#D-300 6/29/81

Second Supplement to Memorandum 81-24

Subject: Study D-300 - Enforcement of Judgments (AB 707--Rate of Interest on Judgments)

Section 685.010 (page 20 of AB 707) provides that interest accrues at the rate of 10 percent on a money judgment. The section also provides that the Legislature reserves the right to lower this rate in the future and to make the lower rate applicable to interest on judgments then existing or thereafter entered. The lower interest rate would apply only to interest that accrues after the operative date of the act which lowers the interest rate. This is consistent with the prior published recommendation of the Law Revision Commission on the rate of interest.

It appears likely that the Legislature at the 1981 session will enact legislation to provide for a variable rate of interest based on a statutory formula. This raises the policy issue whether the provisions relating to interest in AB 707 should be revised to conform to this formula which probably will be enacted in 1981. The staff recommends that no change be made in the rate of interest provisions of AB 707.

Senate Bill 203 was introduced in 1981 by Senator Rains, the Senate member of the Law Revision Commission, to effectuate the Commission's recommendation on the rate of interest on judgments. The bill passed the Senate. It was supported by the California Judges Association, the California Bankers Association, the California Trial Lawyers Association, the Association of Municipal Court Clerks of California, the Los Angeles County Municipal Court Judges' Association, and the State Bar of California. It was opposed by the State Farm Insurance Companies. The bill was set for hearing by the Assembly Judiciary Committee on June 24. At the time of the hearing, Senator Rains offered amendments to the bill to incorporate a variable rate theory of interest on judgments. I did not know prior to the hearing that he intended to do this. He advised me that he had decided to amend the bill because he believes that the variable rate theory was a more desirable statutory solution to the interest problem than the solution proposed by the Law Revision Commission.

The amendment offered by Senator Rains would delete the substance of Section 685.010 of AB 707 and substitute the following standard for the rate of interest on a money judgment:

> 1916.7. The rate of interest upon a judgment rendered in any court of this state shall be 3 percent per annum plus the rate prevailing on the 25th day of December or the 25th day of June whichever most closely precedes the date of entry of the judgment established by the Federal Reserve Bank of San Francisco on advances to member banks under Sections 13 and 13a of the Federal Reserve Act as now in effect or hereafter from time to time amended, rounded off to the nearest whole percentage point (or if there is no such single determinable rate for advances, the closest counterpart of such rate as shall be designated by the Superintendent of Banks of the State of California). The rate of interest upon a judgment shall not, however, in the aggregate exceed 10 percent per annum.

The Commission considered this solution and strongly rejected it in the Commission's recommendation. See the discussion beginning at the bottom of page 12 of the attached Commission recommendation. The formula's deficiency when the discount rate is above 7 percent is that a person--especially the uninformed judgment creditor or judgment debtor--cannot tell from the statute what the interest rate is. How is the average person going to obtain the necessary information to determine what the interest rate is? If the discount rate does fall below seven percent, there will then be judgments with interest at varying rates and the court clerks will have to maintain records of the rate on each judgment and the levying officers will have to make sure that the proper rate is applied to each judgment. The plaintiff will have to compute interest at the proper rate and the court clerk will have to check the interest as to rate and computation on each judgment when a writ of execution is obtained. See Exhibit 1 attached.

The staff wonders how the new interest provision will apply to statutory or contract provisions that provide for interest "at the legal rate" or "at the rate payable on money judgments."

A serious problem is presented by amended SB 203 as to how the bill will apply to judgments entered before its operative date. It may be that the bill is intended not to raise the interest rate above 7 percent for judgments entered prior to the operative date of the bill. This would be consistent with the scheme that the date of entry fixes the rate of interest and that that rate remains in effect throughout the life of the judgment. However, the bill <u>will</u> apply to judgments entered

prior to the operative date since a provision of the bill specifies that it applies to the rate of interest after the operative date on judgments entered prior to the operative date. The staff believes this is a reasonable provision in view of the grossly inadequate rate of interest under existing law. But the bill requires that the rate of interest be determined according to the statutory formula as of the date of entry of the judgment. This means that for existing judgments, the court clerk will have to apply the formula in the statute to determine what the rate under the formula would be using the discount rate as of the date of the entry of the judgment and the rate so computed will be the rate of interest on the judgment after the operative date of the new statute. This will require the court clerk to use the formula and apply it to all the judgments entered in past years.

Another serious problem presented by the bill is its application to judgments for child and spousal support and to other installment judgments. The rate of interest will be determined as of the date of entry of the judgment. But interest will not commence to accrue until there is a default in the payment of an installment, which may occur many years after the judgment was entered. For existing support judgments, this will require a computation of the rate under the formula for many years in the past. What would be the effect of a modification of the support order? Would the date of modification be considered the date of entry of the judgment? For new judgments entered after the statute is enacted, the rate will be computed according to the discount rate at a time different than the time where there is a failure to pay pursuant to the judgment. This would be unfair to the support obligor who has paid support as required for a number of years and then defaults on a payment. Or is the interest rate to be computed at the rate applicable at the time of each default in an installment?

The staff is also concerned about the meaning of the last sentence of the proposed interest rate provision. It provides: "The rate of interest upon a judgment shall not, however, in the aggregate exceed 10 percent per annum." Does the "in the aggregate" limitation mean that the average rate of interest over the life of the judgment may not exceed 10 percent, so that if the judgment bears interest at a lesser rate than 10 percent for a period, then it may bear interest at a greater rate than 10 percent for a period, so that the aggregate rate over the

total period is 10 percent? For example, suppose a money judgment is entered at a time when the interest rate is 7 percent and remains unpaid for 5 years. Can the interest rate under the formula then be 13 percent for the next five years, since the "aggregate interest rate" for the 10-year period will then be 10 percent? The provision cannot be given this meaning, however, because the state constitution provides that the rate of interest upon a judgment shall be "not more than 10 percent per annum." This being the case, the staff is unable to understand the meaning of the phrase "in the aggregate."

Consideration should be given to the effect of renewal of a judgment under the new procedure provided by AB 707 and the effect of renewal on the rate of interest. When an action is brought on a judgment and a new judgment is entered, it appears likely that the interest rate would be determined under SB 203 as of the date of entry of the new judgment. In the case of a judgment renewed by the new procedure under AB 707, since the date of entry determines the rate of interest, the adoption of the scheme of SB 203 makes necessary a specific provision for the rate of interest on the renewed judgment. In order to avoid the cost to the county of keeping records relating to the judgment prior to renewal and in the interest of simplification, AB 707 should be revised to provide that the rate of interest on a renewed judgment is determined as of the date of renewal if the variable interest rate and the date of entry scheme is to be retained.

The benefit of the variable rate formula is, of course, that it is not necessary to amend the law in the event that the discount rate falls below seven percent--the rate automatically is adjusted downward. (However, under the formula, the rate is never adjusted downward on existing judgments.) The staff believes that this benefit is too slight to justify the confusion created by inserting a formula that the average person cannot understand into the statute and the confusion and extra expense of county clerks and levying officers should the discount rate ever fall below seven percent. Also, if the increased rate is to apply to existing judgments, the administrative costs of computing the interest rate on existing judgments based on the date of entry of the judgment would be substantial. The problems identified above caused the Commission to recommend a flat 10 percent rate. Accordingly, we recommend that no change be made in the interest rate provisions of AB 707.

The California State Legislative Committee, Credit Managers Associations, approved the flat 10 percent interest rate provision of AB 707 but suggested that "if at all possible the interest rate [should] be established at a percentage higher than the suggested ten percent (10%). . . ." See Exhibit 1 of the Third Supplement to Memorandum 81-24 (page 1). The Committee gives reasons in support of this suggestion. However, the rate of interest is limited by the California Constitution to 10 percent. The only issue presented is whether the Commission wishes to draft a recommendation to propose a constitutional amendment to increase the rate of interest. If so, the staff could prepare background information on this problem. It would appear, however, that there are various interest groups that could sponsor such a constitutional amendment and that the efforts of the Commission would better be directed to other areas of the law.

Respectfully submitted,

John H. DeMoully
Executive Secretary

Exhibit 1

BANK OF AMERICA

SOUTHERN CALIFORNIA HEADQUARTERS

January 21, 1981

RICK SCHWARTZ
Senior Counsel
(213) 683-2522

Alan Pedlar, Esq.
Chairman
Stutman, Treister & Glatt
3701 Wilshire Boulevard, Penthouse
Los Angeles, California 90010

Re: AB 188

Dear Mr. Pedlar:

AB 188 introduced by Assemblyman Statham is identical to AB 2026 which he introduced last year. It proposes to set the rate of interest on judgments rendered in California at 3% over the prevailing discount rate at the San Francisco Federal Reserve Bank on the 25th day of the month preceding the date of entry of judgment.

The maximum rate on judgments authorized by the voters in 1978 was 10%, and the proposed legislation would have a 10% cap.

Last year the Committee reviewed AB 2026 and recommended that legislation be enacted simply calling for a flat 10% rate of interest on all existing and future judgments. Although it is unlikely, based upon the formula in Assemblyman Statham's AB 188, that the rate of interest would ever be below 10%, if the discount rate did dip below 7% considerable confusion could occur. The legislature clearly has the power to change the rate of interest if economic conditions change to the extent that a reduction from 10% is deemed to be necessary or desirable.

Since the Internal Revenue Service has now increased to 12% the amount of interest it charges on delinquent taxes, it does not appear unreasonable that a flat 10% rate of interest on existing and future judgments be legislated.

A floating rate of interest on judgments is not practical or necessary and could cause considerable confusion in determining the rate of interest if in fact the discount rate was reduced below 7% for any period of time. Indeed, the discount rate frequently changes several times during a year, and it would be nearly impossible to require the plaintiff and/or clerks of the Municipal Court to compute accrued interest if the rate changed several times during a one year period. SB 1394 introduced last year adopted a flat 10% rate of interest on judgments however, it had an insurance industry backed 7% rate for judgments on appeal.

Governor Brown vetoed SB 1394 last year because it had the special 7% rate of interest for judgments on appeal. Governor Brown indicated in his veto message that he would not sign legislation with the 7% provision in it and that the legislature should pass legislation increasing the interest rate to a flat 10%.

Indeed, of all of the bills proposed last year by the California Law Revision Commission, the only bill which was not enacted was a bill raising the rate of interest on judgments to a flat 10% without the "floating rate" provided in Assemblyman Statham's bill which has been reintroduced as AB 188 in this session.

We should support the California Law Revision Commission's proposal to increase the rate of interest on judgments to a flat 10% which is the maximum amount authorized by the California Constitution or amend AB 188 to provide for a flat 10% rate.

Very truly yours,

Rick Schwarz
Vice Chairman

RS:cl

cc: Committee Members

RECOMMENDATION

relating to

INTEREST RATE ON JUDGMENTS

The California Constitution sets the rate of interest on judgments at seven percent, but gives the Legislature authority to set the rate at not more than 10 percent and to provide a variable rate.[1] The Legislature has not exercised this authority.

Postjudgment interest serves two important functions—it compensates the judgment creditor for the loss of use of the money until the judgment is paid and it acts as an incentive for the judgment debtor to pay the judgment promptly. These functions are served when the rate of interest on judgments approximates the prevailing interest rate in the money market. The judgment creditor is compensated at a rate that would be obtainable were the judgment satisfied and the funds available for investment; the judgment debtor has no incentive to delay payment since it would not be advantageous to invest the money elsewhere.

When the rate of interest on judgments is below the market rate, however, neither of the functions of postjudgment interest is accomplished. The judgment creditor is not fully compensated for the loss of use of the money and the judgment debtor is motivated to defer payment of the judgment as long as possible in order to make money by investing at the market rate. This is the situation in California at present. With the interest rate on judgments at seven percent and the market rate at 12 percent or higher, the judgment debtor may delay payment as long as possible and benefit from the five percent or greater interest differential during the period of delay.

The insurance industry is perhaps the most identifiable group that benefits from maintaining a below market rate of interest on judgments. Insurance company reserves for the payment of claims may be invested at the market rate, so any delay in payment of a judgment that accrues interest

[1] Cal. Const., Art. 15, § 1.

at a low rate is advantageous. The Commission is informed that when an insurance company loses a judgment, it frequently files a notice of appeal and obtains a stay of enforcement, thereby giving it the benefit of several months' delay in payment. Ordinarily the appeal is not pursued further unless there is a legitimate issue justifying an appeal in the case.[2] Where an appeal is pursued further, the process can take several years and the loss of money to the creditor and the gain to the debtor resulting from a low interest rate on the judgment can be substantial. For less responsible debtors than insurance companies, a low interest rate is also an incentive to avoid prompt and voluntary payment for as long as possible thereby forcing resort to execution with its delays.

For these reasons, most jurisdictions have increased the rate of interest on judgments. The following chart indicating the changes that have occurred in the various jurisdictions in the past decade is instructive.

Rate (percent)	*Number of States*	
	1968	*1979*
4	1	0
5	5	1
6	40	22
7	4	4
8	0	13
8.75	0	1
9	0	1
10	0	6
12	0	2

The Law Revision Commission believes that California's interest rate on judgments should be increased to a rate that more nearly approximates market rate. One possible approach is to adopt a flexible or variable interest rate on judgments based on a standard such as the prime rate, Federal Reserve Bank discount rate, or treasury bill

[2] Prosecution of an appeal for the sole reason of delaying payment of the judgment appears to be infrequent; the costs of appeal may outweigh any profit to be made by exploitation of the interest rate differential.

discount rate.[3] Ideally, such a variable rate would be continuously revised by a state agency and the interest accruing on the judgment would continuously change. The Commission believes that such a scheme would be too complex and would be impractical to administer.

An alternative is to allow the interest rate to vary from time to time and to have a single rate for each judgment based on the rate in effect at the time of entry. This scheme would make the interest rate on a judgment a rough approximation of market rate at the time of entry, although if the judgment were not satisfied promptly this interest rate could easily become out of line with changing market rates. This scheme would also necessitate a procedure to preserve a record of the interest rate in effect at the time of entry of the judgment. The Commission believes that this scheme would require too much administration for too little benefit.

A third alternative—the one recommended by the Commission—is to fix the interest rate on judgments at 10 percent but to reserve to the Legislature the right to lower the rate at any time both as to judgments thereafter entered and judgments previously entered. The virtues of this scheme are:

(1) It is simple—there is no need for bureaucratic computations of market rates; there will be a single rate known by debtor, creditor, court clerk, and levying officer.

(2) It is accurate—it appears unlikely that the market rate will drop below 10 percent in the near future.

(3) It satisfies the functions of postjudgment interest—to compensate the judgment creditor as nearly as possible and remove the judgment debtor's incentive to delay payment.

Fixing the rate at 10 percent creates a danger of inequity should the market rate drop below 10 percent and the debtor in fact be unable to pay the judgment. But the proposed law allows the Legislature to enact legislation to change the interest rate on judgments and to make the new rate applicable to all judgments, whether entered before or after the rate change.[4] This will avoid the inequity that might otherwise result.

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[3] Senate Bill 101 (Rains) was introduced in the Legislature at the 1979 session to provide a variable interest rate based on the Federal Reserve Bank of San Francisco rate on advances to member banks. This rate would fluctuate monthly and thereby provide a constant corrective so that the legal rate of interest would approximate the market rate at the time of entry of judgment. The bill failed to obtain approval of the Judiciary Committee of the Senate.

[4] *Cf.* White v. Lyons, 42 Cal. 279 (1871) (prejudgment interest accrues at rate fixed by statute until time of change in statute and thereafter accrues at changed rate).