terms, the lender would receive a true interest rate of 15.57% per annum.<sup>30</sup>

The correct way to calculate interest when the borrower is reducing the principal by installments is specified in the Arkansas statutes:

[T]he interest shall be calculated to the time when the first payment shall have been made, and such payment shall be applied to the payment of such interest; and if such payment exceed the interest, the balance shall be applied to diminish the principal, and the same course shall be used in all subsequent payments; but in no case when a payment shall fall short of paying the interest due at the time of making such payment shall the balance of such interest be added to the principal.<sup>31</sup>

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Reynolds Co. v. McIlroy Bank and Trust Co., 197 Ark. 621, 124 S.W.2d 222 (1939). Cf. Daniels v. Johnson, 234 Ark. 315, 351 S.W.2d 853 (1962).

26. First Nat'l Bank v. Nowlin, 374 F.Supp. 1037, 1039 (E.D. Ark. 1974).

27. *Id.*

28. *Id.*

29. *Id.*

30. *Id.*

31. Ark. Stat. Ann. § 68-606 (Repl. 1957).

A contract that recites a face value of 10% interest may be rendered usurious by the court's characterization of a service or finance charge as interest.<sup>32</sup> In such a contract, the service charge is included in the principal amount of the loan on which the 10% interest is computed. The court's characterization of a service charge as interest turns on whether the charge inures to the benefit of the lender rather than to the benefit of the borrower.<sup>33</sup> The court will look beyond mere labels affixed to charges; thus, a meaningless label attached to such a charge does nothing to validate it.<sup>34</sup> The court may assume until it is convinced by proof to the contrary that the difference between the principal of the loan and the face amount of the contract represents interest on the debt.<sup>35</sup>

In a like manner, a "carrying charge," "time-price differential," "finance charge," or "service charge" added to the cash price of merchandise sold on credit may be viewed as interest and thus render the contract void for usury.<sup>36</sup> It has been held that the addition of the pro rata share of overhead to the principal of a loan is the addition of interest.<sup>37</sup> Similarly, a bonus added to the principal is viewed as interest if the bonus inures to the benefit of the lender's agent.<sup>38</sup>

On the other hand, a service charge based in whole or in part on services rendered for the benefit of the borrower is viewed as a legitimate addition to the principal even though the named compensation may be greater than that which is usually paid for services of the same kind.<sup>39</sup> There is a divergence of authority on the question of whether the discount of a note in Arkansas with general endorsement for a sum in excess of 10% annual interest constitutes usury.<sup>40</sup>

The Arkansas Supreme Court has held that an honest error of calculation will not render a contract usurious.<sup>41</sup> If the lender by

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32. *Sloan v. Sears, Roebuck & Co.*, 228 Ark. 464, 308 S.W.2d 802 (1958); *Hare v. Gen. Contract Purchase Corp.*, 220 Ark. 601, 607-10, 249 S.W.2d 973, 977-78 (1952) (caveat).

33. *Smith v. Eason*, 223 Ark. 747, 750, 268 S.W.2d 389, 390 (1954).

34. *Harris v. McCann*, 229 Ark. 972, 977, 319 S.W.2d 832, 835 (1959) (dictum).

35. *Id.* See also *Jones v. Jones*, 227 Ark. 836, 838, 301 S.W.2d 737, 738 (1957).

36. *Sloan v. Sears, Roebuck & Co.*, 228 Ark. 464, 308 S.W.2d 802 (1958). See also *Hare v. Gen. Contract Purchase Corp.*, 220 Ark. 601, 607-10, 249 S.W.2d 973, 977-78 (1952) (caveat).

37. *Strickler v. State Auto Finance Co.*, 220 Ark. 565, 574, 249 S.W.2d 307, 311 (1952).

38. *Smith v. Eason*, 223 Ark. 747, 750, 268 S.W.2d 389, 390-91 (1954).

39. *Siebert v. Hall*, 63 F.2d 517, 521 (8th Cir. 1933).

40. *Haley v. Greenshaw*, 235 Ark. 481, 486, 360 S.W.2d 753, 756 (1962). But see *First Nat'l Bank v. Nowlin*, 374 F. Supp. 1037, 1041 (E.D. Ark. 1974). See generally *Hare v. Gen. Contract Purchase Corp.*, 220 Ark. 601, 249 S.W.2d 973 (1952).

41. *Davidson v. Commercial Credit Equip. Corp.*, 255 Ark. 127, 129, 499 S.W.2d 68, 69

mistake of fact, by error in calculation, or by inadvertence in the insertion of an incorrect date contracts to receive an illegal rate of interest, such mistake, error, or inadvertence will not stamp the contract with the taint of usury.<sup>42</sup> However, when the lender uses the wrong interest rate in computing the amount of interest to be charged, he commits a mistake of law that will not be forgiven.<sup>43</sup> Similarly, if the lender charges 10% annual interest on the outstanding principal on the same day each year regardless of when the advances were made, he has made a mistake of law that renders the contract usurious.<sup>44</sup> A lender may not assume for the purpose of computing interest that there are four weeks in every month and thus charge the borrower 10% interest based on a forty-eight week year. The lender is charged with knowledge of a fifty-two week year.<sup>45</sup>

The Arkansas Supreme Court held in *Cagle* that the use of a 365/360 daily interest factor computation in addition to the use of a compound monthly interest charge rendered the construction note that recited 10% annual interest void for usury.<sup>46</sup> It is implicit in the opinion that either method alone would have rendered the contract void for usury because each method raised the effective annual interest rate above 10%.<sup>47</sup>

Boyle Mortgage Company argued that there was no intent to collect a usurious rate of interest since the note recited a face value of 10% annual interest.<sup>48</sup> The court was not persuaded by this argument because Boyle's monthly statements showed a computation of interest above the legal rate.<sup>49</sup> It was significant that in a companion transaction with *Cagle*, Boyle collected the principal and interest on the loan in accordance with the monthly statements that had been sent to *Cagle*.<sup>50</sup>

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(1973); *Whiddon v. Universal C.I.T. Credit Corp.*, 227 Ark. 824, 826, 301 S.W.2d 567, 568 (1957).

42. *Davidson v. Commercial Credit Equip. Corp.*, 255 Ark. 127, 129, 499 S.W.2d 68, 69 (1973).

43. *Ford Motor Credit Co. v. Catalani*, 238 Ark. 561, 564, 383 S.W.2d 99, 101 (1964). Lender believed that 10.5% interest was the maximum legal rate in Arkansas.

44. *Brooks v. Burgess*, 228 Ark. 150, 153, 306 S.W.2d 104, 106 (1957).

45. *Holland v. C.T. Doan Buick Co.*, 228 Ark. 340, 344, 307 S.W.2d 538, 540 (1957).

46. *Cagle v. Boyle Mortgage Co.*, 261 Ark. 437, 440, 549 S.W.2d 474, 475 (1977).

47. *Id.* at 439, 549 S.W.2d at 475.

48. *Id.* at 440, 549 S.W.2d at 475.

49. *Id.*

50. *Id.*

Boyle also argued that it made a mistake of fact in the calculation of the interest and that the note and mortgage should be enforced according to its provisions.<sup>51</sup> The court discounted this argument, stating that it was not convinced that the monthly statements were mere mathematical errors in calculation.<sup>52</sup> The court cited two mistake of law cases to support the proposition that mathematical errors which are caused by a misconception of Arkansas law will not be forgiven.<sup>53</sup> It therefore seems that the Arkansas Supreme Court based its holding in *Cagle* upon a finding that Boyle's calculation of interest was induced by a mistake of law which was not forgivable.

*Cagle* is important because it is the first Arkansas case to deal with the 365/360 daily interest factor computation. The case implicitly held that any contract that recites a 10% simple interest rate will be held void for usury if the 365/360 method of computation of daily interest is used. It is significant to note that the holding in *Cagle* is not expressly limited to long-term contracts.

States other than Arkansas have ruled on this matter but have distinguished between long-term and short-term contracts. The New Jersey Supreme Court held that the 365/360 computation of daily interest may not be used to calculate interest on loans that are to extend beyond a period of one year; however, that court sanctioned the use of 365/360 daily interest factor for short-term loans (less than one year) as a part of the custom and usage of lending institutions.<sup>54</sup>

The Mississippi Supreme Court held in 1840 that the 365/360 method of computing daily interest would not render a contract that recited the maximum legal rate of interest usurious.<sup>55</sup> This rule was reaffirmed by the Mississippi Supreme Court in 1938<sup>56</sup> because of the long reliance of the commercial world upon the rule that was stated in 1840.<sup>57</sup> The reaffirmance was also based on the fact that Mississippi has a statute authorizing the use of a 360-day year when

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51. *Id.*

52. *Id.*

53. *Id.*, citing *Ford Motor Credit Co. v. Catalani*, 238 Ark. 561, 383 S.W.2d 99 (1964); *Brooks v. Burgess*, 228 Ark. 150, 306 S.W.2d 104 (1957).

54. *Silverstein v. Shadow Lawn Sav. & Loan Ass'n.*, 51 N.J. 30, —, 237 A.2d 474, 479 (1968).

55. *Planter's Bank v. Snodgrass*, 4 How. 573 (Miss. 1840).

56. *Dickey v. Bank of Clarksdale*, 183 Miss. 748, 184 So. 314 (1938).

57. *Id.* at —, 184 So. at 316.

computing interest for fractional parts of the year. The Mississippi Supreme Court stated that what is nonusurious for a fractional part of the year, such as 360 days, should be good as to a whole year, 365 days:

If the note [for \$1500] had been made for 180 days, 4% interest could have been lawfully collected on the completion of the 180 days, and a renewal taken for another 180 days, at the end of which time another 4% interest could have been lawfully collected, making 8% or \$120 at the end of 360 days; and then the note could have been renewed for 5 days and \$1.67 in interest could have been collected, making the total interest of \$121.67 for the 365 days.<sup>58</sup>

An argument similar to the one made by the Mississippi court could be made in Arkansas because title 68, section 605 of Arkansas Statutes Annotated<sup>59</sup> authorizes the use of a 360-day year when computing interest for fractional parts of the year. It states that “[f]or the purpose of calculating interest, a month shall be considered the twelfth part of a year, and as consisting of thirty (30) days; and interest for any number of days less than a month, shall be estimated by the proportion which such number of days shall bear to thirty (30).”<sup>60</sup> Although the Arkansas Supreme Court did not consider the effect of *Cagle* on this statute, it is possible that the statute will be held to be unconstitutional because of the holding in *Cagle*. It might therefore be wise for lenders who are relying on this statute to change their method of computing daily interest to 365/365. Likewise, the use of a 360/360 daily interest factor may cause some contracts reciting a 10% annual interest to exceed the legal rate.

The decision in *Cagle* affects every lender and “credit seller” of merchandise who has relied upon the 365/360 method of calculating a daily interest factor on contracts reciting a 10% simple interest. The impact is clear: All such contracts are void as to principal and interest. A mistake of law is no defense. Lender beware!

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58. *Id.* at —, 184 So. at 315.

59. (Repl. 1957).

60. Ark. Stat. Ann. § 68-605 (Repl. 1957).