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# USURY IMPLICATIONS OF FRONT-END INTEREST AND INTEREST IN ADVANCE

by B. Prater Monning, III

The moneylender has never enjoyed complete freedom in the pursuit of his profession, primarily due to the usury laws. Disdain of the "usurer" is of ancient origin,<sup>1</sup> and the prohibition of excessive interest has its basis in the religious,<sup>2</sup> philosophical,<sup>3</sup> and literary<sup>4</sup> history of the western world. Today, usury is a matter of state law,<sup>5</sup> almost all states having some type of usury statute.<sup>6</sup> In addition, most states have sophisticated provisions for special loans, most notable of which are corporate exceptions statutes<sup>7</sup> and consumer protection laws.<sup>8</sup>

In a tight-money market, when the market rate of interest approaches the maximum legal rate, the restraining influence of the usury laws forces lenders to discontinue conventional modes of lending and to develop new, perhaps more profitable, perhaps illegal, methods. This Comment will

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1. The CODE OF HAMMURABI § 51 (ca. 1600 B.C.) prohibited exorbitant rates of interest. In addition, there were usury statutes in ancient China, the KORAN OF MOHAMMED, and the TWELVE TABLES OF ROME. In early Athens moneylenders were viewed with such public contempt that legislation could serve no further purpose. Dunham v. Gould, 16 Johns. 367, 376 (N.Y. 1819).

2. See, e.g., Deuteronomy 23:20; Exodus 22:25; Leviticus 25:36-37; Nehemiah 5:7, 10-12; Ezekiel 18:8 (Mod. Eng. ed.). See also W. BLACKSTONE, COMMENTARIES 482-84 (B. Gavit ed. 1941); H. SPIEGEL, THE GROWTH OF ECONOMIC THOUGHT 64-65 (1971); Frierson, *Changing Concepts of Usury: Ancient Times Through the Times of John Calvin*, 7 AM. BUS. L.J. 115 (1970).

3. See, e.g., ARISTOTLE, POLITICS, Book I, c.10; F. BACON, MORAL ESSAYS; OF USURY (1625); J. BENTHAM, DEFENSE OF USURY (1841); PLATO, DIALOGUES 124 (B. Jowett trans. 1931). See also J. KEYNES, GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY 351-52 (1936); B. NELSON, THE IDEA OF USURY (1949); Frierson, *supra* note 2; Noonan, *Tokos and Atokion: An Examination of the Natural Law Reasoning Against Usury and Against Contraception*, 10 NAT. L. FORUM 215 (1965).

4. See, e.g., DANTE, DIVINE COMEDY, *Inferno*, Canto 17:45; W. SHAKESPEARE, MERCHANT OF VENICE, Act 2, Scene 1:129-35. See also Note, *Shakespeare and the Legal Process: Four Essays*, 61 VA. L. REV. 390, 402-11 (1975).

5. National banks are limited in their lending practices by state usury laws. 12 U.S.C. § 85 (1945). See generally Morris, *The Laws of Usury as Applied to National Banks*, 81 BANKING L.J. 847 (1964).

6. Massachusetts is the only exception. See the discussion in Merriman & Hanks, *Revising State Usury Statutes in Light of a Tight Money Market*, 27 MD. L. REV. 1, 8 (1967).

7. See, e.g., TEX. REV. CIV. STAT. ANN. art. 1302-2.09 (Supp. 1974), which provides that loans to corporations may carry interest up to 18%, rather than 10% which is the ceiling to individuals as provided in TEX. REV. CIV. STAT. ANN. art. 5069-1.02 (1971). See generally Comment, *Using a "Dummy" Corporate Borrower Creates Usury and Tax Difficulties*, 28 SW. L.J. 437 (1974). The Dallas court of civil appeals recently held in *Skeen & Skeen v. Glenn Justice Mortgage Co.*, 526 S.W.2d 252 (Tex. Civ. App.—Dallas 1975, no writ) that the Texas corporate exception statute allows incorporation for the sole purpose of avoiding the usury laws.

8. See, e.g., TEX. REV. CIV. STAT. ANN. arts. 5069-2.01 to -50.06 (1971). See generally Smyer, *A Review of Significant Legislation and Case Law Concerning Consumer Credit*, 6 ST. MARY'S L.J. 37 (1974). The Texas Consumer Credit Code provides for numerous classifications of consumer loans and lenders, allowing in some instances up to 240% interest. Comment, *Consumer Credit Regulation in Texas—The Case for the Consumer*, 49 TEXAS L. REV. 1001, 1026 (1971). See also Pub. L. No. 93-501 (Oct. 29, 1974), which supersedes state law insofar as loans of a business or agricultural nature are concerned. Wallenstein, *Property, Annual Survey of Texas Law*, 29 SW. L.J. 29, 44-45 (1975), discusses several problems raised by this legislation.

discuss usury implications of two such methods, interest in advance and front-end interest, placing particular emphasis upon Texas decisions relating to the operation of, and the interest computations necessitated by the use of these two methods.

Perhaps due to confusion of interest in advance with front-end interest, the Sixty-Fourth Legislature of Texas has seen fit to codify the so-called "spreading" concept for the computation of interest rates on loans secured by any interest in real property.<sup>9</sup> This Comment will discuss the background, need, and validity of that legislation.

### I. PRELIMINARY CONSIDERATIONS

The Revised Statutes of Texas define usury as "interest in excess of the amount allowed by law,"<sup>10</sup> and in the normal, non-corporate,<sup>11</sup> commercial situation the law allows a maximum rate of "ten per cent per annum."<sup>12</sup> Case law defines usury as including three elements: (1) an agreement to lend money; (2) an absolute obligation of the borrower to repay the principal; and (3) greater compensation (interest) than that allowed by law.<sup>13</sup> There is considerable authority for the proposition that there must exist an intent on the part of the lender to charge usurious interest,<sup>14</sup> but cases have seldom turned on the issue.<sup>15</sup> In fact, intent has been found self-evident where the loan was usurious on its face.<sup>16</sup>

The major problems regarding usury implications of front-end interest and interest in advance loans revolve around the determination of the actual or true principal<sup>17</sup> amount of a loan and the methods of applying interest charges to that principal. Because of basic differences in the two types of loans, it will be necessary at the outset to distinguish them from one another and to familiarize the reader with their operation.

9. Ch. 26, §§ 1-4, [1975] Tex. Laws Reg. Sess. 47-48, to be codified as TEX. REV. CIV. STAT. ANN. art. 5069-1.07. The law affects only those loans consummated after Sept. 2, 1975. *Id.*

10. TEX. REV. CIV. STAT. ANN. art. 5069-1.01(d) (1971).

11. See note 7 *supra*.

12. TEX. REV. CIV. STAT. ANN. art. 5069-1.02 (1971).

13. See generally Pearce & Williams, *Punitive Past to Current Convenience—A Study of the Texas Law of Usury*, 22 Sw. L.J. 233, 236-37 (1968).

14. See, e.g., *Dorfman v. Smith*, 517 S.W.2d 562 (Tex. Civ. App.—Houston [1st Dist.] 1974, no writ); *Hernandez v. United States Fin. Co.*, 441 S.W.2d 859 (Tex. Civ. App.—Waco 1969, writ dism'd).

15. See Note, *Usury—A Loan Can be Usurious Even Though the Lender Has No Intent To Charge Interest Above the Statutory Maximum*, 48 TEXAS L. REV. 711 (1970). The intent requirement is to a degree implicit in the penalty provision of the Texas usury laws: "[T]here shall be no penalty for a violation which results from an accidental or bona fide error." TEX. REV. CIV. STAT. ANN. art. 5069-1.06(1) (1971). Also, the federal penalty provision requires *scienter* as a prerequisite to recovery. 12 U.S.C. § 86 (1970).

16. *Moser v. John F. Buckner & Sons*, 292 S.W.2d 668, 672 (Tex. Civ. App.—Waco 1956, writ ref'd) (applying doctrine of *res ipsa loquitur*); *accord*, *Freeman v. Hernandez*, 521 S.W.2d 108 (Tex. Civ. App.—Dallas 1975, no writ); *Johns v. Jaeb*, 518 S.W.2d 857 (Tex. Civ. App.—Dallas 1974, no writ).

17. By actual or true principal is meant the actual amount of money loaned to the borrower by the lender. The "stated" principal on the face of a loan agreement is frequently more than the true principal, particularly in loans involving front-end interest where an amount is subtracted from the principal before advancement. For usury determinations it is the true principal that is important. See notes 77-79 *infra* and accompanying text.

A. *Interest in Advance*

Simply stated, interest in advance is interest actually paid before the borrower has had the use of the borrowed funds for the time period for which such interest is charged.<sup>18</sup> Such transactions generally entail a higher rate of interest being charged and paid in the early years of a loan period than is charged and paid in later years. Functionally, the lender will compute the amount of interest chargeable on a given principal at a straight-line rate over an entire loan period, and deduct sums which would ordinarily accrue in later years; he will then "squeeze"<sup>19</sup> such sums into the interest payments in earlier years of the loan term. For example, consider a loan of \$1,000 for five years, with interest only payable at the end of each year and principal payable in lump sum at the end of the loan term. The lender will first compute the maximum amount of interest chargeable, which, assuming a ten percent maximum rate,<sup>20</sup> will be \$100 per year: \$500 for the entire loan term. Rather than charging \$100 interest in the first and second years of the loan term, the interest in advance lender will require \$125, "squeezing" \$25 into those charges. The "squeezed" interest will be balanced by charging only \$75 interest in the fourth and fifth years of the loan term. The payment schedule would thus appear:<sup>21</sup>

Year	\$ Interest Paid	Yearly Rate
1	\$125	12.5%
2	125	12.5%
3	100	10.0%
4	75	7.5%
5	75	7.5%
	<hr/> \$500	<hr/> 10.0%
	(total)	(average)

Thus, while the lender will charge and receive only \$500 over the entire loan term, his rate of return is considerably greater in the interest in advance transaction than in a transaction calling for a straight-line rate (\$100 per year). From the standpoint of the usury laws, the major thrust of interest in advance is that in the early years of the loan term it imposes upon the borrower the obligation to pay interest for a greater length of time than he has had the use of the principal amount of the loan.

18. As will be noted later, front-end interest is never actually paid at the "front-end" of a loan, but is applied to a reduction of the stated principal amount of the loan. It is therefore actually paid only when the stated principal is paid to the lender. *See* discussion at notes 76-79 *infra* and accompanying text.

19. The "squeezing" label for such loans was first used by the Texas Commission of Appeals in *Commerce Trust Co. v. Ramp*, 135 Tex. 84, 87, 138 S.W.2d 531, 533 (1940).

20. As provided by TEX. REV. CIV. STAT. ANN. art. 5069-1.02 (1971). For the purpose of this Comment, a 10% maximum rate of interest will be assumed, unless otherwise indicated.

21. This sample transaction is adopted from those presented by the available opinions. *See, e.g.*, *Commerce Trust Co. v. Ramp*, 135 Tex. 84, 138 S.W.2d 531 (1940) (discussed *infra* notes 35-40 and accompanying text); *Commerce Trust Co. v. Best*, 124 Tex. 583, 80 S.W.2d 942 (1935); *Dallas Trust & Sav. Bank v. Brashear*, 65 S.W.2d 288 (Tex. Comm'n App. 1933, jdgmt adopted). More complex interest in advance transactions are possible. *See, e.g.*, *Riverdrive Mall v. Larwin Mortgage Inv.*, 515 S.W.2d 5 (Tex. Civ. App.—San Antonio 1974, no writ); *Southwestern Inv. Co. v. Hockley County Seed & Delinting, Inc.*, 476 S.W.2d 38 (Tex. Civ. App.—Amarillo 1972), *writ ref'd n.r.e., per curiam*, 516 S.W.2d 136 (Tex. 1974).

It is unfortunate that courts and commentators have been inconsistent in the labeling of loan transactions,<sup>22</sup> and this has perhaps contributed to widespread confusion of interest in advance analysis with front-end interest analysis.<sup>23</sup> Suffice it to say that it is essential to a proper understanding of the analysis in this Comment to plant the above example of the interest in advance transaction firmly in one's mind. A useful tool for testing one's understanding of "true" interest in advance is a brief discussion of a peculiar line of cases involving error in judicial nomenclature regarding discounted interest on short-term<sup>24</sup> loans.

Courts have frequently referred to a certain variety of short-term loans as involving "interest in advance." Because of the "interest in advance" connotation it is necessary to distinguish such loans from the true interest in advance situation discussed above. The typical short-term "interest in advance" loan is one in which the borrower will make a short-term note for a "principal" sum, but the lender's advance will be discounted or reduced by an amount of interest charged on the "principal." Thus, when the borrower pays his "principal" note, his payment will include both interest and true principal. Contrary to logic, courts have always allowed a discount of ten percent on short-term loans.<sup>25</sup>

The "discount" transaction differs from the true interest in advance transaction in two ways; the stated principal amount of the loan is more than the true principal; and the final "principal" payment includes both interest and principal. The discounted interest is actually paid at the end of the loan term, while interest in advance is paid early in the loan term.<sup>26</sup>

### B. *Front-end Interest; Points*

The term "front-end interest" has been used to denote a fee or charge, received by the lender, in consideration for the loan of money, at the inception of the loan.<sup>27</sup> Such fees or charges are ordinarily in addition to the

22. See, e.g., *Bethke v. Idaho Sav. & Loan Ass'n*, 93 Idaho 410, 462 P.2d 503 (1969); *Pierce & Williams, supra* note 13, at 246-47; Comment, *Usury in Texas: Spreading Interest Over the Entire Period of the Loan*, 12 HOUS. L. REV. 159 (1974).

23. See, e.g., *Loiseaux, Some Usury Problems in Commercial Lending*, 49 TEXAS L. REV. 419, 426-30 (1971); *Pierce & Williams, supra* note 13, at 246-47; Comment, *supra* note 22.

24. For the purposes of this Comment, short-term loans are those which run no longer than one year.

25. The practice of allowing discounts at the maximum rate was first established by the English Statute of Usury, 13 Anne, c. 15 (1713), and has been followed without exception. 6A A. CORBIN, *CONTRACTS* § 1504 (1962); 2 PATTON'S *DIGEST, Interest & Usury* § 15 (1942, Supp. 1951); 14 S. WILLISTON, *CONTRACTS* § 1694 (3d ed. 1972). An expansion of the practice is followed in Oklahoma, where discounting for the first year of a multi-year loan is allowed. *Pickering v. Taylor*, 67 P.2d 949 (Okla. 1937).

Inssofar as the usury laws are concerned the effect of allowance is not monumental; it merely allows a maximum rate of 11% rather than 10%. This is algebraically shown as follows: When the stated principal is \$X, the highest interest deductible will be 10% of \$X, or \$(X/10). The amount actually loaned will be \$X minus the interest deduction, or \$(X-X/10). Computing the true rate of interest (I), the formula is:  $X/10 = I(X-X/10)$ ; eliminating X,  $I = 1/9$ , or .111. This formula assumes the borrower will be allowed to retain the "true" principal during the entire year. An installment loan would require a different formula, but the result would be substantially similar.

26. See notes 68-74 *infra* and accompanying text for application of the above analysis to the distinction between interest in advance and front-end interest.

27. See note 32 *infra*.

stated interest rate on the face of the loan and may or may not be referred to as interest by the loan contract. In fact, front-end interest often results from a judicial determination that sundry "loan fees" are not bona-fide.<sup>28</sup> For example, consider a borrower, seeking a loan of \$1,000, and a lender who agrees to make the loan at eight percent, but requires the borrower to "pay" a five percent processing fee. The lender will advance the \$1,000 to the borrower, and the borrower will immediately pay the lender the \$50 (5 percent) fee. It requires only the shallowest of logic to see that only \$950 has actually been loaned.<sup>29</sup> However, the front-end interest lender will charge interest on the full \$1,000.

In the more usual situation, a borrower will expect to "pay" a certain number of "points" at the front-end of a loan. In such a case there is generally no question that the "points" are consideration for the loan of money: interest. However, interest is still charged on a stated principal with no reductive allowance for the "points." Both judicial<sup>30</sup> and contractual<sup>31</sup> front-end interest are treated identically for usury determinations.

Perhaps it would be more appropriate to discontinue the use of the term "front-end interest" since, as will be later discussed, the charges do not operate as interest at the front-end of a loan but are allocated by the courts in the determination of usury to a reduction of the stated principal. This is universally recognized in the lending business and in some jurisdictions where the term "point" is preferred.<sup>32</sup> The use of "points" rather than "front-end interest" also avoids etymological problems that arise in distinguishing front-end interest loans from interest in advance loans.<sup>33</sup> Nevertheless, most courts seem to have a certain affinity for the term front-end interest, and for the purpose of this Comment the terms will be used interchangeably.

## II. USURY AND INTEREST IN ADVANCE

Use of the interest in advance transaction is a means of relief to the lender who finds his margin of profit pinched by the usury laws. By converting late gain, interest which would ordinarily accrue in the final period of a loan

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28. See notes 75-76 *infra* and accompanying text.

29. See note 79 *infra*.

30. Meaning front-end interest resulting from a judicial nonacceptance of "loan fees."

31. Meaning "points" or other charges known to be, and considered by the parties as, interest.

32. Since the late 1940's the term 'point' has been a term of general usage in the mortgage lending industry . . . [Point] simply denotes a fee or charge equal to one per cent (1%) of the principal amount of the loan which is collected by the lender at the time the loan is made . . . . The basic tenet to remember is that it is a fee or charge which is collected only once, at the inception of the loan, and is in addition to the constant long term stated interest rate on the face of the loan.

B.F. Saul Co. v. West End Park N., 250 Md. 707, 246 A.2d 591, 595 n.2 (1968). Statutes in Maryland and Virginia employ the use of the term. *Id.* See also Rev. Rul. 69-188, 1969-1 CUM. BULL. 54, stating that a "loan processing fee" fits into the general term "points."

33. See, e.g., Southwestern Inv. Co. v. Hockley County Seed & Delinting, Inc., 511 S.W.2d 724 (Tex. Civ. App.—Amarillo), writ *ref'd n.r.e.*, per curiam, 516 S.W.2d 136 (Tex. 1974), discussed in notes 56-67 *infra* and accompanying text.

term, into early gain, the lender converts money foregone into money available for other loans. Though the interest payments received by the lender in the final period of the loan will be reduced, the lender by that time will have had the use of funds equal to the reduction for some time. The benefits derivative of the interest in advance transaction are not, however, irrevocable, for the transaction runs the risk of usury's taint and commensurate penalties.<sup>34</sup>

*The General Rule.* In *Commerce Trust Co. v. Ramp*<sup>35</sup> a loan of \$50,000 for ten years was evidenced by a note with ten interest coupons, each representing six and one-half percent interest for one year and due at the end of each consecutive year.<sup>36</sup> Four promissory notes were also executed, such notes representing two and one-half percent interest for ten years.<sup>37</sup> However, the latter four notes were due in the first four years of the loan term. The Texas Commission of Appeals, affirming the judgment of the court of civil appeals,<sup>38</sup> held that, because the borrower was required to pay more than ten percent interest in each of the first four years of the loan, it was usurious.<sup>39</sup> The rule applied by the court is, simply stated, that interest in excess of the legal rate paid in early years cannot be balanced against interest less than the legal rate in later years to save the transaction from the taint of usury.<sup>40</sup>

In transactions involving interest in advance, the full amount of the "stated" principal is delivered to the borrower, thus making the question whether the interest rate is to be computed on the "true" or "stated" principal of no moment.<sup>41</sup> The sole consideration is that part of the interest

34. Penalties are provided by TEX. REV. CIV. STAT. ANN. art. 5069-1.06 (1971), discussed in *Pierce & Williams, supra* note 13, at 247-49, and *Loiseaux, supra* note 23, at 441-42.

35. 135 Tex. 84, 138 S.W.2d 531 (1940).

36. Each of the ten coupons was for \$3,250. No principal was due until the end of the ten-year loan term. Thus, the ten coupons amounted to 6½% interest on \$50,000 for ten years. *Id.* at 86, 138 S.W.2d at 532.

37. The four notes were for \$3,125 each, totalling \$12,500, or 2½% interest on \$50,000 for ten years. *Id.* at 87, 138 S.W.2d at 532.

38. *Commerce Farm Credit Co. v. Ramp*, 166 S.W.2d 1144 (Tex. Civ. App.—Amarillo 1938), *aff'd sub nom. Commerce Trust Co. v. Ramp*, 135 Tex. 84, 138 S.W.2d 531 (1940).

39. [T]he additional 2½ per cent interest on the principal of the loan was 'squeezed' into four annual payments of \$3,125 each, instead of being spread over the ten-year period of the loan, and this resulted in making the rate for the first four years in excess of 10 per cent per annum. 135 Tex. at 87, 138 S.W.2d at 533. Had the court applied all the coupons and notes to the full ten-year term, the rate would have been only 9%.

40. See *Pierce & Williams, supra* note 13, at 246-47. See also *Dallas Trust & Sav. Bank v. Brashear*, 65 S.W.2d 288 (Tex. Comm'n App. 1933, jdgmt adopted). In *Brashear* the loan was of a principal amount of \$3,000 for ten years, evidenced by notes of \$200 due at the end of the second, third, and fourth years, and a note for \$2,400 due at the end of the tenth year. These notes bore interest until maturity at 7%. A "second mortgage" secured payment of five additional interest notes of \$102 due consecutively in the first five years. Since the "second mortgage" notes were to be paid in the first five years and not over the entire ten-year term, and therefore exceeded the maximum allowable interest for the shorter period, the loan was held usurious. See also *Commerce Trust Co. v. Best*, 124 Tex. 583, 80 S.W.2d 942 (1935).

41. As noted earlier, logic would make "true" principal determinations necessary regarding short-term loans. It is only by judicial sanction of the peculiar rule that the "stated" interest is used for calculations. See notes 24-27 *supra* and accompanying text. In front-end interest loans, "true" principal is of primary importance. See note 77 *infra* and accompanying text.

is "squeezed"<sup>42</sup> into the early years of the loan, requiring the borrower to pay "for more time than he has had [the use of] the money."<sup>43</sup> The rule applied to such loans is uncomplicated; the court must merely ask: At the time of the interest payment, has the borrower paid to the lender more than ten percent interest for the length of time he has had the use of the principal?

"Spreading" and Interest in Advance. There is some authority allowing the "spreading" of interest paid in advance forward over the entire term of the loan in Arkansas,<sup>44</sup> New Mexico,<sup>45</sup> Oklahoma,<sup>46</sup> and the District of Columbia.<sup>47</sup> Further, in *Shropshire v. Commerce Farm Credit*<sup>48</sup> the Amarillo court of civil appeals "spread" interest in advance over the entire ten-year term of the disputed loan to find the loan free of usury. In reversing the court of civil appeals in *Shropshire*, the Texas Supreme Court did not rely on the "squeezed" payment schedule, but rather on a usurious acceleration provision of the same disputed loan.<sup>49</sup> Nevertheless, the subsequent opinions of the commission of appeals in *Dallas Trust & Savings Bank v. Brashear*<sup>50</sup> and *Commerce Trust Co. v. Ramp*<sup>51</sup> clearly defined the Texas rule as denying the "spreadability" of interest in advance.<sup>52</sup>

42. For this reason, such loans are referred to as "squeezed" loans. See, e.g., *Commerce Trust Co. v. Ramp*, 135 Tex. 84, 87, 135 S.W.2d 531, 533 (1940).

43. *Galveston & Houston Inv. Co. v. Grymes*, 94 Tex. 609, 615, 63 S.W. 860, 862 (1901). For analysis of the net economic positions of lender and borrower in "squeezed" loans, see notes 68-74 *infra* and accompanying text.

44. *Green v. Conservative Loan Co.*, 153 Ark. 219, 240 S.W. 13 (1922). *Green* involved a transaction similar to that in *Ramp*, and the Arkansas Supreme Court declared it free of usury because all the interest actually paid was less than could legally have been collected over the ten-year period of the disputed loan. However, *Green* is irreconcilable with a later decision of the Arkansas Supreme Court in *Coss Mortgage Co. v. Jordon*, 167 Ark. 34, 267 S.W. 590 (1924), which declared a virtually identical transaction usurious, the court refusing to spread "squeezed" interest over the entire ten-year period of the disputed loan.

45. *American Inv. Co. v. Roberts*, 29 N.M. 99, 218 P. 1037 (1923); *American Inv. Co. v. Lyons*, 29 N.M. 1, 218 P. 183 (1923).

46. *Metz v. Winne*, 15 Okla. 1, 79 P. 223 (1904). In this case, the interest in advance was "squeezed" into the first year only. The decision was most likely founded upon the Oklahoma practice of sanctioning extra first year interest on long-term loans. See note 25 *supra*.

47. *Montgomery Fed. Sav. & Loan Ass'n v. Baer*, 308 A.2d 768 (D.C. App. 1973).

48. 266 S.W. 612 (Tex. Civ. App.—Amarillo 1924), *rev'd*, 280 S.W. 181 (Tex. Comm'n App. 1926, opinion adopted), *superseded, aff'd on other grounds*, 120 Tex. 400, 30 S.W.2d 282 (1930), *motion for rehearing overruled*, 120 Tex. 412, 39 S.W.2d 11, *cert. denied*, 284 U.S. 675 (1931).

49. *Shropshire v. Commerce Farm Credit Co.*, 120 Tex. 400, 30 S.W.2d 282 (1930), *motion for rehearing overruled*, 120 Tex. 412, 39 S.W.2d 11, *cert. denied*, 284 U.S. 675 (1931). The acceleration clause provided that, upon borrower's default, all interest, accrued and unaccrued, became due and payable, and thus could be squeezed into a shorter loan period. For a discussion of this aspect of the case see *Pierce & Williams, supra* note 13, at 243-44.

50. 65 S.W.2d 288 (Tex. Comm'n App. 1933, judgment adopted) (see facts in note 40 *supra*).

51. 135 Tex. 84, 138 S.W.2d 531 (1940), *discussed in text* accompanying notes 35-40 *supra*.

52. The loan in *Brashear* included an acceleration clause similar to that in *Shropshire*; thus "squeezed" interest was not the sole reason for the court's declaring the loan usurious. However, the Texas Supreme Court later observed that the usurious nature of the loan in *Brashear* did not turn on the acceleration clause but rather on the squeezed interest payments. *Lincoln Nat'l Life Ins. Co. v. Anderson*, 124 Tex. 556, 559-60, 81 S.W.2d 1112, 1113 (1935). *Ramp* involved no such clause, the court holding the loan usurious because "interest on the principal of the loan was 'squeezed' . . . making the



Cases in other jurisdictions,<sup>53</sup> and the court of civil appeals in *Shropshire*, which have allowed "spreading" of interest in advance have apparently relied upon the rationale of opinions in cases involving front-end interest.<sup>54</sup> None have recognized the fact that interest in advance differs from front-end interest in that the former is actually paid before the borrower has had full use of the principal amount of the loan while this is never the case where front-end interest is involved.<sup>55</sup>

*Southwestern Investment Co. v. Hockley County Seed & Delinting, Inc.*<sup>56</sup> The confusion of interest in advance with front-end interest arose again in *Hockley Seed*, in which the terms of the loan provided for more than ten percent interest in early years to be offset by lower rates later.<sup>57</sup> The trial court found that during the first year, and for six months of the second and third years, the borrower paid in excess of ten percent interest,<sup>58</sup> and that the loan was, therefore, usurious.<sup>59</sup> On appeal, the lender argued that, since the total amount of interest paid over the entire life of the loan was less than would have been paid had a straight ten percent interest been charged for each year the loan was to run, there was no usury.<sup>60</sup> The argument was

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rate for the first four years in excess of 10 per cent per annum." *Commerce Trust Co. v. Ramp*, 135 Tex. 84, 87, 138 S.W.2d 531, 533 (1940).

53. See notes 44-47 *supra* and accompanying text.

54. In addition, most of these cases have given lip service to the idea that the maximum interest "rate" for usury purposes should have no bearing on the time for which interest payments are charged. "Thus the phrase '8 percent per annum' in section 28-3301 [D.C. CODE (Supp. 1974)] relates to the rate of interest and rate alone. It has no bearing on the time of payment . . ." *Montgomery Fed. Sav. & Loan Ass'n v. Baer*, 308 A.2d 768, 771 (D.C. App. 1973). The conclusion that the usury laws have no bearing on time of interest payment, however, does not logically follow from such a construction of "rate." If time of interest payment made no difference, a lender could conceivably collect, *ab initio*, all interest that would accrue over the entire term of a loan. For example, on a ten-year loan of \$100 at 10%, the lender could deliver the \$100 principal to the borrower and at the same time require the borrower to return immediately the \$100 as "interest" for the entire loan term, remaining liable for \$100 ten years later.

55. See notes 77-79 *infra* and accompanying text.

56. 511 S.W.2d 724 (Tex. Civ. App.—Amarillo), writ *ref'd n.r.e., per curiam*, 516 S.W.2d 136 (Tex. 1974).

57. The schedule of payments is not stated in the opinion, which speaks only of total principal and of four individual interest payments.

58. 511 S.W.2d at 729. Note that *Hockley Seed*, the borrower, was a corporation, but the court nevertheless applied the 10% rate. In a prior decision, it was decided that the corporate exception statute, TEX. REV. CIV. STAT. ANN. art. 1302-2.09 (Supp. 1974) (raising the rate on certain corporate loans to 18%), was inapplicable for the reason that the loan was executed prior to the adoption of the new statute, and the statute was not retroactive. *Hockley County Seed & Delinting, Inc. v. Southwestern Inv. Co.*, 476 S.W.2d 38 (Tex. Civ. App.—Amarillo 1971, writ *ref'd n.r.e.*). The prior opinion is discussed in Lebowitz, *Corporations, Annual Survey of Texas Law*, 27 Sw. L.J. 85, 120 (1973), and Larson, *Commercial Transactions, Annual Survey of Texas Law*, 27 Sw. L.J. 67, 75-76 (1973).

59. That the six-month payments in excess of 10% were usurious is somewhat questionable. The Texas usury statute speaks in terms of interest per annum and it would thus appear that interest could be "spread" over at least one year. TEX. REV. CIV. STAT. ANN. art. 5069-1.02 (1971). However, the corporate exception statute, TEX. REV. CIV. STAT. ANN. art. 1302-2.09 (Supp. 1974), sets the maximum rate at 1½% per month or 18% per annum, which may be interpreted to disallow "spreading" even over a one-year term. See Wallenstein, *Property, Annual Survey of Texas Law*, 28 Sw. L.J. 27, 46-47 nn.132-34 (1974). See also Loiseaux, *supra* note 23, at 438-39. Furthermore, the economic effect of "squeezing" high interest in the early months of a year is no different conceptually from the effect of "squeezing" interest in early years of a long-term loan. See note 74 *infra*.

60. 511 S.W.2d at 732.

rejected under authority of *Dallas Trust & Savings Bank v. Brashear*<sup>61</sup> and *Commerce Trust Co. v. Ramp*:<sup>62</sup> "[A] loan contract is considered usurious if for the first year<sup>63</sup> or first few years it requires the payment of more than the lawful rate, even though the interest over the entire loan period does not exceed the statutory limit."<sup>64</sup>

Unfortunately, the loan in *Hockley Seed* was thought by some to have been one involving front-end interest.<sup>65</sup> The Supreme Court of Texas found to the contrary, refusing writ of error, *per curiam*,<sup>66</sup> in reliance upon *Commerce Trust Co. v. Ramp*.<sup>67</sup> It appears, therefore, that the rules previously discussed are still the law in Texas.

*An Economic Analysis of Interest in Advance.* A brief rate-of-return analysis of the interest in advance transaction will show that the Texas rule for usury determinations, as opposed to the "spreading" concept, is a proper one. For this purpose, it will be helpful to refer to the transaction involved in *Shropshire v. Commerce Farm Credit Co.*,<sup>68</sup> in which three percent interest for the entire ten years of the loan term was "squeezed" into payments due in the first five years. In addition, ten notes representing six percent interest were due at the end of each year.<sup>69</sup> Applying the "spreading" concept to determine usury ("whether the contract is usurious is determined by ascertaining whether the interest collectible for the entire loan period exceeds the amount of interest that could be legally collected on the amount of the principal . . . of which the borrower had the use during the period"<sup>70</sup>) the court of civil appeals found the loan free of usury, since only nine percent, in the aggregate,<sup>71</sup> was charged over the life of the loan. What "could be legally collected" via payments of ten percent for ten years and what was collected, twelve percent for five years and six percent for the remaining years, were,

61. 65 S.W.2d 288 (Tex. Comm'n App. 1933, jdgmt adopted), discussed in notes 40 and 52 *supra*.

62. 135 Tex. 84, 138 S.W.2d 531 (1940), discussed in notes 35-40 *supra* and accompanying text.

63. Cf. *Bothwell v. Farmers' & Merchants' State Bank & Trust Co.*, 120 Tex. 1, 30 S.W.2d 289 (1930), stating the special rule regarding short-term loans. Here the court of civil appeals is apparently speaking of "squeezed" interest in the first year of a long-term loan.

64. 511 S.W.2d at 732.

65. Four amici curiae so argued. See also Comment, *supra* note 22.

66. 516 S.W.2d 136 (Tex. 1974). The court noted that the disputed loan raised "no question as to the spreading of front-end charges over the life of a loan . . ." and found no reversible error. *Id.* at 137.

67. 135 Tex. 84, 138 S.W.2d 531 (1940).

68. 120 Tex. 400, 30 S.W.2d 282 (1930), *motion for rehearing overruled*, 120 Tex. 412, 39 S.W.2d 11, *cert. denied*, 284 U.S. 675 (1931). The loan transaction is better described in the opinion of the court of civil appeals. 266 S.W. 612 (Tex. Civ. App.—Amarillo 1924).

69. The loan was in the amount of \$4,200 and the schedule of payments thus appeared.

Years	6% notes	3% notes	Annual %
1-5	\$ 252	\$ 252	12%
6-10	252	0	6%
TOTAL	\$2520	\$1260	9% (average)

70. 266 S.W. at 614.

71. See note 69 *supra*.

however, substantially different. The three percent "squeezed" interest in the first five years was "saved" in the last five years due to reduced payments, but only partially so. The "squeezed" interest for the first year was recovered in the sixth year; the "squeezed" interest in the second year was recovered in the seventh year, and so on. But, by the time of each recovery the borrower had been without the use of the amount of the "squeezed" interest for five years. So, compared with the situation had a straight-line rate been charged and paid, the borrower was without the use of three percent interest for five years five times.<sup>72</sup> The spreading concept is correct only when a straight-line rate is charged and paid, and the court of civil appeals in *Shropshire* was, therefore, in error.<sup>73</sup> To determine the net economic positions of the borrower and lender in *Shropshire* relative to the positions if a straight-line nine percent interest had been paid, one could apply a basic rate of return analysis, finding the borrower in a substantial net minus position.<sup>74</sup>

When a borrower has actually paid extra interest in early years, he is not fully recompensed by reduced interest payments in later years. Likewise, when a lender receives "extra" interest in early years he is not placed in equilibrium by foregoing it in later years. Thus, the application of the "spreading" concept to interest in advance transactions will fail to reflect both the actual interest paid under a loan and the true economic position of the parties.

### III. USURY AND FRONT-END INTEREST

Many expenses are incurred by both lender and borrower incidental to a loan transaction, and a lender will often require his borrower to recompense him for his expenses. There is nothing usurious regarding such a practice. However, when the "recompensation" of the lender turns out to be more than the payment of bona fide charges or fees representing payment for services rendered by some third party or compensation to the lender<sup>75</sup> for services or expenses other than those incurred by the actual loan of money, the usury laws must take their place, as such charges constitute "front-end

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72. Note that the borrower was "without the use of" 3%, not 6%, interest. This is because only 3% was "squeezed." If the loan had been at a straight-line rate, the borrower would have paid 9% per annum.

73. The decision of the court of civil appeals was reversed by the Supreme Court of Texas, but on other grounds. 120 Tex. 400, 30 S.W.2d 282 (1930), *motion for rehearing overruled*, 120 Tex. 412, 39 S.W.2d 11, *cert. denied*, 284 U.S. 675 (1931). See note 49 *supra* and accompanying text. The position of the court of civil appeals, as has already been noted, is not in accord with later cases. See notes 49-52 *supra* and accompanying text.

74. Assuming a reasonable rate of return to be 9%, the borrower in *Shropshire* was in a net minus position of \$283.50. In years 1 through 5, the borrower paid \$126 (3% of the \$4,200 principal) "squeezed" interest, which was recovered five years later in years 6 through 10. The borrower was, therefore, without the use of \$126 for five years, five times. Applying the assumed 9% rate of return, the net minus position is  $\$126 \times .09 \times 5$  (years)  $\times 5$  (times), or \$282.50. Of course, what is foregone by the borrower is gained by the lender, and he is, therefore, in a net plus position of the same amount.

75. An example is the true commitment fee, which is in actuality an option purchased by the prospective borrower by which the lender promises to set aside a certain amount of money for loan on a certain future date. See Wallenstein, *supra* note 59, at 43 n.116.

interest."<sup>76</sup> Though front-end interest is charged at the beginning of the loan transaction, it is never actually paid at that time. The lender charging front-end interest simply loans a reduced principal, but continues to compute interest based upon the stated principal without any reduction due to the front-end interest charge.<sup>77</sup> It is, therefore, essential to remember that in transactions involving front-end interest, the borrower is paying interest computed on a sum greater than the amount actually loaned to him.<sup>78</sup> In addition, when the "stated" principal is repaid to the lender, it is essentially a payment of true principal and an amount of interest attributable to the front-end charge.<sup>79</sup>

The same holds true when the lender requires the borrower to "prepay" a certain amount of interest via a charge usually termed "points."<sup>80</sup> When the

76. Words of art will not determine whether a charge or fee is front-end interest or a bona fide recompensation. Courts have generally looked to substance rather than form in determining the nature of such payments. "Commitment fees": held interest—*Imperial Corp. of America v. Frenchman's Creek Corp.*, 453 F.2d 1338 (5th Cir. 1972); *In re Feldman*, 259 F. Supp. 218 (D. Conn. 1966); held not interest—*Regional Enterprises, Inc. v. Teachers' Ins. & Annuity Ass'n of America*, 352 F.2d 768 (9th Cir. 1965) (fee was consideration for option to borrow); *Pivot City Realty Co. v. State Sav. & Trust Co.*, 88 Ind. App. 222, 162 N.E. 27 (1928). "Commission": held interest—*Deming Inv. Co. v. Giddens*, 41 S.W.2d 260 (Tex. Civ. App.—Amarillo 1931, writ dismissed); held not interest—*Dewey v. American Nat'l Bank*, 382 S.W.2d 524 (Tex. Civ. App.—Amarillo 1964, writ refused n.r.e.) (commission was to agent of borrower). "Service charge": held interest—*Bethke v. Idaho Sav. & Loan Ass'n*, 93 Idaho 410, 462 P.2d 503 (1969); *Terry v. Teachworth*, 431 S.W.2d 918 (Tex. Civ. App.—Houston [14th Dist.] 1968, writ refused n.r.e.); held not interest—*Bettum v. Montgomery Fed. Sav. & Loan Ass'n*, 262 Md. 360, 277 A.2d 600 (1971).

77. What actually happens was stated most simply in *Adleson v. B.F. Dittmar Co.*, 124 Tex. 564, 80 S.W.2d 939 (1935), in which the lender charged a \$240 "commission" on a loan of \$6,000: "Stripped of the formalities . . . the transaction was that when [lender] paid [borrower] \$6,000, [he] took it in one hand and with the other gave back to [lender] \$240. His note in the principal sum of \$6,000 was given for a loan of but \$5,760." *Id.* at 566, 80 S.W.2d at 940.

78. Such operation was carried *ad absurdum* in a hypothetical posed by the Supreme Court of Georgia in *McCall v. Hefring*, 116 Ga. 235, 42 S.E. 468 (1902), wherein the lender borrowed "\$500" for 15 years at 8%, paying a loan fee equal to all interest payable over the term of the loan. "[The borrower] would not only get nothing, but would pay the lender \$100 for the privilege of executing to him his promissory note [for \$500]." 42 S.W. at 472.

79. It has been contended that front-end interest is "paid" at the "front-end" or in the first year of a loan period: "For example, if 8 percent is the stated rate of interest and interest payments are to be made at the end of each year over the term of the loan, a front-end fee of 3 percent obligates the borrower to pay 11 percent interest over the first year." Comment, *supra* note 22, at 159 n.4. See also *Montgomery Fed. Sav. & Loan Ass'n v. Baer*, 308 A.2d 773 (D.C. App. 1973); *Imperial Corp. of America v. Frenchman's Creek Corp.*, 453 F.2d 1338 (5th Cir. 1972); *Pierce & Williams*, *supra* note 13, at 246.

Simple logic will show this contention to be erroneous, that though a front-end charge is charged at the front-end of a loan, it is not paid until the "principal" is repaid to the lender. Allusion can be directed to child's play, where *A* requests of *B* a loan of a quarter, agreeing to repay it upon receipt of his allowance the following week. *B* agrees, but only if "You (*A*) will pay me a nickel today." This quarter-for-a-nickel exchange amounts to nothing more than a loan of 20 cents. *A* will not pay the nickel to *B* until the following week when he gives *B* the quarter (which is 20 cents true principal and 5 cents front-end interest). This reasoning is essential to an understanding of the difference between front-end interest and interest in advance. Regarding the former, it is never actually paid until the "stated" principal is repaid, for the true principal was of a lesser amount, "stated" principal less the front-end charge. Interest in advance entails a delivery by the lender of the entire "stated" principal, and interest is actually paid on that amount at the time the interest is charged. See *Asimow, Principle and Prepaid Interest*, 16 U.C.L.A.L. REV. 36, 69 (1968).

80. In a recent case, the Beaumont court of civil appeals made the rather amazing statement: "[W]e hold that such 'points' are not interest within the usury statutes." *Wagner v. Austin Sav. & Loan Ass'n*, 525 S.W.2d 724, 728 (Tex. Civ. App.—Beaumont

lender advances a "stated" principal amount upon the borrower's payment to him of "points," the amount actually loaned is the "stated" principal less the "points." Only when this "stated" principal is repaid, and only then, are the "points" actually paid.

Rules of usury determination can best be explained by considering amortized and unamortized loans separately.

*Front-end Interest on Amortized Loans.* In an amortized loan the interest rate remains constant, but the principal declines with each payment,<sup>81</sup> and if the parties fail to provide otherwise, installment payments are applied first to accrued interest and then to principal.<sup>82</sup> The true rate of interest is the rate which, when applied to the true principal balance at the time each payment is made, will result in an amortization of the entire principal and entire interest through the stated payments required by the loan agreement.<sup>83</sup>

With respect to amortized loans, front-end interest problems have been settled in Texas since 1935.<sup>84</sup> Front-end interest is to be deducted from the stated principal amount of the loan and the interest payments (including the interest hidden in the stated principal) are to be applied to the true (reduced) principal to determine if usurious interest has been charged.<sup>85</sup>

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1975, no writ). The statement was made in the interpretation of TEX. REV. CIV. STAT. ANN. art. 852a, § 5.07 (1964), which provides:

Every [savings and loan] association may require borrowing members to pay all reasonable expenses incurred in the making, closing [etc.] . . . of real estate loans . . . . In addition, associations may charge premiums for making such loans as well as penalties for prepayments . . . . The expenses, fees and charges authorized herein shall be in addition to the interest authorized by law, and shall not be deemed a part of the interest collected or agreed to be paid on such loans . . . .

The *Wagner* court apparently thought "points" fitted the category of "premium" within § 5.07. The author expresses no opinion on what was intended by the legislature as inclusive in the definition of "premium." However, if "points" are indeed a "premium," and, therefore, not interest under § 5.07, there are severe constitutional problems, for § 5.07 places no limit upon the amount of such "premiums"; nor would it appear that legislative exclusion of such an ambiguous term from interest is a proper execution of legislative power to define interest. TEX. CONST. art. XVI, § 11. See generally notes 125-33 *infra* and accompanying text.

It is believed that the correct interpretation of § 5.07 was recently disclosed in *Freeman v. Gonzales County Sav. & Loan Ass'n*, No. 978 (Tex. Civ. App.—Corpus Christi Aug. 29, 1975, no writ): "The Legislature, by allowing such an exception, intended that, before such a charge can be made (without the same being treated as interest), there must be proof that such an expense was a 'reasonable expense' and was incurred in connection with the making of the real estate loan." *Id.* at 10 (emphasis by court; slip opinion). Cf. notes 75-76 *supra* and accompanying text. Suffice it to say that it would be inadvisable for a lender to assume that sundry front-end charges are "premiums" and, therefore, not interest under § 5.07 because of problems of constitutional validity. The only front-end charges which are free from the interest connotation are those necessary to the making and performance of the loan contract.

81. Compare the situation involved in "squeezed" loans concerning interest in advance; the interest rate decreases while principal generally remains constant.

82. *Community Sav. & Loan Ass'n v. Fisher*, 409 S.W.2d 546 (Tex. 1966).

83. This is the so-called American rule, as announced in *Jencks v. Alexander*, 11 Paige's Ch. 619 (N.Y. 1845).

84. *Adleson v. B.F. Dittmar Co.*, 124 Tex. 564, 80 S.W.2d 939 (1935).

85. *Id.* at 566-67, 80 S.W.2d at 940. Oddly enough, it was the lender in *Adleson* who argued that the front-end interest was interest in the first year only. This was an attempt to fall without the two-year statute of limitations. The loan in *Adleson* was found usurious, as the amortized payments provided for 11.3% interest on the true principal. One year after *Adleson* the same test was used to find an amortized loan free of usury in *Eubanks v. Simpson*, 90 S.W.2d 291 (Tex. Civ. App.—Amarillo 1936, writ ref'd), because the amortized payments provided for less than 10% interest on the true principal.

In so far as the usury laws are concerned, the significance of an amortized loan is that the rate of interest is constant and the principal declines with each payment. Though front-end interest will reduce the principal upon which the rate is to be computed, the rate of interest in the first payment will be identical to that in all subsequent payments. The payments themselves "spread" front-end interest over the term of the loan.<sup>86</sup>

Later cases, perhaps for the sake of simplicity,<sup>87</sup> have relied on a rule correct in application but incorrect in principle regarding usury computations on amortized loans:<sup>88</sup> "If the contract for the use and detention of the principal debt is not a sum greater than such debt would produce at ten percent per annum from the time the borrower had the use of the money until it is repaid, it is not usurious."<sup>89</sup> The rule is correct in application because amortized loans<sup>90</sup> by definition have a constant interest rate, and if such a rate is less than ten percent per annum, the total will obviously be less than could be collected at ten percent for the entire loan tenure. The rule is incorrect in principle for the reason that it fails to take into full account the time and amount of the actual payments required by a particular transaction,<sup>91</sup> an important consideration regarding unamortized loans with fluctuating interest rates.

*Front-end Interest on Unamortized Loans.* When the rate of interest charged on a particular loan is not constant, or where "balloon" principal payments are required,<sup>92</sup> different considerations are necessary. In *Nevels v. Harris*<sup>93</sup> a loan in the "principal amount" of \$6,400 was evidenced by the borrower's note for that amount, maturing five years after issue. Five interest coupons were executed, each being for \$512<sup>94</sup> and due at the end of each year. A \$320 "service charge" was deducted from the initial principal advance. The court found the "service charge" to be front-end interest<sup>95</sup> and deducted it

86. This is because the reduction in principal precipitated by the front-end charge is "captured" in part each time a payment is made.

87. Computation of interest rates on amortized loans is virtually impossible without the use of rate tables, e.g., LAKE'S MONTHLY INSTALLMENT & INTEREST TABLES (6th ed. 1971).

88. See cases cited notes 88, 92-100 *infra*.

89. *Griffin v. B & W Fin. Co.*, 389 S.W.2d 350, 352 (Tex. Civ. App.—Tyler 1965, no writ); *accord*, *Montgomery Fed. Sav. & Loan Ass'n v. Baer*, 308 A.2d 768, 772 (D.C. App. 1973); *Bethke v. Idaho Sav. & Loan Ass'n*, 93 Idaho 410, 462 P.2d 503, 509 (1969) (concurring opinion); *Continental Assurance Co. v. Gibner*, 119 S.W.2d 588, 591 (Tex. Civ. App.—Amarillo 1938, writ *dism'd*); *Southern States Mortgage Co. v. Lykes*, 85 S.W.2d 780, 783 (Tex. Civ. App.—Amarillo 1935, writ *ref'd*).

90. And any other loan with a constant interest rate. See notes 103-05 *infra* and accompanying text.

91. The Maryland court of appeals apparently does so. See, e.g., *Bettum v. Montgomery Fed. Sav. & Loan Ass'n*, 262 Md. 360, 277 A.2d 600, 603 (1971); *B.F. Saul Co. v. West End Park N.*, 250 Md. 707, 246 A.2d 591, 597 (1968). In both cases, the court computed the actual interest rate paid and found it to be less than 8% (the legal rate).

92. "Balloon" payments refer to payments which are substantially disproportionate to other payments required by the loan agreement. This term includes loans in which interest only is payable over the loan term, and principal becomes due in a lump sum at the end of the loan term. See, e.g., MODEL CONSUMER CREDIT ACT § 2.042 (Nat'l Consumer Law Center 1973).

93. 129 Tex. 190, 102 S.W.2d 1046 (1937).

94. This represented 8% of the stated principal of \$6,400.

95. The \$320 was paid directly to the lender as compensation for the loan. See note 75 *supra* and accompanying text.

from the stated principal.<sup>96</sup> In finding the loan free of usury, the court computed the maximum legal amount of interest on a \$6,080 loan for five years<sup>97</sup> to be more than the amount of interest actually paid.<sup>98</sup>

Thus, the court applied the rule previously discussed,<sup>99</sup> which is correct in application but incorrect in principle. Rather than finding what rate was actually paid,<sup>100</sup> the court simply found that the total sum actually paid was less than could have been charged. The doctrine of *Nevels v. Harris* has been interpreted to allow the "spreading" of front-end interest,<sup>101</sup> whereby such interest is applied to the entire term of the loan. Conceptually, "spreading" is no different from the practice of computing maximum interest that could be paid on a loan of a given principal,<sup>102</sup> and it too is generally correct in application but incorrect in principle.

To allow "spreading" as a positive rule of law is to forget to look at the substance of a loan—to look at what could have been done rather than what has been done. It is a valid concept so long as the interest rate required by the loan is constant.<sup>103</sup> It is not, however, unforeseeable that a loan could involve both interest in advance and front-end interest.<sup>104</sup> Even in such a case "spreading" would be "correct in application" if it were applied only to the front-end interest part of the loan and not to interest in advance, which must be treated as interest when actually paid.<sup>105</sup>

Due to confusion of interest in advance with front-end interest,<sup>106</sup> it

96. "He, in fact, only loaned \$6,400 less \$320, or \$6,080. We must therefore treat this last-named figure as the real amount of the loan." 129 Tex. at 196, 102 S.W.2d at 1048.

97. Ten percent interest for five years was \$3,040.

98. Interest actually paid was composed of the five \$512 notes plus an additional \$320 when the principal note was paid. This aggregated \$2,880.

99. See notes 88-91 *supra* and accompanying text.

100. The \$320 interest paid concurrently with the final stated principal was 1.05%. The \$512 yearly payments were 8.4%. Thus the actual rate paid was 9.45%.

101. *Imperial Corp. of America v. Frenchman's Creek Corp.*, 453 F.2d 1338 (5th Cir. 1972). *Nevels v. Harris* also involved usurious implications of an acceleration clause. The court held that an acceleration clause would not render a loan usurious if the contract provided, via the "savings clause," that upon acceleration, no unaccrued interest would be collected. *Frenchman's Creek* interpreted *Nevels* as saying that the "savings clause" was necessary to allow "spreading" of front-end interest. In fact, the discussion of the "savings clause" in *Nevels* had no relation to the computation of interest over the life of the loan. 129 Tex. at 198, 102 S.W.2d at 1050.

102. See text accompanying note 89 *supra*.

103. See note 91 *supra* and accompanying text for the reason this is true regarding amortized loans. In unamortized loans, front-end interest is actually paid when the stated principal is paid. Since front-end interest is "rent" for the entire time for which the borrower has the use of the true principal, *Imperial Corp. of America v. Frenchman's Creek Corp.*, 453 F.2d 1338, 1343 (5th Cir. 1972), it is applicable to the entire term of forbearance.

104. The only litigated instance found by the writer which involved such a scheme is *Riverdrive Mall, Inc. v. Larwin Mortgage Inv.*, 515 S.W.2d 5 (Tex. Civ. App.—San Antonio 1974, no writ). The case was before the court of civil appeals upon the trial court's denial of borrower's motion for a preliminary injunction restraining foreclosure by the lender. In affirming the action of the trial court, the court of civil appeals did not decide the usury issue, but did notice that problems would be presented by the intermingling of interest in advance and front-end interest. The facts as presented by the court are inadequate to determine whether usury was in fact present. The case has since been settled.

105. See notes 60-75 *supra* and accompanying text.

106. See, e.g., *Petitioner's Application for Writ of Error at 55-57, Southwestern Inv. Co. v. Hockley County Seed & Delinting, Inc.*, 511 S.W.2d 724 (Tex. Civ. App.—Amarillo 1974, writ ref'd n.r.e.). See also note 79 *supra*.

would appear advisable for courts to refrain from employing the concept of "spreading" and to look at the interest payments actually paid or required by a particular loan under consideration in order to guard against an improper decision concerning a loan with both front-end interest and interest in advance,<sup>107</sup> or improper application of "spreading" to an interest in advance transaction.

*Computation of Front-end Interest Reconsidered.* There is little difficulty in formulating a rule which will correctly apply to both front-end interest and interest in advance. Cases considering interest in advance require that interest is to be considered for usury purposes in the year paid. Cases previously discussed have also established that front-end interest is to be deducted from the stated principal to find the actual amount of the loan. To test a loan for usury, whether it involves front-end interest, interest in advance, or both, it is necessary only to find whether the terms of the loan require payments in excess of the legal rate of interest on the true amount of the loan for the length of time that such payments represent. With the exception of "interest in advance" on short term loans,<sup>108</sup> the test will apply correctly to any type of transaction considered in this Comment and will avoid the possibility of error when considering a hybrid loan scheme.

#### IV. HOUSE BILL 351

In its regular session the Sixty-Fourth Legislature of Texas enacted an amendment to the Texas usury laws<sup>109</sup> providing, *inter alia*,<sup>110</sup> that:

On any loan or agreement to loan secured or to be secured, in whole or in part, by a lien, mortgage, security interest, or other interest in or with respect to any interest in real property, determination of the rate of interest for the purpose of determining whether the loan is usurious under all applicable Texas laws shall be made by amortiz-

107. For example, assume a five-year loan of \$1,000, with five notes, representing 6% interest, due at the end of each year; with two notes, representing 2% interest for the five-year term but due at the end of each of the first two years; and with a five-point (\$50) front-end charge. The actual payment schedule will look like this:

Year	Interest			Total	Principal
	6% notes	2% notes	Points		
1	\$60	\$50	\$ 0	\$110	\$ 0
2	60	50	0	110	0
3	60	0	0	60	0
4	60	0	0	60	0
5	60	0	50	110	950
Total Interest				\$450	

The loan is usurious, because of "squeezed" payments in the first two years. However, if the rule "incorrect in principle" (*see* text accompanying note 89 *supra*) were applied, it would be found that the total interest paid over the life of the loan was less than would have been paid had a straight 10% interest been charged on a loan of \$950.

108. *See* notes 24-27 *supra* and accompanying text.

109. The regular session of the 64th Legislature adjourned on June 2, 1975.

110. The legislation also provided for increased interest rates on loans exceeding \$500,000, ch. 26, § 1, [1975] Tex. Laws Reg. Sess. 47-48, to be codified as TEX. REV. CIV. STAT. ANN. art. 5069-1.07(b), and interest "refunds" on pretermitted loans, *id.*, to be codified as art. 5069-1.07(a).



ing, prorating, allocating, and spreading, in equal parts during the period of the full stated term of the loan, all interest at any time contracted for, charged, or received from the borrower in connection with the loan.<sup>111</sup>

The amendment was intended to codify decisions in Texas and other jurisdictions which purportedly allowed the "spreading" of front-end interest to determine usury.<sup>112</sup> However, "all interest at any time contracted for, charged, or received"<sup>113</sup> would certainly include interest in advance, and would, therefore, appear to be subject to the same statutory "amortizing, prorating, allocating and spreading"<sup>114</sup> as is front-end interest.

As has already been discussed, while "spreading" may be justified as applied to the calculation of interest rates precipitated by front-end interest,<sup>115</sup> it is inaccurate and inappropriate in the interest in advance or "squeezing" situation.<sup>116</sup> Because the lender receives "squeezed" interest in the early years of the loan term, the application of "spreading" fails to reflect the actual rate of interest.<sup>117</sup>

*Was the "Spreading" of Interest in Advance Intended?* Throughout the legislative history of House Bill 351 appears the statement that the bill does not change the statutory rate of interest.<sup>118</sup> The overriding intent of the bill

111. *Id.*

112. "[W]hat we are doing by the interest amortization in the first provision is just codifying what the existing law is." Statement of Mr. Larry Temple, representative of Texas Mortgage Bankers Association, *Minutes of the Economic Development Committee of the Senate*, 64th Legislature of Texas, at 7 (March 10, 1975).

A virtually identical bill was passed by the 63rd Legislature of Texas, Senate Bill No. 209 (1973), but was vetoed by the Governor. Proclamation of the Governor, June 16, 1973. On Senate Bill No. 209 see generally Wallenstein, *supra* note 59, at 47-48. Referring to the bill, Senator Bill Patman, in a letter to the Governor, stated that "S.B. 209 was passed under an explanation that it allowed the spread[ing] of 'origination fees' and points that are charged in the first year of the loan throughout the loan." Letter from Senator Bill Patman to Governor Dolph Briscoe, May 24, 1973, at 3.

113. Ch. 26, § 1, [1975] Tex. Laws Reg. Sess. 47-48, to be codified as TEX. REV. CIV. STAT. ANN. art. 5069-1.07(a).

114. *Id.* See also TEXAS OBSERVER, Mar. 28, 1975, at 11-12.

115. Notes 84-106 *supra* and accompanying text.

116. Note 74 *supra* and accompanying text.

117. Refer to the economic comparison of "spreading" and true computation regarding interest in advance, notes 68-74 *supra* and accompanying text.

118. "[H.B. 351] would limit interest rates plus points to a maximum of 10%." Bill Analysis, "What the Bill Proposes to Do," H.B. 351, 64th Leg. (Second Official House Printing, Feb. 19, 1975). In committee hearings, the following discussion took place between Senator Bill Patman and Larry Temple, representative of Texas Mortgage Bankers Association:

Patman: . . . And this is the important part [of a prior statement by the House sponsor of H.B. 351], 'there is no way this bill can amend, change, or affect the constitutional 10 percent ceiling.' Do you agree with that?

Temple: Yes, sir.

Patman: If you will put that in this bill, I will vote for it.

Temple: Well, Senator, I think it is in there.

. . . .  
I think it is implicit in there and I don't see any need to change the bill.

. . . .  
[N]obody shows us where it changes the constitutional ceiling and I don't know of a lawyer around who has written anything to indicate that he thinks it does change the constitutional ceiling.

Minutes of the Economic Development Committee of the Senate 7-8 (Mar. 10, 1975). See also TEX. S.J. 474 (1975).

was to codify the "spreading" of front-end interest,<sup>119</sup> due to confusion regarding judicial allowance of the practice following *Southwestern Investment Co. v. Hockley County Seed & Delinting, Inc.*<sup>120</sup> There is, however, substantial evidence that at least some members of the legislature and lobbyists knew that the express language of the amendment allowed "spreading" of interest in advance.<sup>121</sup> Nevertheless, the available legislative history evidences no intent to increase the statutory rate of interest by "spreading" interest paid in advance.

*Constitutional Validity.* The Constitution of Texas provides that:

The Legislature shall have authority to classify loans and lenders, license and regulate lenders, 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 . . . .<sup>122</sup>

It is therefore arguable that, even though House Bill 351 does allow the collection of usurious interest, it is a valid exercise of legislative power to fix maximum rates. Legislative allowance of collection of more than the maximum rate is not, however, the same as legislative determination of the maximum rate.<sup>123</sup> Another portion of the bill signifies what the legislature may lawfully prescribe. That portion provides that persons borrowing \$500,000 or more may be charged the same rate of interest as corporations.<sup>124</sup>

In *State v. Community Finance & Thrift Corp.*<sup>125</sup> the court of civil appeals considered the constitutionality of the Certificate Plan Act,<sup>126</sup> which provided that, as a condition to making a loan, a lender could require an installment borrower to purchase an "investment certificate" which equalled the amount of the cash advance of the loan plus ten percent interest (essentially a statutory front-end interest allowance).<sup>127</sup> Finding that loans made pursuant to the Act could result in collection of more than ten percent

119. See note 110 *supra*.

120. 511 S.W.2d 724 (Tex. Civ. App.—Amarillo), writ *ref'd n.r.e., per curiam*, 516 S.W.2d 136 (Tex. 1974). It has already been noted that the confusion, notes 65-66, 78-79 *supra* and accompanying text, was unwarranted, since *Hockley Seed* involved "[n]o question as to the spreading of front-end charges over the life of a loan . . . ." 516 S.W.2d at 137.

121. See TEX. S.J. 474-75 (1975); TEXAS OBSERVER, Mar. 28, 1975, at 11-12 ("the bill effectively avoids the constitutional ban against interest rates above 10 percent").

The lobbying effort of the banking industry in the 64th Legislature was tainted by alleged violations of the Lobby Control Act. Dallas Times Herald, Apr. 17, 1975, § A, at 7, cols. 6-8.

122. TEX. CONST. art. XVI, § 11. Proposed constitutional amendments are substantially identical. S.J.R. 11, [1975] Tex. Laws Reg. Sess., to be codified as TEX. CONST. art. X, § 22.

123. *Community Fin. & Thrift Corp. v. State*, 161 Tex. 619, 343 S.W.2d 232 (1961). *Community Finance* is discussed *infra* notes 125-33 and accompanying text.

124. Ch. 26, § 1, [1975] Tex. Laws Reg. Sess. 48, to be codified as TEX. REV. CIV. STAT. ANN. art. 5069-1.07(b).

125. 334 S.W.2d 559 (Tex. Civ. App.—Austin 1960), writ *ref'd n.r.e., per curiam*, 161 Tex. 619, 343 S.W.2d 232 (1961).

126. Ch. 472, §§ 1-6, [1951] Tex. Laws 832-34 (repealed 1963).

127. The transaction allowed was complex, and is not worthy of detailed consideration here. Essentially it provided that the lender could require a borrower of \$1,000 to execute a note for \$1,100, due at the end of the loan term. The loan was of the installment nature (declining principal) and, therefore, most any short-term loan was usurious. See *Harrell v. Colonial Fin. Corp.*, 341 S.W.2d 545 (Tex. Civ. App.—San Antonio 1960, writ *ref'd n.r.e.*).

interest, the court of civil appeals held the Act unconstitutional. However, the Act was held unconstitutional under the 1891 usury amendment to the constitution of 1876;<sup>128</sup> the amendment provided simply that all contracts calling for more than ten percent interest were usurious, and contained no provision allowing the legislature to fix maximum rates, as does the present constitutional provision.<sup>129</sup> The per curiam opinion of the Supreme Court of Texas<sup>130</sup> did discuss the effect of the present constitution on the holding of the court of civil appeals.

While application for writ of error was pending in *Community Finance*, the Texas Constitution's usury provision was amended to its present form. The supreme court was, therefore, faced with lenders' arguments that even if the Certificate Plan Act was unconstitutional, it had been validated by constitutional amendment, allowing legislative alteration of the legal rate. The court held that it was not required to consider the rather sticky question of "vitalization by a constitutional amendment,"<sup>131</sup> since the Act did "not purport to define interest and in our opinion cannot be regarded as an attempt by the Legislature to fix maximum rates of interest."<sup>132</sup>

At the close of its opinion in *Community Finance* the supreme court definitively stated:

Petitioners' argument assumes that without establishing any ceiling on interest the Legislature may legalize a subterfuge which enables lenders to charge varying rates in excess of ten per cent per annum, but this is not so. The constitutional amendment provides that in the absence of legislation fixing maximum rates of interest all contracts for a greater rate than ten per cent per annum shall be deemed usurious. In our opinion [the Certificate Plan Act] would be unconstitutional if adopted now before maximum rates have been fixed by the Legislature.<sup>133</sup>

The language is clearly applicable to House Bill 351; if construed, as its express language seems to require, to allow "spreading" of interest in advance and to permit thereby the collection of more than ten percent interest, the bill is unconstitutional.<sup>134</sup>

## V. CONCLUSION

Interest in advance and front-end interest are no more nor less than schemes in avoidance of the usury laws. However, when the market rate of interest exceeds the legal rate, such schemes tend toward necessity. In the case of interest in advance, the lender must assure himself that his borrower will not seek retribution at some future time, for Texas courts have virtually assured the borrower's victory. The interest in advance transaction cannot stand even under recent amendments to the Texas usury laws, for amendments so construed would violate the Texas Constitution.

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128. TEX. CONST. art. XVI, § 11 (1891).

129. TEX. CONST. art. XVI, § 11.

130. *Community Fin. & Thrift Corp. v. State*, 161 Tex. 619, 343 S.W.2d 232 (1961), discussed in *Pearce & Williams*, *supra* note 13, at 256.

131. *Id.* at 621, 343 S.W.2d at 233.

132. *Id.*

133. *Id.* at 622, 343 S.W.2d at 234.

134. The amendment contains the usual severability clause; therefore, other provisions, note 110 *supra*, will stand.

Though this Comment has discussed several instances in which front-end charges were fairly calculated and found in compliance with the law, front-end interest is, without question, merely a device to make a loan contract appear to be something that it is not. A contract which represents a loan, accompanied by sundry front-end charges, states a greater amount of money loaned at a lower rate of interest than in actuality has occurred. It has been argued that, in a commercial context, the parties know what they are doing when they enter into such loans, and should, therefore, be free to do so.<sup>135</sup> Though the courts, lenders, and most borrowers are unfoiled by the imposition of front-end interest, a continuation of the scheme still constitutes a material misrepresentation to the uninformed. If front-end interest did in fact serve some legitimate purpose,<sup>136</sup> there might be a sufficient ground for the continuance of the practice, but legitimacy fails to be one of its virtues. The Sixty-Fourth Legislature's sanction of the use of front-end interest is, therefore, misdirected. It relieves no pressure exerted by the usury laws upon legitimate commercial practices.

What is necessary, if the public and commercial approval of the purpose of the usury laws is to be restored, is to raise the legal rate of interest to a realistic level. Were lenders able to legally charge a rate of interest which would permit them to make a legitimate profit upon the forbearance of money, devices in evasion and avoidance of the law would be unnecessary. The legal rate of interest should be raised to a level well above the market rate but below the level of clear unconscionability, and schemes in evasion and avoidance of the law should be legislatively proscribed.<sup>137</sup> Few can be injured by the allowance of honest profit.

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135. See, e.g., Loiseaux, *supra* note 23, at 442-43.

136. It has been argued that front-end interest is a legitimate tool for avoiding tax liability in the first year of the loan. Section 163 of the Internal Revenue Code allows a deduction for "all interest paid or accrued within the taxable year on indebtedness." INT. REV. CODE OF 1954, § 163(a). In 1969 the Internal Revenue Service recognized that "points" could constitute payment for the use of money and ruled that such charges could be deducted as interest. Rev. Rul. 69-188, 1969-1 CUM. BULL. 54. The service did not say when the deduction was allowable. In a later ruling the service determined that points would not be considered to cause a material distortion of income when paid out of the separate funds of the borrower, and accordingly were deductible in the year "paid." Rev. Rul. 69-582, 1969-2 CUM. BULL. 29. However, in the cases discussed in this Comment, "points" were not "paid" in the first year of the loan but were merely deducted from the principal advance. A recent article on the subject is illustrative:

In some cases, a lender . . . will deduct the amount charged the borrower for the points from the amount of the loan. The deduction of the points from the loan in this manner does not constitute payment of the points by the [borrower] in the year of settlement.

Bedell, *The Interest Deduction: Its Current Status*, N.Y.U. 32D INST. ON FED. TAX. 1117, 1120 (1974). "Points" not paid out of the separate funds of the borrower will be denied first-year deduction as a material distortion of income. Rev. Rul. 69-643, 1968-2 CUM. BULL. 76. See also Asimow, *Principle and Prepaid Interest*, 16 U.C.L.A.L. REV. 36 (1968); Comment, *The Prepaid Interest Deduction Viewed from the Perspective of Real Estate Transactions*, 29 SW. L.J. 412 (1975) (The author questions the validity of the Internal Revenue Service's position, but concludes, "the advisability of taking a prepaid interest deduction remains questionable at best." *Id.* at 430).

137. Francis Bacon was in accord more than three centuries ago, making a similar argument for the same reasons: "If it be objected that this doth in a sort authorize usury, which before was in some places but permissive, the answer is that it is better to mitigate usury by declaration than to suffer it to rage by connivance." F. BACON, *supra* note 3.