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. Article 5069-1.09 concerns certain loans guaranteed or insured by the federal government. These loans include those made by the Federal Housing Administration and Veteran's Administration and are exceptions because they are regulated by federal laws.

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

JACK H. ROBISON

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. The Texas Legisla-
ture has defined interest as the legal compensation “for the use or forbearance or detention of money.” 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.

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. These fees are commonly assessed in addition to the stipulated interest, and are therefore not referred to as interest by the parties. 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. The courts closely scrutinize front-end fees to determine whether they are bona fide charges for separate services or merely disguises to conceal usury. Recompense exacted for ordinary operating costs or “overhead expenses” is not exempt from judicial classification as interest.

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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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, 865 (1938).


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, 196-96, 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).

Fees that have been judicially declared interest despite designation as something other than interest by the parties to the loan agreement include service charges,20 closing fees,21 handling charges,22 carrying charges, and origination charges.23 It must be clearly noted that the labels attached to these fees are not binding upon the court.24 When conflicting evidence results in dispute concerning whether the charge is simply a guise for additional interest charges, the matter becomes a jury question.25

A unique situation arises when a lender requires a third party to pay a fee as a condition precedent to approving a loan.26 While this is a relatively


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).


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.).


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).

common practice in the real estate loan industry. Texas courts have rarely examined the usury implications of such a transaction. In Goodman v. Seely 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. 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. Conversely, in view of judicial proclivity to consider the substance of a transaction paramount to its form when testing for usury, 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.

A 1960 amendment to the Texas Constitution increased the legislature's authority to define usury, and pursuant to this authority, the legislature enacted the Texas Savings and Loan Act. 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.

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.


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).


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.


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
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.\footnote{Id.} The Wagner interpretation was subsequently rendered inconsequential by Gonzales County Savings & Loan Ass'n v. Freeman,\footnote{Id.} when the court in effect ruled section 5.07 unconstitutionally vague for failure to define interest or fix a maximum rate of interest.\footnote{Id.} 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.\footnote{Id.} 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."\footnote{Id.} Noting that the fee under scrutiny plainly fit the statutory definition of interest,\footnote{Id.} 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.\footnote{Id.} re...
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" portions of interest payments due later in the repayment term (if computed by the straight-line method) into the early payments.448 The net result is inflated payments early in the term and deflated payments late in the term.449 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.450 Until recently, prepayment of interest was also advantageous to some borrowers as prepaid interest was a federal income tax deduction.451 This tax advan-

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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.


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).


450. As an example, consider a five year $1,000 loan at ten percent per annum with yearly interest payments. The principal 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."

<table>
<thead>
<tr>
<th>Year</th>
<th>Straight-line Payments</th>
<th>Interest in Advance Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$100</td>
<td>$150</td>
</tr>
<tr>
<td>2</td>
<td>$100</td>
<td>$125</td>
</tr>
<tr>
<td>3</td>
<td>$100</td>
<td>$100</td>
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<tr>
<td>4</td>
<td>$100</td>
<td>$ 75</td>
</tr>
<tr>
<td>5</td>
<td>$100</td>
<td>$ 50</td>
</tr>
<tr>
<td></td>
<td><strong>$500 Total</strong></td>
<td><strong>$500 Total</strong></td>
</tr>
</tbody>
</table>


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
The term "spreading" describes the practice of averaging the total amount of interest charged over the entire repayment term when examining a loan transaction for usury. This technique was implemented by the Texas Supreme Court in *Nevels v. Harris* 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. The *Nevels* doctrine of spreading has been followed by a number of Texas courts examining loans containing "front-end" charges. In contrast with the *Nevels* doctrine, another line of cases adopted a "year-by-year" test for usury. 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.
This conflict was apparently resolved by Tanner Development Co. v. Ferguson 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. 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." 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. When testing cash loan transactions involving "front-end" charges, the "true principal" to be used is the sum actually received by the borrower. 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. 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. Although some courts have taken the further step of adding the front-end fee to stipulated interest, the 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).


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).


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).

found this method to be an obvious error. 460 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. 461 This distinction between cash loans and purchase money loans secured by real property has attracted valid criticism as arbitrarily favoring the real estate financier. 462 The borrower in Tanner was paying interest as consideration for the lender's forbearance of the stipulated principal of $226,388.77. 463 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. 464 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. 465 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. 466 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. 467 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. 468 A literal reading of the words "consideration (such as land)" within context indicates that this procedure is not necessarily lim-

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460. 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).

461. See Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 782 (Tex. 1977). 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. 464 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. 465


466. See id. at 787.
ited to seller-financed land sales, but could conceivably be extended to sales of goods. 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. 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.

Prepayment Penalties

Most loan agreements assess penalty charges upon borrowers who elect to discharge their indebtedness ahead of schedule. These charges are not considered interest by Texas courts when examining loan agreements for usury, and have been statutorily sanctioned for real property loans. 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. If, however, judicial examination discloses excessive or unreasonable penalties under the circumstances, the penalties may be declared a mere disguise for usurious interest.

Late Charges

Loan agreements also commonly provide penalties for late payment.

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).
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.e. per curiam, 447 S.W.2d 676 (Tex. 1969).
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 “inconvenience suffered” by the lender as a result of borrower’s prepayment. Id. at 908 (dictum). See also Texas 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).
Savings and loan associations have been authorized by law to levy reasonable penalties for late payments on real estate loans487 and these penalties are therefore not treated as interest.488 Conversely, late payment penalties that are not statutorily authorized will be judicially declared interest when loan transactions are scrutinized for usurious content.489

In Parks v. Lubbock490 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 acceleration 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 borrower's default.497 When the terms of the agreement allow the lender's exercise of his acceleration option to result in the borrower's

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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.
492. 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).
payment of interest at a rate exceeding the legal maximum, the transaction is usurious. As with late charges, the finding of usury is based upon the statutory designation of interest as compensation for the "detention" of money. Any charges levied against a borrower for his detention of funds due the lender are considered interest rather than penalties. In Shropshire v. Commerce Farm Credit Co., the Texas Supreme Court examined an acceleration clause that expressly prohibited the "abatement" of unearned interest. The court held the contract usurious because of its provision for the lender's retention of usurious interest upon the borrower's default. Subsequent cases have found that acceleration clauses without provision for the cancellation of unaccrued interest do not necessarily render usurious an otherwise legal contract. It has recently been held that termination of payments on a usurious loan agreement does not constitute default justifying acceleration of maturity.

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, 30 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, 30 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. The Texas Supreme Court recently examined a loan transaction involving a commitment fee in Gonzales County Savings & Loan Ass'n v. Freeman. The debtors in Freeman borrowed $38,400 for one year at the stipulated interest rate of nine percent per annum. They were also charged an additional two percent "loan fee" of $786. The court of civil appeals erroneously surmised that even if the "loan fee" was a commitment fee, it would constitute interest. In rejecting that reasoning the Texas Supreme Court held that a bona fide commitment fee is not interest. 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.


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. In *Crow v. Home Savings Ass'n* the borrower solicited the aid of a broker in his endeavors to obtain funding for a business venture. The broker arranged for the borrower to meet with a lender who subsequently made the desired loan. 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.

While it is of fundamental importance that the lender derive no benefit from compensation paid to the broker, it is not imperative that there be no relationship between the lender and the broker. In *Nevels v. Harris* 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.” As in all usury cases, however, the court will consider substance over form in scrutinizing the transaction for any subterfuge masking usury.

Credit Insurance Premiums

The required payment of reasonable credit insurance premiums as a

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.


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.


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

521. *Id.* at 190, 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 190, 102 S.W.2d at 1046-49.

condition precedent to a loan is not considered interest unless found to be a disguise for the exaction of usurious interest. 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; 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. 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).


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. He must also be allowed the option to meet the insurance requirements through existing policies he owns or controls. If the lender denies the borrower the right to choose an insurance carrier, the premiums paid will be considered interest in usury computations.

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. 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 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. 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. This figure was then used in computing the rate of interest. 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.

528. See id. § 11.
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."^{335}

In *Texas International Mortgage Co. v. M.P. Crum Co.*,^{336} 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.^{337} The borrower contended that since it only had use of $400,000, the collection of interest on $500,000 constituted usury.^{338} 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.^{339} While the borrower was denied the unrestricted use of the compensating deposit, he was not deprived of the interest earned by the fund.^{340}

*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.^{341} The contention of the borrower in *Crum* is supported by *Tanner Development Co. v. Ferguson*,^{342} 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.^{343} This proposition is grounded upon the premise that the borrower should only be required to...

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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).


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

543. *Id.* at 787.
pay interest on money that he has had the opportunity to use. 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. 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. 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.

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. In Commerce Savings Ass’n v. GGE Management Co. the court examined a transaction in which the debtor was required to retain brokered deposits with both the lender and a separate bank. 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. The court emphasized that the creditor received no brokerage fees and that the borrower’s negotiations with the brokers constituted independent transactions. 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.

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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).
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 borrower is required to pay compensation exceeding the legal interest rate, but whether the lender receives usurious interest.\textsuperscript{554} Texas courts have construed usury statutes as penal in nature, designed to punish the creditor who extracts usurious interest from his debtor.\textsuperscript{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.\textsuperscript{556}

**Participation Schemes**

The ensuing segment of this commentary will examine several non-conventional 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.\textsuperscript{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.\textsuperscript{558} The transaction inures to the benefit of the vendor/lessee by allowing liquidation of his equity and acquisition of funds

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

\textsuperscript{555}. See, e.g. First State Bank v. Miller, 583 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).

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


to improve the property while retaining its use.\textsuperscript{559} The sale-leaseback scheme allows the original owner to obtain one hundred percent of the property value\textsuperscript{560} whereas a conventional mortgage would be unlikely to yield more than seventy-five percent of the fair market value.\textsuperscript{561} Further the vendor/lessee enjoys an excellent tax advantage since rent on income-producing property is tax deductible.\textsuperscript{562} On the other hand, the vendee/lessor receives a significantly higher return on his investment than he would as an ordinary mortgagee.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{567}

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


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


\textsuperscript{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).


\textsuperscript{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.\textsuperscript{568} Other factors commonly considered in this regard are whether the contract includes an option for repurchase\textsuperscript{569} and whether significant disparity exists between market value and sale price.\textsuperscript{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.\textsuperscript{571}

**Sale-Buyback**

A Texas court has examined a scheme analogous to the sale-leaseback in *Commerce Savings Ass'n v. GGE Management Co.*\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{576}

**Income Participation**

For purposes of this section, the term "income participation" encompasses

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\textsuperscript{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).

\textsuperscript{573} Id. at 74.

\textsuperscript{574} Id. at 79.

\textsuperscript{575} Id. at 79.

ses loan transactions that entitle the lender to share in the profits or proceeds of the borrower’s enterprise. 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. In Beavers v. Taylor the lender agreed to make a loan at “no interest,” however, she was to receive a percentage of the borrower’s gross profits. 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. 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. 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.

**Equity Participation**

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

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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).


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. Jaeb586 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


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.


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).


essential that the wrap-around mortgagee assume the first mortgage, provided that the primary obligation thereunder is met from the wrap-around mortgage receipts. 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. 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. 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.

The Purchase Money Wrap-Around Mortgage

One type of wrap-around mortgage was examined by a Texas court in Ferguson v. Tanner Development Co., in which the lender owned property subject to an outstanding mortgage. 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. This type of note has been referred to as a "purchase money wrap-around mortgage." The danger

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).


595. See id. at 1237.


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).


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

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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

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601. See id. at 810-11.
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." 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. Sufficient collateral exists, however, to support a much larger loan. 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. 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.

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. 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. The determination ultimately depends upon whether the court


610. Id. at 323.


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. 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. A major policy consideration is that the wrap-around mortgage is normally advantageous to all parties involved.

Another significant factor in testing wrap-around transactions for usury is the applicability of "spreading." 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. 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. 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." Judicial commentary on the usury implications of wrap-around financing is rare. 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.

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.


616. See note 555 supra and accompanying text.


620. See id. at 787-89.

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


STUDENT SYMPOSIUM

CONCLUSION

The variety of schemes designed to circumvent usury restrictions result from economic realities such as tight money markets and inflation. 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. Remedial suggestions range from proposed statutory changes to the complete abrogation of legal restrictions on interest rates in commercial transactions.

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. 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. In view of the judicial climate, the prudent lender should anticipate intense scrutiny of all loan transactions and exercise appropriate caution.


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).


630. See id. at 37.