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Transactional Analysis in Usury Law: The Identification of Interest Student Symposium: A Study of Texas Usury Law.

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5069-1.08 allows the corporate rate of interest to be extended to consumer debit balances for Registered Securities brokers or dealers.[405] Article 5069-1.09 concerns certain loans guaranteed or insured by the federal government.[406] These loans include those made by the Federal Housing Administration and Veteran's Administration and are exceptions because they are regulated by federal laws.[407]

III. TRANSACTIONAL ANALYSIS IN USURY LAW: THE IDENTIFICATION OF INTEREST

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This section will examine judicial analysis of some of the more common techniques implemented by creditors attempting to maximize their return on loans while remaining within the applicable interest ceilings. Fundamental to this analysis is consideration of various charges levied in connection with loans to determine whether these charges will be treated as interest by courts examining transactions for usury.[408] The Texas Legisla-

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405. *See id.* art. 5069-1.08.

> Interest charged by a broker or dealer registered under the Federal Securities and Exchange Act of 1934, as now or hereafter amended, and the Securities Act, as now or hereafter amended, for carrying a debit balance in an account for a customer shall not be subject to any of the limitations or other provisions of Title 79, Revised Civil Statutes of Texas (Article 5069-1, et. seq., Vernon's Texas Civil Statutes) as now or hereafter amended, if such debit balance is payable on demand, or at will by the customer without penalty, and is secured by stocks, bonds, or other securities, and if such interest does not exceed a rate of 1½ percent per month on the monthly debit balance.

Id. art. 5069-1.08.

406. *See id.* art. 5069-1.09.

407.
> Any loan insured by the Federal Housing Administration, pursuant to the provisions of the National Housing Act approved June 27, 1934, its amendments and supplements (12 U.S.C.A., Section 17.01 et seq. (1969), as amended), may bear such rate of interest, or be discounted at such rate as is permitted under the National Housing Act, its amendments and supplements, and the regulations promulgated from time to time by the Federal Housing Administration or its successor; and provided further that any loan guaranteed or insured by the Veterans Administration or its successor pursuant to the provisions of the Veterans' Benefits code approved September 2, 1958, its amendments and supplements (Title 38 U.S.C.A. (1959), as amended), may bear such rate of interest or be discounted at such rate as is permitted under the Veterans' Benefits code, its amendments and supplements, and the regulations promulgated from time to time by the Veterans Administration or its successor.

Id. art. 5069-1.09. Concern over the constitutionality of this statute led the Federal National Mortgage Association to restrict and threaten a cut-off of its purchases of VA and FHA mortgages in Texas. The concern centered around allegations that by this statute the legislature had unconstitutionally delegated its duty to "fix maximum rates of interest" in Texas. *See* TEX. CONST. art. XVI, § 11; SAN ANTONIO LIGHT, May 3, 1979, at 6-A, col. 1; *id.*, May 1, 1979, at 1, col. 4.

408. Stipulation by the parties that certain compensation is not considered interest is not binding on the courts. The court will examine the entire transaction and determine what is or is not interest. *See* Gonzales County Sav. & Loan Ass'n v. Freeman, 534 S.W.2d 903,

ture has defined interest as the legal compensation "for the use or forbearance or detention of money."[409] As the following commentary will disclose, this definition has been subject to varying interpretations. In examining the transaction for the taint of usury, courts will look past the form of a transaction to its substance.[410]

DIRECT COMPENSATION

Front-End Fees

The term "front-end fee" is used broadly in reference to fees or charges collected by the lender at the time of making the loan.[411] These fees are commonly assessed in addition to the stipulated interest, and are therefore not referred to as interest by the parties.[412] It is well established in Texas that these fees are not considered interest when they constitute an extra charge for additional considerations separate from the lending of money.[413] The courts closely scrutinize front-end fees to determine whether they are bona fide charges for separate services or merely disguises to conceal usury.[414] Recompense exacted for ordinary operating costs or "overhead expenses" is not exempt from judicial classification as interest.[415]

Texas courts have held the following charges to be bona fide consideration for collateral services and therefore not interest within legislative con-

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906 (Tex. 1976); Stacks v. East Dallas Clinic, 409 S.W.2d 842, 845 (Tex. 1966); Schmid v. City Nat'l Bank, 132 Tex. 115, 117, 114 S.W.2d 854, 855 (1938).

409. TEX. REV. CIV. STAT. ANN. art. 5069-1.01(a)(Vernon 1971).

410. *See* Gonzales County Sav. & Loan Ass'n v. Freeman, 534 S.W.2d 903, 906 (Tex. 1976); Stacks v. East Dallas Clinic, 409 S.W.2d 842, 845 (Tex. 1966); Schmid v. City Nat'l Bank, 132 Tex. 115, 117, 114 S.W.2d 854, 855 (1938).

411. *See* Loiseaux, *Some Usury Problems In Commercial Lending*, 49 TEXAS L. REV. 419, 422-29 (1971); Comment, *Usury Implications of Front-End Interest and Interest in Advance*, 29 Sw. L.J. 748, 751-52 (1975).

412. *See* Comment, *Usury Implications of Front-End Interest and Interest in Advance*, 29 Sw. L.J. 748, 751-52 (1975).

413. *See, e.g.*, Ross v. Walker, 554 S.W.2d 189, 190 (Tex. 1977) (per curiam); Greever v. Persky, 140 Tex. 64, 66, 165 S.W.2d 709, 712 (1942); Nevels v. Harris, 129 Tex. 190, 196, 102 S.W.2d 1046, 1049 (1937). If there is a conflict in evidence regarding whether there exists a collateral service meriting separate consideration, it becomes a question of fact for the jury. *See* Ross v. Walker, 554 S.W.2d 189, 190 (Tex. 1977)(per curiam).

414. *See, e.g.*, Nevels v. Harris, 129 Tex. 190, 195-96, 102 S.W.2d 1046, 1048-49 (1937); James v. Davis, 150 S.W.2d 326, 333 (Tex. Civ. App.—Galveston 1941, writ dism'd judgmt cor.); C.C. Slaughter Co. v. Eller, 196 S.W. 704, 708 (Tex. Civ. App.—Amarillo 1917, no writ). The court in *Nevels* determined that a \$160 inspection fee and a \$64 attorney fee were bona fide separate considerations while ruling that a \$320 loan fee was interest. *See* Nevels v. Harris, 129 Tex. 190, 196, 102 S.W.2d 1046, 1048-49 (1937).

415. *See* Thrift Fin. Co. v. State, 351 S.W.2d 653, 655 (Tex. Civ. App.—Dallas 1961, writ ref'd n.r.e.).

templation: attorney fees,[416] recording fees,[417] inspection fees,[418] and membership fees.[419] Fees that have been judicially declared interest despite designation as something other than interest by the parties to the loan agreement include service charges,[420] closing fees,[421] handling charges,[422] carrying charges,[423] and origination charges.[424] It must be clearly noted that the labels attached to these fees are not binding upon the court.[425] When conflicting evidence results in dispute concerning whether the charge is simply a guise for additional interest charges, the matter becomes a jury question.[426]

A unique situation arises when a lender requires a third party to pay a fee as a condition precedent to approving a loan.[427] While this is a relatively

416. *See* Nevels v. Harris, 129 Tex. 190, 196, 102 S.W.2d 1046, 1048-49 (1937); Sapphire Homes, Inc. v. Gilbert, 426 S.W.2d 278, 284 (Tex. Civ. App.—Dallas 1968, writ ref'd n.r.e.); James v. Davis 150 S.W.2d 326, 333 (Tex. Civ. App.—Galveston 1941, writ dism'd judgmt cor.); Miller v. Gibralter Sav. & Bldg. Ass'n, 132 S.W.2d 606, 607-08 (Tex. Civ. App.—Beaumont 1939, writ dism'd judgmt cor.).

417. *See* Harrell v. Colonial Fin. Corp., 341 S.W.2d 545, 546 (Tex. Civ. App.—San Antonio 1960, writ ref'd n.r.e.).

418. *See, e.g.*, Nevels v. Harris, 129 Tex. 190, 192, 102 S.W.2d 1046, 1048-49 (1937); Harrell v. Colonial Fin. Corp., 341 S.W.2d 545, 545-46 (Tex. Civ. App.—San Antonio 1960, writ ref'd n.r.e.); Miller v. Gibralter Sav. & Bldg. Ass'n, 132 S.W.2d 606, 607-08 (Tex. Civ. App.—Beaumont 1939, writ dism'd judgmt cor.).

419. *See* Noel v. Panhandle Bldg. & Loan Ass'n, 85 S.W.2d 773, 776 (Tex. Civ. App.—Amarillo 1935, writ ref'd); *cf.* Loomis v. Blacklands Prod. Credit Ass'n, 579 S.W.2d 560, 563 (Tex Civ. App.—Waco 1979, no writ)(stock purchase required as condition to loan not interest); Hexemer v. Farm & Home Sav. & Loan Ass'n, 115 S.W.2d 458, 460 (Tex. Civ. App.—Fort Worth 1938, writ dism'd) (stock subscription separate contract and not interest though required as condition to loan).

420. *See* Thrift Fin. Co. v. State, 351 S.W.2d 653, 654-55 (Tex. Civ. App.—Dallas 1961, writ ref'd n.r.e.).

421. *See* Riverdrive Mall, Inc. v. Larwin Mortgage Investors, 515 S.W.2d 5, 8 (Tex. Civ. App.—San Antonio 1974, writ ref'd n.r.e.).

422. *See* Trinity Fire Ins. Co. v. Kerrville Hotel Co., 129 Tex. 310, 318-19, 103 S.W.2d 121, 125 (1937).

423. *See* Forreston State Bank v. Brooks, 51 S.W.2d 645, 646 (Tex. Civ. App.—Waco 1932, no writ).

424. *See* Terry v. Teachworth, 431 S.W.2d 918, 924 (Tex. Civ. App.—Houston [14th Dist.] 1968, writ ref'd n.r.e.).

425. *See* Gonzales County Sav. & Loan Ass'n v. Freeman, 534 S.W.2d 903, 906 (Tex. 1976). A common form of front-end fee is the "point," which is charged in addition to the stipulated interest. *Cf.* Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 783 (Tex. 1977); I.R.C. § 461(g)(2); Loiseaux, *Some Usury Problems in Commercial Lending*, 49 TEXAS L. REV. 419, 422 (1971); Comment, *Usury Implications of Front-End Interest and Interest in Advance*, 29 Sw. L.J. 748, 757-62 (1975). A "point" is equivalent to one percent of the principal. Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 783 n.6 (Tex. 1977); 19 CASE W. RES. L. REV. 819, 859 n.194 (1968).

426. *See* Gonzales County Sav. & Loan Ass'n. v. Freeman, 534 S.W.2d 903, 906 (Tex. 1976).

427. *See* Orlanski, *Usury and Third Party Payments*, 50 L.A. B. BULL. 262, 263 (1975).

common practice in the real estate loan industry,[428] Texas courts have rarely examined the usury implications of such a transaction.[429] In *Goodman v. Seely*[430] a fee paid by the vendor of real estate to the purchaser's lender as consideration for making the loan was held not to be interest.[431] Absent a finding that such a charge has ultimately been borne by the borrower/purchaser, it is unlikely to be declared interest by a court.[432] Conversely, in view of judicial proclivity to consider the substance of a transaction paramount to its form when testing for usury,[433] should the fact-finder determine that the seller has passed the charge on to the buyer through an inflated sales price, it is possible that "seller's points" may be judicially declared interest.[434]

A 1960 amendment to the Texas Constitution increased the legislature's authority to define usury,[435] and pursuant to this authority, the legislature enacted the Texas Savings and Loan Act.[436] Section 5.07 of the Act was apparently intended to permit savings and loan associations to charge "premiums" that were to be exempted from treatment as interest within the purview of usury statutes.[437] In *Wagner v. Austin Savings & Loan*

Lenders frequently attempt to circumvent usury laws and obtain a "double-digit" return on real estate loans through implementation of this practice. *See id.* at 263.

428. *See id.* at 262-63.

429. Goodman v. Seely, 243 S.W.2d 858 (Tex. Civ. App.—San Antonio 1951, writ ref'd), is apparently the only such transaction examined for usury by a Texas appellate court. *See* American Sav. & Loan Ass'n v. United States, No. H-77-833 (S.D. Tex., Nov. 13, 1978) (order denying motions for summary judgment).

430. 243 S.W.2d 858 (Tex. Civ. App.—San Antonio 1951, writ ref'd).

431. *Id.* at 860. There was no indication that the borrower/purchaser was required to absorb any portion of this fee. Actually it was found that the borrower was completely unaware of the agreement between the seller and lender. *See id.* at 850.

432. *Cf.* American Sav. & Loan Ass'n. v. United States, No. H-77-833 (S.D. Tex., Nov. 13, 1978) (order denying motions for summary judgment) (any increase in purchase price attributable to fee paid by seller to borrower's lender is interest); Goodman v. Seely, 243 S.W.2d 858, 860 (Tex. Civ. App.—San Antonio 1951, writ ref'd) (vendor's agreement to pay purchaser's lender a fee as consideration for approving loan is not an agreement to pay interest).

433. *See, e.g.*, Gonzales County Sav. & Loan Ass'n v. Freeman, 534 S.W.2d 903, 906 (Tex. 1976); Stacks v. East Dallas Clinic, 409 S.W.2d 842, 845 (Tex. 1966); Schmid v. City Nat'l Bank, 132 Tex. 115, 117, 114 S.W.2d 854, 855 (1938).

434. *See* American Sav. & Loan Ass'n v. United States, No. H-77-833 (S.D. Tex., Nov. 13, 1978) (order denying summary judgment).

435. TEX. CONST. art. XVI, § 11. Prior to 1960, the legislature's power to control usury was limited to enacting penalties for violations of the ten percent ceiling imposed by the constitution. *See* TEX. CONST. art. XVI, § 11 (1876). The 1960 amendment gave the legislature the power to define interest and to fix maximum interest rates. *See* TEX. CONST. art. XVI, § 11.

436. TEX. REV. CIV. STAT. ANN. art. 852a (Vernon 1964).

437. *Id.* § 5.07. Section 5.07 provides in pertinent part:

> Every association may require borrowing members to pay all reasonable expenses incurred in connection with the making, closing, disbursing, extending, readjusting or

Ass'n[438] the Beaumont Court of Civil Appeals held that "points" charged by the lender were to be considered "premiums" within the contemplation of section 5.07 of the Act, and were, therefore, not to be considered interest when testing for usury.[439] The *Wagner* interpretation was subsequently rendered inconsequential by *Gonzales County Savings & Loan Ass'n v. Freeman,*[440] when the court in effect ruled section 5.07 unconstitutionally vague for failure to define interest or fix a maximum rate of interest.[441] In *Freeman* the lender contended that a two point "loan fee" of $786 was a "commitment fee" or alternatively a "premium" and in either case not to be considered interest.[442] In response to the argument that the "loan fee" was a "premium," the court stated that savings and loan associations would not be permitted to circumvent usury laws merely by contending that front-end fees were legislatively sanctioned "premiums."[443] Noting that the fee under scrutiny plainly fit the statutory definition of interest,[444] the court ruled that pending legislative designation of maximum rates for these fees or a change in the statutory definition of interest, "premiums" will be considered interest in examining a loan transaction for usury.[445]

> renewing of *real estate loans*. . . . In addition, associations may charge *premiums*. . . . The expenses, fees and charges authorized herein . . . shall not be deemed to be part of the interest . . . within the meaning of any law of this State which limits the rate of interest which may be exacted in any transaction.

Id. § 5.07 (emphasis added).

438. 525 S.W.2d 724, 728 (Tex. Civ. App.—Beaumont 1975, no writ).

439. *Id.* at 728.

440. 534 S.W.2d 903 (Tex. 1976), *noted in* 13 HOUS. L. REV. 773 (1976).

441. *Id.* at 908. The legislature may not legalize a subterfuge allowing lenders to circumvent the maximum legal interest rates by not establishing a maximum. Community Fin. & Thrift Corp. v. State, 161 Tex. 619, 621, 343 S.W.2d 232, 234 (1961); *see* TEX. CONST. art XVI, § 11 ("The Legislature shall have the authority to . . . *define interest and fix maximum rates of interest;* provided, however, in the absence of legislation fixing maximum rates of interest all contracts for a greater rate of interest than ten per centum (10%) per annum shall be deemed usurious") (emphasis added). The failure of the legislature to specifically designate a maximum rate of interest in section 5.07 of the act effectively imposes the ten percent limit. *See* Gonzales County Sav. & Loan Ass'n v. Freeman, 534 S.W.2d 903, 908 (Tex. 1976); Community Fin. & Thrift Corp. v. State, 161 Tex. 619, 621, 343 S.W.2d 232, 234 (1961); TEX. CONST. art XVI, § 11.

442. *See* Gonzales County Sav. & Loan Ass'n v. Freeman, 534 S.W.2d 903, 905 (Tex. 1976). The case was remanded for a factual determination whether the "loan fee" was a reasonable fee. *Id.* at 908. For an examination of "commitment fees" in Texas, see notes 506-512 *infra* and accompanying text.

443. *Id.* at 908. The court again emphasized its intention to look beyond mere labels to the substance of the transaction. *Id.* at 908.

444. *Id.* at 908. Interest is statutorily defined as "compensation allowed by law for the use, forbearance or detention of money." TEX. REV. CIV. STAT. ANN. art. 5069-1.01(a) (Vernon 1971).

445. *See* Gonzales County Sav. & Loan Ass'n v. Freeman, 534 S.W.2d 903, 908 (Tex. 1976).

Unless the legislature responds to the *Freeman* decision, it is clear that "points" paid by a borrower will be considered interest if they do not constitute compensation for a bona fide collateral service.[446]

Interest in Advance

"Interest in advance" refers to prepaid interest or interest paid prior to its pro rata accrual.[447] The usual method for charging interest in advance on an amortized loan is to "squeeze"[448] portions of interest payments due later in the repayment term (if computed by the straight-line method) into the early payments.[449] The net result is inflated payments early in the term and deflated payments late in the term.[450] This practice inures to the benefit of the lender by accelerating his rate of return and providing him with the opportunity to reinvest the funds at an earlier date.[451] Until recently, prepayment of interest was also advantageous to some borrowers as prepaid interest was a federal income tax deduction.[452] This tax advan-

446. Since loans not involving real estate were not affected by the Savings & Loan Act, it is reasonably safe to assume that points will be treated as interest in these transactions also.

447. *See* Comment, *Usury Implications of Front-End Interest and Interest in Advance*, 29 Sw. L.J. 748, 750 (1975).

448. In Commerce Trust Co. v. Ramp., 135 Tex. 84, 87, 138 S.W.2d 531, 533 (1940), the court described the process of inflating early interest payments in excess of accrual as "squeezing" unaccrued interest to the front of the term. *Id.* at 87, 138 S.W.2d at 533; *see* Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 784 (Tex. 1977); Shropshire v. Commerce Farm Credit Co., 120 Tex. 400, 404, 30 S.W.2d 282, 282 (1930), *cert. denied*, 284 U.S. 675 (1931).

449. *See* Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 784-85 (Tex. 1977); Commerce Trust Co. v. Ramp, 135 Tex. 84, 87, 138 S.W.2d 531, 533 (1940); Dallas Trust & Sav. Bank v. Brashear, 65 S.W.2d 288, 289 (Tex. Comm'n App. 1933, judgmt adopted); Comment, *Usury Implications of Front-End Interest and Interest in Advance*, 29 Sw. L.J. 748, 750 (1975).

450. As an example, consider a five year $1,000 loan at ten percent per annum with yearly interest payments. The princial is due in full at the end of the term. The following table illustrates a comparison of straight-line interest payments with accelerated interest payments resulting in "interest in advance."

Year	Straight-line Payments	Interest in Advance Payments
1	$100	$150
2	$100	$125
3	$100	$100
4	$100	$ 75
5	$100	$ 50
	$500 Total	$500 Total

451. *See* Comment, *Usury Implications of Front-End Interest and Interest in Advance*, 29 Sw. L.J. 748, 753 (1975).

452. Prior to 1975, a taxpayer using the cash receipts and disbursements method of accounting was allowed to deduct interest paid up to five years in advance. *See* Fackler v. Commissioner, 39 B.T.A. 395, 398; I.T. 3740, 1945 C.B. 109, 109-10. Those taxpayers using

tage was effectively terminated by the ruling of the United States Tax Court in *Burck v. Commissioner*,[453] hence prepayment of interest no longer yields any obvious advantage to the borrower.

Spreading: A Conflict Resolved?

The term "spreading" describes the practice of averaging the total amount of interest charged[454] over the entire repayment term when examining a loan transaction for usury.[455] This technique was implemented by the Texas Supreme Court in *Nevels v. Harris*[456] when it held that a $320 front-end fee, determined to be interest by the court, did not render the loan usurious since the total interest charged over the entire five year repayment term did not exceed the legal maximum.[457] The *Nevels* doctrine of spreading has been followed by a number of Texas courts examining loans containing "front-end" charges.[458] In contrast with the *Nevels* doctrine, another line of cases adopted a "year-by-year" test for usury.[459] These decisions were based upon the proposition that a loan transaction is usurious if the maximum legal interest rate is exceeded in any one year of the loan term.[460]

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the accrual basis of accounting were previously limited to deducting accrued interest only. *See* I.T. 3740, 1945 C.B. 109, 109-10.

453. 63 T.C. 556, 562 (1975), *noted in* 11 TULSA L.J. 442 (1976). Unless a taxpayer can prove that a prepaid interest deduction does not distort his income he may only deduct interest in the year of accrual. *See id.* at 562. *See generally* Comment, *The Prepaid Interest Deduction Viewed From the Perspective of Real Estate Transactions*, 29 Sw. L.J. 412 (1975).

454. The total reflects stipulated interest as well as judically determined interest.

455. *See* Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 781 (Tex. 1977).

456. 129 Tex. 190, 192, 102 S.W.2d 1046, 1049 (1937).

457. *See id.* at 192, 102 S.W.2d at 1049. In *Nevels* the stipulated principal in the note was $6,400 payable in five years at eight percent per annum. *See id.* at 192, 102 S.W.2d at 1047. The court deducted the $320 "loan fee" arriving at $6,080 true principal, and calculated the maximum legal interest of ten percent per annum over the five year term to be $608 yearly, or a total of $3,040. *See id.* at 192, 102 S.W.2d at 1049. Since the total interest charged by the lender was only $2,880, the loan was not usurious. *See id.* at 191, 102 S.W.2d at 1049.

458. *See, e.g.*, Imperial Corp. of America v. Frenchman's Creek Corp., 453 F.2d 1338, 1343 (5th Cir. 1972); Commerce Sav. Ass'n v. GGE Management Co., 539 S.W.2d 71, 73 (Tex. Civ. App.—Houston [1st Dist.]), *aff'd as modified*, 543 S.W.2d 862 (Tex. 1976) (per curiam). The "spreading" doctrine has also been used in a number of decisions not involving front-end fees. *See* Griffin v. B & W Fin. Co., 389 S.W.2d 350, 352 (Tex. Civ. App.—Tyler 1965, no writ); Anderson v. Hirsch, 112 S.W.2d 535, 540 (Tex. Civ. App.—Amarillo 1937, writ ref'd); Southern States Mortgage Co. v. Lykes, 85 S.W.2d 780, 783 (Tex. Civ. App.—Amarillo 1935, writ ref'd).

459. *See* Commerce Trust Co. v. Ramp, 135 Tex. 84, 85, 138 S.W.2d 531, 533 (1940); Dallas Trust & Sav. Bank v. Brashear, 65 S.W.2d 288, 292 (Tex. Comm'n App. 1933, judgmt adopted); Southwestern Inv. Co. v. Hockley County Seed & Delinting, Inc., 511 S.W.2d 724, 732 (Tex. Civ. App.—Amarillo), *writ ref'd n.r.e. per curiam*, 516 S.W.2d 136 (Tex. 1974).

460. *See* Southwestern Inv. Co. v. Hockley County Seed & Delinting, Inc., 511 S.W.2d 724, 732 (Tex. Civ. App.—Amarillo), *writ ref'd n.r.e. per curiam*, 516 S.W.2d 136 (Tex. 1974).

This conflict was apparently resolved by *Tanner Development Co. v. Ferguson*[461] when the Texas Supreme Court held that interest paid in advance should be spread over the entire term of the loan when testing for usury.[462] While acknowledging "technical and economic differences" between front-end interest and interest in advance, the court expressly refrained from distinguishing the terms, and stated that "all forms of compensation for the use, forbearance or detention of the principal debt have been treated alike in applying the usury laws for such a long period of time that it would only create more confusion if they were now treated in any different manner."[463] If all forms of interest are to receive identical treatment in computations testing for usury, it follows that all charges determined to be interest should be spread over the entire loan term when computing the interest rate.

The supreme court in *Tanner,* however, distinguished loans of money from loans involving sales of real estate for purposes of calculating the rate of interest.[464] When testing cash loan transactions involving "front-end" charges, the "true principal" to be used is the sum actually received by the borrower.[465] The rationale for deducting the "front-end" fee is that the borrower is never allowed to make use of that money, hence it cannot fairly be considered principal.[466] Once the "true principal" has been calculated, it is then compared with the actual amount of interest paid to determine the true rate of interest.[467] Although some courts have taken the further step of adding the front-end fee to stipulated interest,[468] the *Tanner* court

In the per curiam opinion the supreme court noted that the facts in *Hockley* did not require a ruling on the issue of "spreading," and refrained from expressing an opinion on it. *See* Southwestern Inv. Co. v. Hockley County Seed & Delinting, Inc., 516 S.W.2d 136, 137 (Tex. 1974) (per curiam).

461. 561 S.W.2d 777 (Tex. 1977), *noted in* 9 Tex. Tech. L. Rev. 759 (1978).

462. *Id.* at 787. In so holding the court expressly overruled the "year-by-year" method implemented in *Ramp* and *Hockley. Id.* at 787.

463. *Id.* at 785. In support of its holding the court also noted legislative sanction of the *Nevels* doctrine of spreading with respect to loans secured by an interest in property. *Id.* at 786; *see* Tex. Rev. Civ. Stat. Ann. art. 5069-1.07(a) (Vernon Supp. 1978-1979). The statute provides that when examining loans involving real estate for usury the interest rate is to be calculated by "amortizing, prorating, allocating, and *spreading,* in equal parts during the period of the full stated term of the loan, all interest." *Id.* (emphasis added).

464. *See* Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 782 (Tex. 1977).

465. *Id.* at 782; *accord,* Nevels v. Harris, 129 Tex. 190, 196-97, 102 S.W.2d 1046, 1049 (1937).

466. *See* Adleson v. B.F. Dittmar Co., 124 Tex. 564, 566, 80 S.W.2d 939, 940 (1935). In *Adleson* the court described the essence of the transaction as the borrower taking the money (principal) in one hand and giving it back with the other. *Id.* at 566, 80 S.W.2d at 940.

467. *See, e.g.,* Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 787 (Tex. 1977) (on motion for rehearing); Nevels v. Harris, 129 Tex. 190, 192, 102 S.W.2d 1046, 1049 (1937); Adleson v. B.F. Dittmar Co., 124 Tex. 564, 566, 80 S.W.2d 939, 940 (1935).

468. *See* First State Bank v. Miller, 563 S.W.2d 572 (Tex. 1978); Ferguson v. Tanner Dev. Co., 541 S.W.2d 483, 490, 496-99 (Tex. Civ. App.—Houston [1st Dist.] 1976), *rev'd,* 561 S.W.2d 777 (Tex. 1977).

found this method to be an obvious error.[469]

After discussing the treatment of front-end fees in cash loans, the court in *Tanner* stated that the same reasoning does not apply to purchase money loans in the sale of real estate because the borrower has unrestricted use of the property and has therefore not relinquished any of his consideration.[470] This distinction between cash loans and purchase money loans secured by real property has attracted valid criticism as arbitrarily favoring the real estate financier.[471] The borrower in *Tanner* was paying interest as consideration for the lender's forbearance of the stipulated principal of $226,388.77.[472] The court of civil appeals in *Tanner* held that the net effect of the borrower's payment of the $21,506.93 interest in advance was that the lender forebore collection of only $204,881.84.[473] Rejecting this reasoning, the supreme court determined that the "true principal" to be used in testing for usury in a real estate sale transaction is that amount stipulated in the agreement without deducting any interest paid in advance.[474]

Although the *Tanner* opinion expands the case law regarding spreading, the court did not apply article 5069-1.07(a), the statutory authorization of spreading, because the transaction examined in the case occurred prior to the effective date of that statute.[475] Article 5069-1.07(a) has not been construed by the courts, but the *Tanner* decision acknowledged in dictum that the statute's net effect is to codify the *Nevels* doctrine of spreading.[476] Several ambiguities remain unresolved by the *Tanner* opinion. The supreme court held that when the debtor has full use of the "consideration such as land which is represented by the principal debt," front-end interest will not be deducted from the stated principal, rather, it will be added to stated interest and that sum spread over the entire loan term to compute the interest rate.[477] A literal reading of the words "consideration (such as land)" within context indicates that this procedure is not necessarily lim-

469. *See* Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 782 (Tex. 1977). This procedure has been referred to as "double dipping," and invariably overstates the interest rate. *See* St. Claire, *The Spreading of Interest Under the Actuarial Method*, 10 St. Mary's L.J. 753, 768 n.75 (1979).

470. *See* Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 782 (Tex. 1977). Tanner sold property to Ferguson for a $6,000 down payment and a promissory note for $226,388.77. The loan agreement called for Ferguson to pay $21,506.93 in advance as the first year's interest. *Id.* at 779.

471. *See* St. Claire, *The Spreading of Interest Under The Actuarial Method*, 10 St. Mary's L.J. 753, 769 n.78 (1979); 9 Tex. Tech. L. Rev. 759, 770-72 (1978).

472. *See* Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 779 (Tex. 1977).

473. *See* Ferguson v. Tanner Dev. Co., 541 S.W.2d 483, 490-91 (Tex. Civ. App.—Houston [1st Dist.] 1976), *rev'd*, 561 S.W.2d 777 (Tex. 1977).

474. *See* Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 782 (Tex. 1977).

475. *See id.* at 786; Tex. Rev. Civ. Stat. Ann. art. 5069-1.07(a) (Vernon Supp. 1978-1979).

476. *See* Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 786 (Tex. 1977)(dictum).

477. *See id.* at 787.

ited to seller-financed land sales, but could conceivably be extended to sales of goods.[478] Furthermore, the *Tanner* court held that front-end interest in a cash loan transaction is to be deducted from the principal rather than considered interest.[479] If the cash loan is secured by an interest in real estate that does not constitute consideration for the loan, however, article 5069-1.07(a) would apparently be applicable. Under these circumstances, it is not clear whether front-end interest should be deducted from the principal in computing interest rate or added to stated interest and spread over the loan term. Finally, neither the opinion nor the statute specifies the method for computing interest after spreading.[480]

Prepayment Penalties

Most loan agreements assess penalty charges upon borrowers who elect to discharge their indebtedness ahead of schedule.[481] These charges are not considered interest by Texas courts when examining loan agreements for usury,[482] and have been statutorily sanctioned for real property loans.[483] The courts have determined that prepayment penalties are consideration for the "privilege" of discharging the loan prior to maturity rather than compensation for the use, forbearance, or detention of money.[484] If, however, judicial examination discloses excessive or unreasonable penalties under the circumstances, the penalties may be declared a mere disguise for usurious interest.[485]

Late Charges

Loan agreements also commonly provide penalties for late payment.[486]

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478. *See id.* at 787 (by implication).

479. *See id.* at 787.

480. *See* St. Claire, *The Spreading of Interest Under the Actuarial Method,* 10 ST. MARY'S L.J. 753, 786-821 (1979) (examining five different methods).

481. *See* Loiseaux, *Some Usury Problems in Commercial Lending,* 49 TEXAS L. REV. 419, 431-32 (1971).

482. *See* Vela v. Shacklett, 12 S.W.2d 1007, 1008 (Tex. Comm'n App. 1929, holding approved); Wagner v. Austin Sav. & Loan Ass'n, 525 S.W.2d 724, 729 (Tex. Civ. App.—Beaumont 1975, no writ); Gulf Coast Inv. Corp. v. Prichard, 438 S.W.2d 658, 661 (Tex. Civ. App.—Dallas), *writ ref'd n.r.e. per curiam,* 447 S.W.2d 676 (Tex. 1969).

483. TEX. REV. CIV. STAT. ANN. art. 852a, § 5.07 (Vernon 1964).

484. *See* Boyd v. Life Ins. Co., 546 S.W.2d 132, 133 (Tex. Civ. App.—Houston [14th Dist.] 1977, writ ref'd); Wagner v. Austin Sav. & Loan Ass'n, 525 S.W.2d 724, 729 (Tex. Civ. App.—Beaumont 1975, no writ).

485. *See* Gonzales County Sav. & Loan Ass'n v. Freeman, 534 S.W.2d 903, 908 (Tex. 1976) (dictum). Penalties must relate reasonably to services rendered or "incovenience suffered" by the lender as a result of borrower's prepayment. *Id.* at 908 (dictum). *See also* TEX. REV. CIV. STAT. ANN. art. 5069-3.15 (Vernon 1971) (Texas Consumer Credit Code). All unearned interest must be refunded upon prepayment. *Id.* art. 5069-3.15(6). Prepayment penalties are prohibited in consumer credit transactions. *See id.* art. 5069-3.15(8).

486. *See* 30 BAYLOR L. REV. 174, 181 (1978).

Savings and loan associations have been authorized by law to levy reasonable penalties for late payments on real estate loans[487] and these penalties are therefore not treated as interest.[488] Conversely, late payment penalties that are not stautorily authorized will be judicially declared interest when loan transactions are scrutinized for usurious content.[489]

In *Parks v. Lubbock*[490] the Texas Supreme Court chose to depart from the common law rule that considered late charges to be penalties rather than interest.[491] The court reasoned that the statutory definition of interest as compensation for the use, forbearance, or detention of money, expanded the common law meaning of the term.[492] Detention was interpreted as referring to the case in which a debt became due and the debtor withheld payment without authorization from the lender.[493] Since late charges are compensation for the detention of money, they are to be considered interest.[494] This interpretation was reaffirmed in *Shropshire v. Commerce Farm Credit Co.*[495] and is apparently the law at present.[496]

Acceleration Clauses

An acceleraton clause is a provision in a loan agreement allowing the creditor the option to declare the unpaid balance of the debt due immediately upon the borower's default.[497] When the terms of the agreement allow the lender's exercise of his accelleration option to result in the borrower's

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487. TEX. REV. CIV. STAT. ANN. art. 852a, § 5.07 (Vernon 1964).

488. *Id.* The Texas Consumer Credit Code provides for limited additional interest charges for "default" on installments. *Id.* art. 5069-3.15(5) (Vernon 1971).

489. *See, e.g.*, Shropshire v. Commerce Farm Credit Co., 120 Tex. 400, 403, 30 S.W.2d 282, 285 (1930), *cert. denied*, 284 U.S. 675 (1931); Parks v. Lubbock, 92 Tex. 635, 637, 51 S.W. 322, 323 (1899); Watson v. Cargill, Inc., 573 S.W.2d 35, 42 (Tex. Civ. App.—Waco 1979, writ ref'd n.r.e.).

490. 92 Tex. 635, 51 S.W. 322 (1899).

491. *See id.* at 637, 51 S.W. at 323.

497. *See id.* at 636, 51 S.W. at 323. At common law, interest was defined as "compensation usually reckoned by the loan, use, or forbearance of money." *Id.* at 636, 51 S.W. at 323.

493. *See id.* at 636, 51 S.W. at 323.

494. *Id.* at 636, 51 S.W. at 323; *see* Watson v. Cargill, Inc., 573 S.W.2d 35, 42 (Tex. Civ. App.—Waco 1979, writ ref'd n.r.e.).

495. 120 Tex. 400, 412, 30 S.W.2d 282, 286 (1930), *cert. denied*, 284 U.S. 675 (1931).

496. *See* Watson v. Cargill, Inc., 573 S.W.2d 35, 42 (Tex. Civ. App.—Waco 1979, writ ref'd n.r.e.). Re-enactment of the same statutory definition of interest by the Texas lawmakers indicates legislative sanction of the supreme court's interpretation. Shropshire v. Commerce Farm Credit Co., 120 Tex. 400, 412, 30 S.W.2d 282, 286 (1930), *cert denied*, 284 U.S. 675 (1931). The statutory definition remains unchanged today. *See* TEX. REV. CIV. STAT. ANN. art. 5069-1.01(a) (Vernon 1971). *See generally* 30 BAYLOR L. REV. 174 (1978).

497. *See* Loiseaux, *Some Usury Problems in Commercial Lending*, 49 TEXAS L. REV. 419, 425 (1971); Pearce & Williams, *Punitive Past to Current Convenience—A Study of the Texas Law of Usury*, 22 Sw. L.J. 233, 243 (1968).

payment of interest at a rate exceeding the legal maximum, the transaction is usurious.[498] As with late charges, the finding of usury is based upon the stautory designation of interest as compensation for the "detention" of money.[499] Any charges levied against a borrower for his detention of funds due the lender are considered interest rather than penalties.[500] In *Shropshire v. Commerce Farm Credit Co.*[501] the Texas Supreme Court examined an acceleration clause that expressly prohibited the "abatement" of unearned interest.[502] The court held the contract usurious because of its provision for the lender's retention of usurious interest upon the borrower's default.[503] Subsequent cases have found that acceleration clauses without provision for the cancellation of unaccrued interest do not necessarily render usurious an otherwise legal contract.[504] It has recently been held that termination of payments on a usurious loan agreement does not constitute default justifying acceleration of maturity.[505]

498. *See, e.g.,* Clements v. Williams, 136 Tex. 97, 99, 147 S.W.2d 769, 769 (1941); Shropshire v. Commerce Farm Credit Co., 120 Tex. 400, 410-11, 30 S.W.2d 282, 285 (1930), *cert. denied,* 284 U.S. 675 (1931); Glenn v. McCarty, 130 S.W.2d 295, 304-05 (Tex. Civ. App.—Amarillo 1939), *aff'd,* 137 Tex. 608, 155 S.W.2d 912 (1941).

499. *See* Shropshire v. Commerce Farm Credit Co., 120 Tex. 400, 410-11, 30 S.W.2d 282, 285 (1930), *cert. denied,* 284 U.S. 675 (1931). See notes 490-496 *supra* and accompanying text.

500. *See id.* at 410-11, 30 S.W.2d at 285.

501. 120 Tex. 400, 30 S.W.2d 282 (1930), *cert. denied,* 284 U.S. 675 (1931).

502. *See id.* at 412, 39 S.W.2d at 11 (overruling motion for rehearing).

503. *See id.* at 405-06, 30 S.W.2d at 283. In overruling the creditor's motion for rehearing the court acknowledged its obligation to give the doubtful contract a legal construction if the terms were susceptible to that interpretation. The contract under scrutiny in *Shropshire,* however, contained clear language that the court believed the parties must have understood to demand payment of usurious interest should the lender accelerate maturity upon default. *See id.* at 414-15, 39 S.W.2d at 12-13 (overruling motion for rehearing); *cf.* Marble Sav. Bank v. Davis, 124 Tex. 560, 561, 80 S.W.2d 298, 299 (1935) (acceleration clause providing for "whole indebtedness" due on default interpreted as reference to principal and accrued interest only); Walker v. Temple Trust Co., 124 Tex. 575, 577-78, 80 S.W.2d 835, 936-37 (1935) (transaction free from usury notwithstanding terminology susceptible to construction that unaccrued interest due on acceleration when contract read as whole clearly intended to avoid usury); Sinclair v. Mack Trucks, Inc., 355 S.W.2d 563, 564-65 (Tex. Civ. App.—Fort Worth 1962, writ ref'd n.r.e.) (acceleration clause permitting creditor to declare total "amount due" payable on default not usurious).

504. *See* Nevels v. Harris, 129 Tex. 190, 196-97, 102 S.W.2d 1046, 1049-50 (1937); Sales v. Mercantile Nat'l Bank, 89 S.W.2d 247, 249 (Tex. Civ. App.—Amarillo 1935, writ dism'd). Creditors desiring the right to accelerate maturity upon default are wise to include this provision as a precautionary measure.

505. Ferguson v. Tanner Dev. Co., 541 S.W.2d 483, 493 (Tex. Civ. App.—Houston [1st Dist.] 1976), *rev'd on other grounds,* 561 S.W.2d 777 (Tex. 1977). Interest payments on a usurious contract are illegal and consequently unenforceable. *Id.* at 493-94; *accord,* Wall v. East Tex. Teachers Credit Union, 533 S.W.2d 918, 921 (Tex. 1976); W.E. Grace Mfg. Co. v. Levin, 506 S.W.2d 580, 585 (Tex. 1974).

Commitment Fees

The term "commitment fee" describes a charge levied by the lender as consideration for the commitment to make a future loan.[506] The Texas Supreme Court recently examined a loan transaction involving a commitment fee in *Gonzales County Savings & Loan Ass'n v. Freeman.*[507] The debtors in *Freeman* borrowed $38,400 for one year at the stipulated interest rate of nine percent per annum.[508] They were also charged an additional two percent "loan fee" of $786.[509] The court of civil appeals erroneously surmised that even if the "loan fee" was a commitment fee, it would constitute interest.[510] In rejecting that reasoning the Texas Supreme Court held that a bona fide commitment fee is not interest.[511] A charge levied by a lender for his promise to make a loan at a later time constitutes compensation for an option contract insuring the availability of funds for future loans.[512]

506. *See* Loiseaux, *Some Usury Problems in Commercial Lending,* 49 TEXAS L. REV. 419, 423-24 (1971); Pearce & Williams, *Punitive Past to Current Convenience—A Study of the Texas Law of Usury,* 22 Sw. L.J. 233, 246-47 (1968). *See generally* Hershman, *Usury and the Tight Money Market,* 85 BANKING L.J. 189 (1968); Prather, *Mortgage Loans and the Usury Laws,* 16 BUS. LAW. 181, 188 (1960); Sintenis, *Current Treatment of the Non-Refundable Commitment Fee and Related Problems,* 86 BANKING L.J. 590 (1969).

507. 534 S.W.2d 903 (Tex. 1976), *noted in* 13 HOUS. L. REV. 773 (1976); *see* 54 TEXAS L. REV. 1487 (1976).

508. Gonzales County Sav. & Loan Ass'n v. Freeman, 534 S.W.2d 903, 905 (Tex. 1976).

509. *Id.* at 905. A savings and loan executive testified that this two percent fee was compensation charged for "having a permanent loan approved." *See* Freeman v. Gonzales County Sav. & Loan Ass'n, 526 S.W.2d 774, 778-79 (Tex. Civ. App.—Corpus Christi 1975), *aff'd* 534 S.W.2d 903 (Tex. 1976).

510. Freeman v. Gonzales County Sav. & Loan Ass'n, 526 S.W.2d 774, 779 (Tex. Civ. App.—Corpus Christi 1975), *aff'd on other grounds,* 534 S.W.2d 903 (Tex. 1976). The intermediate appellate court based this conclusion on a previous ruling by the United States Court of Appeals for the Fifth Circuit in Imperial Corp. of America v. Frenchman's Creek Corp., 453 F.2d 1338, 1343-44 (5th Cir. 1972) (applying Texas law). In *Frenchman's Creek* the court held that a "commitment fee" charged by a lender was interest under Texas law. *See id.* at 1343.

511. Gonzales County Sav. & Loan Ass'n v. Freeman, 534 S.W.2d 903, 906 (Tex. 1976). The court again stressed the need to look through the form of the transaction to its substance. *Id.* at 906. The court of civil appeals erroneously emphasized the label "commitment fee" in following the holding in *Frenchman's Creek. Id.* at 906. The charge referred to as a "commitment fee" in *Frenchman's Creek* was not compensation given for the option to enter a future loan, and consequently was not a bona fide commitment fee. *See id.* at 906.

512. *See id.* at 906; Stedman v. Georgetown Sav. & Loan Ass'n, 575 S.W.2d 415, 416 (Tex. Civ. App.—Fort Worth 1979, writ granted). In *Stedman* the loan commitment provided that the defendant would escrow funds for the plaintiff, and that interest would accrue from the date of escrow. The loan was not closed until six months later, although ten percent interest per annum was charged on the principal from the date of the commitment to closing. The court of civil appeals found that although the charges were termed interest by the parties, they were actually separate consideration for an option to borrow, which the plaintiff could

Brokerage Fees

Fees paid to independent third parties for bona fide services rendered are not considered interest within the purview of usury statutes.[513] In *Crow v. Home Savings Ass'n*[514] the borrower solicited the aid of a broker in his endeavors to obtain funding for a business venture.[515] The broker arranged for the borrower to meet with a lender who subsequently made the desired loan.[516] The borrower thereafter sought recovery of usury penalties from the broker. In denying recovery, the court held that a bona fide loan from a creditor, made possible through the efforts of an independent broker, will not be rendered usurious by "heavy" brokerage fees.[517]

While it is of fundamental importance that the lender derive no benefit from compensation paid to the broker,[518] it is not imperative that there be no relationship between the lender and the broker.[519] In *Nevels v. Harris*[520] it was held that bona fide fees paid to special agents of the lender are not interest provided that the lender does not receive any portion of the compensation and the "agents have only limited or special authority."[521] As in all usury cases, however, the court will consider substance over form in scrutinizing the transaction for any subterfuge masking usury.[522]

Credit Insurance Premiums

The required payment of reasonable credit insurance premiums as a

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exercise or not, and therefore the charges were not interest. *Id.* at 416. The court also noted that it was immaterial that the funds were not actually placed in escrow, and thus were available to the lender, since they were required to be available to the plaintiff upon his exercise of the option. *Id.* at 417.

513. *See* Crow v. Home Sav. Ass'n, 522 S.W.2d 457, 459 (Tex. 1975); Greever v. Persky, 140 Tex. 64, 66, 165 S.W.2d 709, 711 (1942); Pearce & Williams, *Punitive Past to Current Convenience—A Study of the Texas Law of Usury,* 22 Sw. L.J. 233, 240-42 (1968).

514. 522 S.W.2d 457 (Tex. 1975).

515. *Id.* at 459.

516. *Id.* at 459. Home Savings, the broker and defendant, also guaranteed the loan and pledged a $150,000 certificate of deposit with the lender as security for the loan. *Id.* at 459.

517. *See id.* at 459-60.

518. *See id.* at 459-60; Walker v. Ross, 548 S.W.2d 447, 450-51 (Tex. Civ. App.—Fort Worth), *writ ref'd n.r.e. per curiam,* 554 S.W.2d 189 (Tex. 1977); Sapphire Homes v. Gilbert, 426 S.W.2d 278, 282 (Tex. Civ. App.—Dallas 1968, writ ref'd n.r.e.); Ware v. Paxton, 266 S.W.2d 218, 224 (Tex. Civ. App.—Eastland 1954, writ ref'd n.r.e.).

519. *See* Nevels v. Harris, 129 Tex. 190, 196, 102 S.W.2d 1046, 1049 (1937).

520. 129 Tex. 190, 102 S.W.2d 1046 (1937).

521. *Id.* at 196-97, 102 S.W.2d at 1049. The borrower in *Nevels* was required to pay a $64 attorney fee and a $160 inspection fee. Both the attorney and inspector were special agents for the lender; however, the charges were found to be compensation for legitimate services rendered. *Id.* at 196-97, 102 S.W.2d at 1048-49.

522. *See* Terry v. Teachworth, 431 S.W.2d 918, 925 (Tex. Civ. App.—Houston [14th Dist.] 1968, writ ref'd n.r.e.); Ware v. Paxton, 266 S.W.2d 218, 224 (Tex. Civ. App.—Eastland 1954, writ ref'd n.r.e.).

condition precedent to a loan is not considered interest[523] unless found to be a disguise for the exaction of usurious interest.[524] Prior to 1963, commissions collected by the lender or his agent from the insurer for writing a policy were expressly exempted by statute from treatment as interest on the loan;[525] however, since the adoption of the Model Act for the Regulation of Credit Life Insurance and Credit Accident and Health Insurance it is not clear whether the commissions are considered interest.[526] It is manda-

523. *See* TEX. INS. CODE ANN. art. 3.53, § 9 (Vernon Supp. 1963-1978). The scope of article 3.53 is limited to credit insurance covering loans of less than five years in duration. *Id.* § 2A(2).

524. *See, e.g.*, Harrell v. Colonial Fin. Corp., 341 S.W.2d 545, 546 (Tex. Civ. App.—San Antonio 1960, writ ref'd n.r.e.); Ware v. Paxton, 266 S.W.2d 218, 223 (Tex. Civ. App.—Eastland 1954, writ ref'd n.r.e.); Hatridge v. Home Life Ins. Co., 246 S.W.2d 666, 669 (Tex. Civ. App.—Dallas 1951, no writ); Rodriguez v. R.P. Youngberg Fin. Corp., 241 S.W.2d 815, 819-20 (Tex. Civ. App.—El Paso 1951, no writ).

525. 1949 Tex. Gen. Laws, ch. 81, § 6, at 134. This section expressly provided that commissions paid to lenders were to be considered payment for services rendered to the insurer, and were not interest. *Id.* at 134.

526. *See* TEX. INS. CODE ANN. art. 3.53, § 9 (Vernon Supp. 1963-1978). While this section does not expressly provide for exemption of commissions collected by a lender from consideration as interest, the "[s]avings clause" added to article 3.53 indicates it is intended to be construed as consistent with the Regulatory Loan Act, which provides in pertinent part:

> any gain, or advantage to the licensee, or any employee, officer, director, agent, general agent, affiliate or associate from such insurance or its provision or sale *shall not be considered as additional interest* or further charge in connection with any loan made under this Act except as specifically provided herein.

1963 Tex. Gen. Laws, ch. 205, § 18(d), at 565 (emphasis added). This act was superseded by TEX. REV. CIV. STAT. ANN. art. 5069-3.01 to 3.21 (Vernon 1971), which was effective October 1, 1967. *See generally* 1949 Tex. Gen. Laws, ch. 81, § 6 at 134 (forerunner of current article 3.53 of the Insurance Code which expressly provided that commissions received by lenders for writing credit insurance contracts were not to be considered interest); Pearce & Williams, *Punitive Past to Current Convenience—A Study of The Texas Law of Usury,* 22 Sw. L.J. 233, 239-40 (1968); Davis, *Does the Texas Credit Insurance Act "Legalize" Usury?,* 11 Sw. L.J. 139 (1957); *see also* TEX. REV. CIV. STAT. ANN. art. 5069-3.18 to 4.02 (Vernon 1971) (Texas Consumer Credit Code). The above notwithstanding, only a state licensed insurer is authorized to issue a credit insurance policy. *See* TEX. INS. CODE ANN. art. 3.53, § 9 (Vernon Supp. 1963-1978). The Texas Commissioner of Insurance has discretion to disapprove the use of policies that do not provide reasonable benefits in relation to the premium charge. *See id.* § 7. Any amount charged a borrower by the lender as consideration for credit insurance may never exceed the actual premium charged the lender by the insurer. *See id.* § 8(D).

In Harrell v. Colonial Fin. Corp., 341 S.W.2d 545 (Tex. Civ. App.—San Antonio 1960, writ ref'd n.r.e.), the borrower was required to insure his life in the amount of the loan as a condition precedent to the agreement. *Id.* at 546. The lender was an agent for the insurer and received a commission on the transaction. *Id.* at 546. The court held that when the insurance requirement was reasonable in order to protect the lender's investment, it was not considered interest, regardless of the express statutory provision that such premiums were not interest (the 1949 version of Article 3.53, § 6 of the Insurance Code was in effect at that time). *See id.* at 546. *But see* United Fin. & Thrift Corp. v. Smith, 387 S.W.2d 752, 755 (Tex. Civ. App.—Tyler 1965, writ ref'd n.r.e.). In *Smith* the defendant lender stipulated that its manager was an agent for the insurer of more than 99% of the loans, and further that this insurer tory that the borrower be allowed to purchase the insurance from the insurer or agent of his choice.[527] He must also be allowed the option to meet the insurance requirements through existing policies he owns or controls.[528] If the lender denies the borrower the right to choose an insurance carrier, the premiums paid will be considered interest in usury computations.[529]

COMPENSATING BALANCES

It is not uncommon for a creditor to require the debtor to maintain or arrange for the deposit of a specified balance with the lender or a separate institution as a condition precedent to a loan.[530] In order to facilitate analysis, compensating balances may be categorized into those in which the borrower is required to maintain a minimum balance with the lender, those requiring the borrower to maintain a deposit with a separate institution, and those in which the borrower retains a third party to maintain the required balance—the brokered deposit.

In *First State Bank v. Miller*[531] the Texas Supreme Court recently examined a transaction of the first category. In *Miller* the parties agreed to a three-year loan of $70,000 with interest stipulated at ten percent per annum. The borrowers were required to leave $14,000 of the stated principal in a non-interest-bearing "frozen" account as security for the first two years' interest.[532] In concluding that the transaction was usurious, the court deducted the $14,000 compensating balance from the $70,000 stated principal to arrive at $56,000 true principal.[533] This figure was then used in computing the rate of interest.[534] It reasoned that since the debtors "had

paid 85% of the premiums collected to the General Fidelity Life Insurance Company, which was wholly owned by the defendant. *See id.* at 755. The court held that this "investment certificate plan of operation used by United Finance & Thrift Corporation was usurious." *Id.* at 755. The court did not purport to base this conclusion on any statute, nor does the opinion specify any basis for finding usury.

527. *See* TEX. INS. CODE ANN. art. 3.53, § 11 (Vernon Supp. 1963-1978).

528. *See id.* § 11.

529. *See, e.g.*, North Am. Acceptance Corp. v. Warren, 451 S.W.2d 921, 925 (Tex. Civ. App.—Dallas 1970, writ ref'd n.r.e.); Ware v. Paxton, 266 S.W.2d 218, 223 (Tex. Civ. App.—Eastland 1954, writ ref'd n.r.e.); Rodriguez v. R. P. Youngberg Fin. Corp., 241 S.W.2d 815, 819-20 (Tex. Civ. App.—El Paso 1951, no writ).

530. *See* Pearce & Williams, *Punitive Past to Current Convenience—A Study of the Texas Law of Usury*, 22 Sw. L.J. 233, 254-58 (1968). *See generally* Loiseaux, *Some Usury Problems in Commercial Lending*, 49 TEXAS L. REV. 419, 429-31 (1971).

531. 563 S.W.2d 572 (Tex. 1978), *noted in* 10 ST. MARY'S L.J. 357 (1978).

532. *Id.* at 573. The $14,000 was retained as security for two postdated checks representing interest on the loan for two years. The Millers had no access to this money while the bank regarded it as part of their "general deposits" and "lendable funds." *Id.* at 576.

533. *See id.* at 576.

534. *Id.* at 575. The maximum legal interest on $56,000 for three years is $16,800. Since First State Bank had contracted for and charged $21,000, the agreement was clearly usurious. *Id.* at 575.

use of only $56,000 of the stated loan, that amount should be considered 'true' principal."[535]

In *Texas International Mortgage Co. v. M.P. Crum Co.*[536] the Dallas Court of Civil Appeals examined a transaction of the second category in which the lender required the borrower to deposit one fifth of the stated loan in an interest-bearing account with a third party as security for repayment.[537] The borrower contended that since it only had use of $400,000, the collection of interest on $500,000 constituted usury.[538] The court rejected this argument and refused to deduct the compensating balance from the stipulated principal emphasizing that the compensating balance was maintained with an independent third party, and therefore, the lender was unable to use these funds.[539] While the borrower was denied the unrestricted use of the compensating deposit, he was not deprived of the interest earned by the fund.[540]

Miller may be distinguished from *Crum* on two major points. First, the deposit in *Crum* earned interest for the debtor while the frozen account in *Miller* was non-interest-bearing; and second, the compensating balance in *Miller* was held by the lender who had use of the money while the certificate of deposit in *Crum* was retained by an independent third party.[541] The contention of the borrower in *Crum* is supported by *Tanner Development Co. v. Ferguson*,[542] which held that any front-end fee or similar deduction by the lender at the inception of a cash loan must be deducted from the purported principal to ascertain a "true" principal.[543] This proposition is grounded upon the premise that the borrower should only be required to

535. *Id.* at 575. The court cited Nevels v. Harris, 129 Tex. 190, 102 S.W.2d 1046 (1937), for the proposition that the net amount of money the borrower receives is to be used in testing for usury. *See* First State Bank v. Miller, 563 S.W.2d 572, 575 (Tex. 1978).

536. 564 S.W.2d 421 (Tex. Civ. App.—Dallas 1978, writ ref'd n.r.e.).

537. *Id.* at 422. The borrower was required to encumber $100,000 of the $500,000 loan in a certificate of deposit with a separate bank. *Id.* at 422.

538. *Id.* at 422.

539. *See id.* at 422. The only benefit derived by the lender from the compensating balance was security for repayment. *Id.* at 422.

540. *Id.* at 422. The court reasoned that the compensating balance benfitted the borrower by providing partial security for the loan as well as earning interest. *See id.* at 422. *But cf.* Community Fin. & Thrift Corp. v. State, 161 Tex. 619, 621, 343 S.W.2d 232, 233-34 (1961) (borrower required to purchase an investment certificate from lender and make payments thereon as security for loan, payments held interest); Flurry v. Hillcrest State Bank, 401 S.W.2d 857 (Tex. Civ. App.—Texarkana 1966, writ ref'd n.r.e.) (borrower required to make monthly deposits in savings account pledged to secure loan, held usurious).

541. *See* First State Bank v. Miller, 563 S.W.2d 572, 573 (Tex. 1978); Texas Int'l Mortgage Co. v. M.P. Crum Co., 564 S.W.2d 421, 422 (Tex. Civ. App.—Dallas 1978, writ ref'd n.r.e.).

542. 561 S.W.2d 777 (Tex 1977).

543. *Id.* at 787.

pay interest on money that he has had the opportunity to use.[544] When the borrower is denied the unrestricted use of a portion of his borrowed money, it is of little consequence to him whether the funds are being held by the lender or a third party. In *Crum*, however, the court recognized just such a distinction.[545] If the compensating balance is on deposit with the lender, then the lender has use of the funds to make further loans and therefore they are not considered part of the "true" principal of the loan.[546] Should the funds be on deposit with a third party, as in *Crum*, although the effect on the borrower is the same, the amount is considered part of the principal of the loan.[547]

The third category, "brokered deposits," encompasses those transactions in which the borrower fulfills his obligation to provide a compensating balance by paying a third party to supply funds for the deposit.[548] In *Commerce Savings Ass'n v. GGE Management Co.*[549] the court examined a transaction in which the debtor was required to retain brokered deposits with both the lender and a separate bank.[550] In overruling the borrower's contention that the brokerage fees paid to procure the required compensating balances were interest, the court observed that there was no documentation of a contractual requirement that the debtor maintain these balances.[551] The court emphasized that the creditor received no brokerage fees and that the borrower's negotiations with the brokers constituted independent transactions.[552] Noting the established rule that fees paid to third parties as compensation for bona fide services rendered are not interest, the court described these compensating balances as "separate and independent debts" between the brokers and the recipients of the deposits.[553]

544. *See* First State Bank v. Miller, 563 S.W.2d 572, 575 (Tex. 1978); Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 787 (Tex. 1977).

545. *See* Texas Int'l Mortgage Co. v. M.P. Crum Co., 564 S.W.2d 421, 422 (Tex. Civ. App.—Dallas 1978, writ ref'd n.r.e.).

546. *See id.* at 422 (dictum).

547. *See id.* at 422.

548. *See* Oxford, *Usury Update*, 16 TEXAS STATE BAR NEWSLETTER, REAL EST., PROB. & TR. LAW SECTION 26, 27 (Oct. 1977). The broker earns a brokerage fee from the borrower in addition to any interest the deposit may yield. *See* Loiseaux, *Some Usury Problems in Commercial Lending*, 49 TEXAS L. REV. 419, 429-30 (1971).

549. 539 S.W.2d 71 (Tex. Civ. App.—Houston [1st Dist.]), *aff'd on other grounds*, 543 S.W.2d 862 (Tex. 1976).

550. *Id.* at 75. The borrowers executed a $600,000 promissory note to the lender. In addition to the twelve percent per annum stipulated interest rate for a ten year term the borrowers were allegedly required to place $600,000 on deposit with the lender and $200,000 in another bank. The expectation of all parties was that the borrower would purchase brokered deposits. *Id.* at 74-75.

551. *Id.* at 79. It is noteworthy in this regard that the jury found that the borrowers were required to maintain these balances as a "condition" for making the loan. *Id.* at 75.

552. *See id.* at 79.

553. *Id.* at 79; *see* Moss v. Metropolitan Nat'l Bank, 533 S.W.2d 397, 399 (Tex. Civ. App.—Houston [1st Dist.] 1976, no writ).

The fundamental distinction between brokered deposits and those discussed in categories one and two lies not in whether the borower is required to pay compensation exceeding the legal interest rate, but whether the lender receives usurious interest.[554] Texas courts have construed usury statutes as penal in nature, designed to punish the creditor who extracts usurious interest from his debtor.[555] In so doing, at least in the area of compensating balances, they have rejected the alternative of applying the statutes to protect any borrower who has been required to pay compensation in excess of the legal maximum interest rate for the loan of money.[556]

Participation Schemes

The ensuing segment of this commentary will examine several nonconventional financing techniques through which lenders seek to enhance their rate of return by participating to some extent in the borrower's business venture. This analysis does not purport to be an exhaustive examination of participation schemes as their variety is limited only by the ingenuity of the parties involved. Some of the most common methods will be discussed. The effectiveness of these arrangements in circumventing usury laws results from difficulty in proving the fundamental elements of usury.[557]

Sale-Leaseback

The term "sale-leaseback," refers to transactions in which a landowner/developer sells his property to an investor who contemporaneously leases it back to the vendor.[558] The transaction inures to the benefit of the vendor/lessee by allowing liquidation of his equity and acquisition of funds

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554. *See* Loiseaux, *Some Usury Problems in Commercial Lending,* 49 Texas L. Rev. 419, 430 (1971).

555. *See, e.g.* First State Bank v. Miller, 563 S.W.2d 572, 577 (Tex. 1978); Stacks v. East Dallas Clinic, 409 S.W.2d 842, 844-45 (Tex. 1966); Commerce Trust Co. v. Best, 124 Tex. 583, 591, 80 S.W.2d 942, 947 (1935). *But see* Glenn v. McCarty, 130 S.W.2d 295, 301 (Tex. Civ. App.—Amarillo, 1939), *aff'd,* 137 Tex. 608, 155 S.W.2d 912 (1941) (usury statute remedial in nature); Goodman v. Seely, 243 S.W.2d 858, 859-60 (Tex. Civ. App.—San Antonio 1951, writ ref'd) (lender's receiving more than legal rate from two sources held not usurious as neither paid usurious rate); Autocredit Inc. v. Prichett, 223 S.W.2d 951, 954 (Tex. Civ. App.—Fort Worth 1949, writ dism'd) (legislature intended that usury statutes be remedial).

556. *See* Loiseaux, *Some Usury Problems in Commercial Lending,* 49 Texas L. Rev. 419, 430-31 (1971).

557. *See generally* Comment, *The Application of Texas Usury Laws to Equity Participation Agreements,* 48 Texas L. Rev. 925, 928-31 (1970).

558. *See* Podell, *The Application of Usury Laws to Modern Real Estate Transactions,* 1 Real Est. L.J. 136, 145-47 (1972). *See generally* Egan, *Sale-Leasebacks: Protecting the Institutional Investor Against New Risks,* 6 Real Est. L.J. 199 (1978); Comment, *Real Estate Sale-Leaseback Agreements Under Texas Usury Law: Circumvention or Sale?,* 7 St. Mary's L.J. 821 (1976).

to improve the property while retaining its use.[559] The sale-leaseback scheme allows the original owner to obtain one hundred percent of the property value[560] whereas a conventional mortgage would be unlikely to yield more than seventy-five percent of the fair market value.[561] Further the vendor/lessee enjoys an excellent tax advantage since rent on income-producing property is tax deductible.[562] On the other hand, the vendee/lessor receives a significantly higher return on his investment than he would as an ordinary mortgagee.[563] Since he holds legal title to the property, he is entitled to depreciate it for tax purposes as well as benefit from any appreciation in property value.[564] The sale-leaseback scheme is a popular investment for institutional creditors, and if properly structured, may provide an effective means of circumventing usury laws by allowing the vendee/lessor to realize a return on his investment exceeding the statutory maximum for return attributable to interest.[565]

Texas courts have not yet examined sale-leaseback transactions for usury. Other jurisdictions evaluate the facts and circumstances surrounding the transaction to determine whether a bona fide sale or a loan was intended.[566] In view of the emphasis by Texas courts on substance over form in testing for usury, it is reasonably certain that Texas will follow this approach should the usury issue arise in a sale-leaseback case.[567]

Whether the parties share a debtor-creditor relationship either before or

559. *See* Marcus, *Real Estate Purchase-Leasebacks as Secured Loans,* 2 REAL EST. L.J. 664, 666 (1974); Note, *The Expanding Definition of "Security": Sale-Leasebacks and Other Commercial Leasing Arrangements,* 1972 DUKE L.J. 1221, 1222-23.

560. *See* Marcus, *Real Estate Purchase-Leasebacks as Secured Loans,* 2 REAL EST. L.J. 664, 666 (1974).

561. *See* Hershman, *Usury and "New Look" in Real Estate Financing,* 4 REAL PROP. PROB. & TR. J. 315, 319 (1969); Comment, *Real Estate Sale-Leaseback Agreements Under Texas Usury Law: Circumvention or Sale?,* 7 ST. MARY'S L.J. 821, 822 (1976).

562. *See* I.R.C. § 212. The sale-leaseback scheme is especially attractive to the vendor/lessee who has fully depreciated improvements on the property. *See* Hershman, *Usury and "New Look" in Real Estate Financing,* 4 REAL PROP. PROB. & TR. J. 315, 319 (1969).

563. *See* Comment, *Real Estate Sale-Leaseback Agreements Under Texas Usury Law: Circumvention or Sale?,* 7 ST. MARY'S L.J. 821, 822 (1976).

564. *See* Comment, *Lender Participation in Borrower's Venture: A Scheme to Receive Usurious Interest,* 8 HOUS. L. REV. 546, 552 (1971); Comment, *Real Estate Sale-Leaseback Agreements Under Texas Usury Law: Circumvention or Sale?,* 7 ST. MARY'S L.J. 821, 822 (1976).

565. *See* Marcus, *Real Estate Purchase-Leasebacks as Secured Loans,* 2 REAL EST. L.J. 664, 665 (1974); Comment, *Real Estate Sale-Leaseback Agreements Under Texas Usury Law: Circumvention or Sale?,* 7 ST. MARY'S L.J. 821, 821 (1976).

566. *See* Bank v. Walters, 130 S.W. 519, 521 (Ark. 1910); Golden State Lanes v. Fox, 42 Cal. Rptr. 568, 571 (Dist. Ct. App. 1965); Kawauchi v. Tabata, 413 P.2d 221, 223 (Hawaii 1966); Peterson v. Philco Fin. Corp., 428 P.2d 961, 966 (Idaho 1967).

567. *Cf.* Calhoun v. Lumpkin, 60 Tex. 185, 189 (1883) (facts surrounding purported sale scrutinized and found not to be a mortgage).

after the sale is often a major factor in determining whether a sale-leaseback is merely camouflage for usury.[568] Other factors commonly considered in this regard are whether the contract includes an option for repurchase[569] and whether significant disparity exists between market value and sale price.[570] When a contract is not usurious on its face the determination whether the transaction is merely a subterfuge for a usurious agreement is properly left to the jury.[571]

Sale-Buyback

A Texas court has examined a scheme analogous to the sale-leaseback in *Commerce Savings Ass'n v. GGE Management Co.*[572] A plan to refinance an apartment complex involved the sale of property to the lender who immediately sold it back to the borrower at a profit of $51,000.[573] The court of civil appeals observed that whether the $51,000 represented a bona fide profit on the sale of real estate or constituted interest for the contemporaneous loan was properly a jury question.[574] "Neither the form of the transaction nor the fact that the money was paid from loan proceeds precluded a finding" that the proceeds were consideration for the loan.[575] The sale-buyback scheme encompasses many of the collateral advantages derived by participants in sale-leaseback transactions as well as the same propensity to be declared a disguise for usury.[576]

Income Participation

For purposes of this section, the term "income participation" encompas-

568. *See* Spataro v. Domenico, 216 P.2d 32, 35 (Dist. Ct. App. 1950); Kawauchi v. Tabata, 413 P.2d 221, 223 (Hawaii 1966); Comment, *Real Estate Sale-Leaseback Agreements Under Texas Usury Law: Circumvention or Sale?*, 7 ST. MARY'S L.J. 821, 829 (1976).

569. *See* Marcus, *Real Estate Purchase-Leasebacks as Secured Loans*, 2 REAL EST. L.J. 664, 672-74 (1974); Comment, *Real Estate Sale-Leaseback Agreements Under Texas Usury Law: Circumvention or Sale?*, 7 ST. MARY'S L.J. 821, 830-33 (1976).

570. *See* Marcus, *Real Estate Purchase-Leasebacks as Secured Loans*, 2 REAL EST. L.J. 664, 671-72 (1974).

571. *See* Walker v. Temple Trust Co., 124 Tex. 575, 577-78, 80 S.W.2d 935, 936 (1935); Cotton v. Cooper, 209 S.W. 135, 136 (Tex. Comm'n App. 1919, judgmt adopted); A.B. Lewis Co. v. National Inv. Corp., 421 S.W.2d 723, 729 (Tex. Civ. App.—Houston [14th Dist.] 1967, writ ref'd n.r.e.). In *Cotton v. Cooper* the jury determined that an alleged purchase of wages was actually a usurious loan. *See* Cotton v. Cooper, 209 S.W. 135, 136 (Tex. Comm'n App. 1919, judgmt adopted).

572. 539 S.W.2d 71 (Tex. Civ. App.—Houston [1st Dist.]), *aff'd as modified*, 543 S.W.2d 862 (Tex. 1976) (per curiam).

573. *Id.* at 74.

574. *Id.* at 79.

575. *Id.* at 79.

576. See notes 549-562 *supra* and accompanying text. *See generally* Hershman, *Usury and "New Look" in Real Estate Financing*, 4 REAL PROP. PROB. & TR. J. 315, 319-23 (1969).

ses loan transactions that entitle the lender to share in the profits or proceeds of the borrower's enterprise.[577] This financing technique may entitle the creditor to a portion of the debtor's gross income, gross income in excess of a specified amount, or a percentage of the net income earned by the borrower's venture.[578] In *Beavers v. Taylor*[579] the lender agreed to make a loan at "no interest," however, she was to receive a percentage of the borrower's gross profits.[580] Over a nine year period her average annual share of the gross profits amounted to more than twenty percent of the principal. The loan was held to be free from usury because the compensation was dependent upon a contingency.[581] It is well settled that an advance of funds providing for compensation exceeding the statutory maximum rate is not usurious if the return is contingent.[582] Conversely, when the assignment of the borrower's profits is not speculative or contingent, and results in the lender's receipt of compensation in excess of the legal rate, the transaction is usurious.[583]

Equity Participation

In this scheme the borrower agrees to convey partial ownership of his

577. Examination of pertinent literature in this area will disclose a lack of uniformity in terminology. This confusion undoubtedly results from the circumstance that many cases simultaneously involve several forms of participation. *See* Hershman, *Usury and "New Look" in Real Estate Financing*, 4 REAL PROP. PROB. & TR. J. 315, (1969); Oxford, *Usury Update*, 16 TEXAS STATE BAR NEWSLETTER, REAL EST., PROB. & TR. LAW SECTION 26 (Oct. 1977); Podell, *The Application of Usury Laws to Modern Real Estate Transactions*, 1 REAL EST. L.J. 136 (1972); Comment, *Lender Participation in Borrower's Venture: A Scheme to Receive Usurisous Interest*, 8 HOUS. L. REV. 546 (1971); Comment, *The Application of Texas Usury Laws to Equity Participation Agreements*, 48 TEXAS L. REV. 925 (1970).

578. *See* Comment, *Lender Particpation in Borrower's Venture: A Scheme to Receive Usurious Interest*, 8 HOUS. L. REV. 546, 550-51 (1971).

579. 434 S.W.2d 230 (Tex. Civ. App.—Waco 1968, writ ref'd n.r.e.).

580. *Id.* at 231. The $5,000 loan agreement was entered into on February 3, 1958, and the borrower had the option to repay it at any time after January 31, 1959. *Id.* at 231.

581. *Id.* at 231. The lender would have received no compensation for the borrower's use of her money had their business venture failed to make a profit. Since the contract was not usurious on its face and there was no proof of usurious intent, the contract was legal and enforceable. *See id.* at 232; *accord,* Wagner v. Austin Sav. & Loan Ass'n, 525 S.W.2d 724, 730-31 (Tex. Civ. App.—Beaumont 1975, no writ); Pansy Oil Co. v. Federal Oil Co., 91 S.W. 2d 453, 457 (Tex. Civ. App.—Texarkana 1936, writ ref'd).

582. *See, e.g.,* Wagner v. Austin Sav. & Loan Ass'n, 525 S.W.2d 724, 731 (Tex. Civ. App.—Beaumont 1975, no writ); Beavers v. Taylor, 434 S.W.2d 230, 231 (Tex. Civ. App.—Waco 1968, writ ref'd n.r.e.); Pansy Oil Co. v. Federal Oil Co., 91 S.W.2d 453, 457 (Tex. Civ. App.—Texarkana 1936, writ ref'd).

583. *See* Thompson v. Hague, 430 S.W.2d 293, 296 (Tex. Civ. App.—Fort Worth 1968, no writ). This case concerned the execution of an interest-free note partially secured by the assignment of rent payments due the borrower. The court found that the value of the rents was not speculative and that the parties contemplated compensation to the lender in excess of the legal limit. *Id.* at 295-96.

business to the lender as consideration for the loan.[584] The lender's participation may take the form of any business entity including, but not limited to, corporation, joint venture, or partnership.[585] In *Johns v. Jaeb*[586] the court found that the formation of a limited partnership was nothing more than a subterfuge to conceal a usurious loan.[587] Once again the usury issue turned on whether the lender's return was truly contingent upon the success of the enterprise.[588] Whether the transaction is intended as a legitimate business investment or a usurious loan is a question for the fact-finder.[589] When the lender becomes a bona fide participant in the business venture, thus rendering his return contingent upon the success or failure of the enterprise, there is no violation of usury law.[590]

Wrap-Around Financing

The term wrap-around mortgage refers to a type of second mortgage on real property ordinarily used as a refinancing technique or to finance a purchase.[591] The face amount of the wrap-around note represents the sum of the existing unsatisfied obligation and the new advance.[592] It is not

584. Comment, *Lender Participation in Borrower's Venture: A Scheme to Receive Usurious Interest*, 8 Hous. L. Rev. 546, 551 (1971). *See generally* Hershman, *Usury and "New Look" in Real Estate Financing*, 4 Real Prop. Prob. & Tr. J. 315, 317-19 (1969).

585. *See* Hershman, *Usury and "New Look" in Real Estate Financing*, 4 Real Prop. Prob. & Tr. J. 315, 317-19 (1969); Comment, *Lender Participation in Borrower's Venture: A Scheme to Receive Usurious Interest*, 8 Hous. L. Rev. 546, 551 (1971).

586. 518 S.W.2d 857 (Tex. Civ. App.—Dallas 1974, no writ).

587. *Id.* at 859. While the lender was purportedly a limited partner in the enterprise, his contribution was secured by a promissory note from the general partner and absolutely repayable. *Id.* at 859.

588. *See id.* at 860. "When the amount invested is not subject to the risk of the enterprise because the party in charge has an absolute obligation to return the funds advanced, any profits agreed to be paid to the investor must be considered compensation for the use of money, and therefore, interest." *Id.* at 860.

589. *See* Ellis v. Security Underground Storage, Inc., 329 S.W.2d 313, 318 (Tex. Civ. App.—Fort Worth 1959, no writ).

590. *See* Johns v. Jaeb, 518 S.W.2d 857, 860 (Tex. Civ. App.—Dallas 1974, no writ); Palmeto Lumber Co. v. Gibbs, 52 S.W.2d 120, 127 (Tex. Civ. App.—Beaumont 1932), *aff'd*, 124 Tex. 615, 80 S.W.2d 742 (1935). This has been referred to as the "risk of loss doctrine." *See* Comment, *Lender Participation in the Borrower's Venture: A Scheme to Receive Usurious Interest*, 8 Hous. L. Rev. 546, 558 (1971).

591. *See* Lane, *The "Wraparound" Mortgage: Tax Problems Related to its Use in Connection with Refinancing or Sale of Real Estate*, 33 N.Y.U. Inst. Fed. Tax. 1235, 1236 (1975); Nad, *Financing Techniques and Problems: Wrap-Around Mortgages, Unusable Interest Deductions, and Interest Subsidy*, 29 N.Y.U. Ann. Inst. Fed. Tax. 1107, 1108 (1971); Note, *Wrap-Around Financing: A Tehcnique For Skirting The Usury Laws?*, 1972 Duke L.J. 785, 787.

592. *See* Lane, *The "Wraparound" Mortgage: Tax Problems Related to its Use in Connection with Refinancing or Sale of Real Estate*, 33 N.Y.U. Inst. Fed. Tax. 1235, 1236 (1975); Nad, *Financing Techniques and Problems: Wrap-Around Mortgages, Unusable Inter-*

essential that the wrap-around mortgagee assume the first mortgage, provided that the primary obligation thereunder is met from the wrap-around mortgage receipts.[593] A borrower finds this financing arrangement attractive as a means of liquidating accumulated equity while avoiding the encumbrance of an additional monthly payment; in fact, he may reduce his monthly obligation by extending the loan term.[594] The mortgagee gains the advantage of a substantial return for a relatively small initial investment by collecting interest calculated not only upon the cash advanced but the entire face value of the wrap-around note.[595] Furthermore, a substantial portion of the loan is deferred and advanced incrementally as the original mortgage matures, which allows the lender to use these "loaned" funds until they become due.[596]

The Purchase Money Wrap-Around Mortgage

One type of wrap-around mortgage was examined by a Texas court in *Ferguson v. Tanner Development Co.*,[597] in which the lender owned property subject to an outstanding mortgage.[598] A portion of this property was conveyed to the borrower who made a down payment thereon and executed a note to the lender for the remaining balance.[599] This type of note has been referred to as a "purchase money wrap-around mortgage."[600] The danger

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est Deductions, and Interest Subsidy, 29 N.Y.U. ANN. INST. FED. TAX. 1107, 1108 (1971); Note, *Wrap-Around Financing: A Technique For Skirting The Usury Laws?*, 1972 DUKE L.J. 785, 787.

593. *See* Hershman, *Usury and "New Look" in Real Estate Financing*, 4 REAL PROP. PROB. & TR. J. 315, 323 (1969). In fact it may be an exceptional instance when the lender does "assume" the underlying obligation. *Cf.* Lane, *The "Wraparound" Mortgage: Tax Problems Related to its Use in Connection with the Refinancing or Sale of Real Estate*, 33 N.Y.U. INST. FED. TAX. 1235, 1236 (1975) (lender "does not assume or, at least in the real property sense, take 'subject to' the first mortgage"); Nad, *Financing Techniques and Problems: Wrap-Around Mortgages, Unusable Interest Deductions, and Interest Subsidy*, 29 N.Y.U. ANN INST. FED. TAX. 1107, 1108 (1971) (lender does not assume liability for first mortgage, but "agrees" to make installment payments on senior mortgage).

594. *See* Lane, *The "Wraparound" Mortgage: Tax Problems Related to its Use in Connection with Refinancing or Sale of Real Estate*, 33 N.Y.U. INST. FED. TAX. 1235, 1237 (1975).

595. *See id.* at 1237.

596. *See* Note, *Wrap-Around Financing: A Technique For Skirting The Usury Laws?*, 1972 DUKE L.J. 785, 788.

597. 541 S.W.2d 483 (Tex. Civ. App.—Houston [1st Dist.] 1976), *rev'd*, 561 S.W.2d 777 (Tex. 1977).

598. *Id.* at 483. This is apparently the first time a wrap-around mortgage has been examined by a Texas appellate court for possible violation of usury statutes. *See* St. Claire, *The Spreading of Interest Under the Actuarial Method*, 10 ST. MARY'S L.J. 753, 766-67 n.72 (1979).

599. *See* Ferguson v. Tanner Dev. Co., 541 S.W.2d 483, 494 (Tex. Civ. App.—Houston [1st Dist.] 1976), *rev'd*, 561 S.W.2d 777 (Tex. 1977).

600. *See* Note, *Wrap-Around Financing: A Technique For Skirting The Usury Laws?*,

of usury being found in a transaction involving a purchase money wrap-around mortgage is minimal since the vendor is wrapping the new mortgage around a personal debt, and actually advances equity in the property commensurate to the obligation incurred by the purchaser/wrap-around mortgagor.[601]

In *Tanner* the lender/wrap-around mortgagee was sued for the statutory usury penalties,[602] although the allegations of usury were based on the terms of the note and were not grounded in the wrap-around financing technique used.[603] The court of civil appeals dismissed the lender's contention that the penalties should be restricted to interest on the difference between the wrap-around mortgage and the first mortgage.[604] The payments made by the borrower clearly benefitted the lender as they were applied to payments due on the first mortgage.[605] The court held that in a usurious wrap-around mortgage transaction of this type, the computation of penalties will not be affected by the underlying mortgage.[606] Thus, the true principal was the face amount of the wrap-around note, and the interest rate was calculated from the payments made on that principal.[607]

1972 DUKE L.J. 785, 801-06. A variation of the "purchase money wrap-around" occurs when the buyer and seller of real estate look to a third party lender who wraps-around the vendor's original mortgage in order to provide financing for the purchaser. *See id.* at 789. For an in depth analysis of the usury implications of this specific transaction, see *id.* at 806-10.

601. *See id.* at 810-11.

602. *See* Ferguson v. Tanner Dev. Co., 541 S.W.2d 483, 485 (Tex. Civ. App.—Houston [1st Dist.] 1976), *rev'd,* 561 S.W.2d 777 (Tex. 1977).

603. *Id.* at 494-95.

604. *Id.* at 494. Tanner's argument was based on the rule that one is not liable for the receipt of usurious interest collected for the benefit of another. *Id.* at 494; *see* Stacks v. East Dallas Clinic, 409 S.W.2d 842, 844-45 (Tex. 1966). It was noted that *Stacks* was based upon interpretation of the usury statute that had not authorized penalties for double the interest demanded, *contracted for,* or received. *See* Ferguson v. Tanner Dev. Co., 541 S.W.2d 483, 494 (Tex. Civ. App.—Houston [1st Dist.] 1976), *rev'd,* 561 S.W.2d 777 (Tex. 1977).

605. *See* Ferguson v. Tanner Dev. Co., 541 S.W.2d 483, 494 (Tex. Civ. App.—Houston [1st Dist.] 1976), *rev'd,* 561 S.W.2d 777 (Tex. 1977). The court observed that Ferguson had not contractually assumed obligation of the first mortgage, and that Tanner retained sole liability upon it. *Id.* at 494. It is not clear from the opinion whether assumption of the underlying mortgage by a wrap-around mortgagor would have changed the result.

606. *See id.* at 494-95.

607. *See id.* at 494-95. At least one writer has suggested that the result may be different in a case in which the vendor sells his property for the amount of his equity and allows the purchaser to assume an existing mortgage. If a third party advances the purchase money, and then takes a wrap-around note that includes both the funds advanced and the amount of the pre-existing mortgage, the true principal may be held to be only so much of the note as was actually advanced. In that event, interest payments on the stated principal would likely result in usury. *See* St. Claire, *The Spreading of Interest Under the Actuarial Method,* 10 ST. MARY'S L.J. 753, 766-67 n. 72 (1979).

The Refinancing Wrap-Around Mortgage

Another form of wrap-around transaction has been referred to as the "refinancing wrap-around mortgage."[608] This technique normally concerns property with a mortgage that the borrower is unable to repay, or the interest rate of the existing mortgage is so low that prepayment is undesirable because of an increase in property value or advanced amortization.[609] Sufficient collateral exists, however, to support a much larger loan.[610] The lender generally makes a new mortgage loan based upon current property value, assumes the borrower's first mortgage obligation, and advances the difference between the second, wrap-around mortgage and the original.[611] In this way the lender can afford to charge less than current market mortgage rates and absorb the difference between the low interest rate of the first mortgage and the rate of the wrap-around mortgage.[612]

Texas courts have not addressed the usury implications of a "refinancing wrap-around mortgage" transaction in which the debtor/mortgagor is paying interest within the statutory limits, but, because of the difference in interest rates between the first mortgage and the wrap-around mortgage, the effective yield to the lender exceeds the legal maximum.[613] The weakness inherent in alleging usury in this transaction is that while the lender may collect considerably more than the statutory limit, it is difficult to demonstrate that the borrower is paying usurious interest.[614] The determination ultimately depends upon whether the court

608. *See* Note, *Wrap-Around Financing: A Technique For Skirting The Usury Laws?*, 1972 DUKE L.J. 785, 787-89. Other terms used in reference to the wrap-around financing technique include "all-inclsive," "hold-harmless," and "overriding" mortgage. *See id.* at 786.

609. *See* Hershman, *Usury and "New Look" in Real Estate Financing*, 4 REAL PROP. PROB. & TR. J. 315, 323 (1969).

610. *Id.* at 323.

611. *See id.* 323; Note, *Wrap-Around Financing: A Technique For Skirting The Usury Laws?*, 1972 DUKE L.J. 785, 787-89; Comment, *The Wrap-Around Mortgage: A Critical Inquiry*, 21 U.C.L.A. L. REV. 1529, 1529-30 (1974).

612. *See* Hershman, *Usury and "New Look" in Real Estate Financing*, 4 REAL PROP. PROB. & TR. J. 315, 323-24 (1969).

613. Since the lender deducts the amount due on the first mortgage from the face value of the wrap-around note, he receives interest payments on a larger sum than was advanced. *See* Note, *Wrap-Around Financing: A Technique For Skirting The Usury Laws?*, 1972 DUKE L.J. 785, 810.

614. *See* Hershman, *Usury and "New Look" in Real Estate Financing*, 4 REAL PROP. PROB. & TR. J. 315, 324 (1969); Note, *Wrap-Around Financing: A Technique For Skirting The Usury Laws?*, 1972 DUKE L.J. 785, 792-97. It could be demonstrated, however, that since only a portion of the stated principal of the wrap-around note was actually advanced, the "true principal" is really the amount of the advance. With the principal so reduced, interest payments on the stated principal would probably be usurious. *See* Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 787 (Tex. 1977). Proper structuring of the transaction could possibly prevent this type of judicial manipulation of the principal. If the lender, as further consideration for the wrap-around note, assumes the principal and interest payments on the pre-existing mort-

chooses to test for usury based upon the amount paid by the borrower or that received by the lender.[615] While there is some authority that Texas courts construe usury statutes as penal in nature and thus make the determination based upon what the lender receives, there is also conflicting authority.[616] A major policy consideration is that the wrap-around mortgage is normally advantageous to all parties involved.[617]

Another significant factor in testing wrap-around transactions for usury is the applicability of "spreading."[618] Under normal conditions the lender will receive interest calculated on the face value of the note, although during the early years of the loan term the entire amount has not yet been advanced.[619] This results in the mortgagee's receipt of inflated interest rates during the early years of the loan term, effectively decreasing as the term advances since the mortgagee is periodically advancing more of the principal in the form of payments on the original obligation.[620] In avoiding usury violations, the application of the "spreading doctrine" is as advantageous to the wrap-around mortgagee as it is to lenders charging "front-end" fees or "interest in advance."[621] Judicial commentary on the usury implications of wrap-around financing is rare.[622] Cautious investors contemplating a wrap-around financing venture would be prudent to structure the transaction so that their return remains within the applicable usury ceilings.[623]

gage, then the justification for determining a "true principal" fails. The payor on the wrap-around note retains the full consideration he was to receive, that is, the funds advanced on the wrap-around and relief from his obligation on the pre-existing mortgage. *See id.* at 786-87.

615. *See* Note, *Wrap-Around Financing: A Technique For Skirting The Usury Laws?*, 1972 DUKE L.J. 785, 795.

616. See note 555 *supra* and accompanying text.

617. *See generally* Galowitz, *How to Use Wrap-Around Financing*, 5 REAL EST. L.J. 107, 112-23 (1976).

618. *See* TEX. REV. CIV. STAT. ANN. art. 5069-1.07(a) (Vernon Supp. 1978-1979). See notes 454-474 *supra* and accompanying text for an analysis of the spreading doctrine.

619. *See* Note, *Wrap-Around Financing: A Technique For Skirting The Usury Laws?* 1972 DUKE L.J. 785, 787-89.

620. *See id.* at 787-89.

621. See notes 454-480 *supra* and accompanying text.

622. *See* Galowitz, *How to Use Wrap-Around Financing*, 5 REAL EST. L.J. 107, 112-23 (1976); Note, *Wrap-Around Financing: A Technique for Skirting Usury Laws?*, 1972 DUKE L.J. 785, 786. An unpublished California case has examined a transaction such as that mentioned above and found it free from the taint of usury. *See* Comment, *The Wrap-Around Mortgage: A Critical Inquiry*, 21 U.C.L.A. L. REV. 1529, 1539 (1974), *citing*, Grossman v. Siarianni, No. 48138 (Cal. Ct. App., 2d Dist., Jan. 27, 1972, not certified for publication).

623. *See* Podell, *The Application of Usury Laws to Modern Real Estate Transactions*, 1 REAL EST. L.J. 136, 150 (1972); Note, *Wrap-Around Financing: A Technique for Skirting Usury Laws?*, 1972 DUKE L.J. 785, 810-11.

CONCLUSION

The variety of schemes designed to circumvent usury restrictions result from economic realities such as tight money markets and inflation.[624] Commentators have noted that these schemes, designed to avoid profit limitations imposed by usury statutes, subject participants to legal risk in addition to economic risk and contend that these uncertainties inhibit economic development.[625] Remedial suggestions range from proposed statutory changes[626] to the complete abrogation of legal restrictions on interest rates in commercial transactions.[627]

Absent a tight money market and inflationary trends, endeavors to avoid legal limitations on investment returns will likely continue, sustained by profit motive alone. The courts have repeatedly declared their intention to thoroughly analyze loan transactions in which usury has been alleged, and to look through the form of the agreement to its substance.[628] Any loan transaction from which the lender anticipates a return in excess of the statutory limit, or for which the method of calculating the rate of interest is uncertain, may be vulnerable to judicial interpretation as usurious regardless of how the transaction may be structured. Analysis of recent cases indicates a judicial tendency to strictly construe usury regulations.[629] In view of the judicial climate, the prudent lender should anticipate intense scrutiny of all loan transactions and exercise appropriate caution.[630]

624. *See* Podell, *The Application of Usury Laws to Modern Real Estate Transactions,* 1 REAL EST. L.J. 136, 150 (1972); Comment, *Lender Participation in Borrower's Venture: A Scheme to Receive Usurious Interest,* 8 HOUS. L. REV. 546, 546-47 (1971); Comment, *Usury Implications of Front-End Interest and Interest in Advance,* 29 SW. L.J. 748, 765 (1975).

625. *See* Loiseaux, *Some Usury Problems in Commercial Lending,* 49 TEXAS L. REV. 419, 442-43 (1971); Podell, *The Application of Usury Laws to Modern Real Estate Transactions,* 1 REAL EST. L.J. 136, 149 (1972).

626. *See* Comment, *Lender Participation in Borrower's Venture: A Scheme to Receive Usurious Interest,* 8 HOUS. L. REV. 546, 567-73 (1971); Comment, *Usury Implications of Front-End Interest and Interest in Advance,* 29 SW. L.J. 748, 766 (1975); 30 BAYLOR L. REV. 174, 181 (1978).

627. *See* Loiseaux, *Some Usury Problems in Commercial Lending,* 49 TEXAS L. REV. 419, 443 (1971). While supporting legislative controls over consumer credit, the author submits that protection of commercial borrowers is unnecessary. *See id.* at 443.

628. *See, e.g.,* Gonzales County Sav. & Loan Ass'n. v. Freeman, 534 S.W.2d 903, 906 (Tex. 1976); Stacks v. East Dallas Clinic, 409 S.W.2d 842, 845 (Tex. 1966); Schmid v. City Nat'l Bank, 132 Tex. 115, 117, 114 S.W.2d 854, 855 (1938).

629. *See* Oxford, *Usury Update,* 16 TEXAS STATE BAR NEWLETTER, REAL EST., PROB. & TR. LAW SECTION 26, 37 (Oct. 1977).

630. *See id.* at 37.