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Does the Texas Certificate Plan Act Legalize Usury

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DOES THE TEXAS CERTIFICATE PLAN ACT "LEGALIZE" USURY?†

by

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INTRODUCTION

THE 52d Legislature of the State of Texas in 1951 passed an act giving comprehensive powers to a certain class of lending companies to lend money under the so-called "investment certificate" plan.[1] This act, which is now article 1524a-1,[2] is sometimes called the "Texas Industrial Loan Law," but will be referred to throughout this paper as the "Texas Certificate Plan Act" or "act."

The Texas Certificate Plan Act is a special "authorization" bill[3] permitting a certain class of loan companies[4] to require installment loan borrowers, as a condition of the loan, to buy "certificates of indebtedness" or "installment investment certificates" (hereinafter called "certificates" as the use of the word "investment" tends to mislead), from the loan companies. The installment loan payments are required to be applied as a credit on the installment "certificates" rather than being applied to reduce the principal of the loans; thus lenders are authorized to charge interest on the full amount loaned for the entire term of the loans, even though the borrowers do not get to use the money for the entire term of the loan. It is the thesis of this Article that such authorization permits "legalized usury" in the sense that as long as the loan companies which have been given such special powers under the act comply with the special privileges given them by the act, they remain immune from the usury loan laws even though they may in fact be committing usury.

It is the writer's position that the purpose of the act is to attempt to authorize the lending companies to obtain greater compensation

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[1] Tex. Rev. Civ. Stat. Ann. art. 1524a (1947).

[2] Id. at art. 1524a-1 (1957 Supp.).

[3] It attempts to authorize certain charges that the lender may make in addition to the constitutional rate of interest. Attorney Generals' opinions have repeatedly held such authorization bills unconstitutional. See 5 Ops. Att'y Gen. 109 (1943); 3 Ops. Att'y Gen. 82 (1941); 1 Ops. Att'y Gen. 186 (1939); Tex. Att'y Gen. Op. No. R-2283, Jan. 31, 1951.

[4] Section 1 of the act limits its authorization to corporations formed for the purposes specified in §§ 48, 49, and 50 of 1302 and 1303(f), Tex. Rev. Civ. Stat. Ann. (1947), and having a minimum paid-in capital of $50,000.00.

for the use of their money than the constitutional limitation of ten per cent interest per annum, and that consequently such legislative authorization is unconstitutional.

No originality can be claimed by the writer for this. The act has been condemned as unconstitutional in other law reviews.[5] Even *Steiner v. Community Finance & Thrift Corp.*,[6] which held the act constitutional because of precedents considered as binding, devotes almost two pages to condemning the act and concludes:

> [A]n examination of the statute and the entire transaction here in issue, impels the opinion that Art. 1524a-1 is merely a cloak under which usurious interest is charged in violation of the Constitution of the State of Texas.
>
> [But] in deference to precedents considered as binding on this court, appellants' points of error are overruled, and the judgment of the trial court is affirmed.[7]

Former Attorney General John Ben Sheppard's office was requested by Banking Commissioner J. M. Falkner in 1956 to pass on the constitutionality of the act but declined to do so with the following comment:

> I am sure that you are aware of the litigation which involved the validity of the certificate device, and I am sure that you are also aware that the courts were presented with such an unfavorable fact situation that they could hardly avoid a holding of constitutionality. In this connection I especially call your attention to the *Steiner* case at 258 S.W.2d 129.
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> While I am inclined to disagree with the holdings of the Court of Civil Appeals, this office is nevertheless bound by existing court decisions. As you recall, we were preparing to file an amicus brief in the Supreme Court when the application for writ of error was dismissed. Moreover, Judge Ocie Speer, former counsel for your department, did file an amicus brief wherein he urged unconstitutionality. I believe that were the Supreme Court to write on this matter where the facts were legitimate, unconstitutionality might result.[8]

The Honorable Will Wilson, present Attorney General, has stated the constitutional issue with reference to the act in this manner:

> The specific legal issue is whether the legislative direction that the two transactions [the borrowing of money and the purchase of certificates]

[5] See Comment, 4 Baylor L. Rev. 104 (1951), and Note, Texas L. Rev. 345 (1953).

[6] 258 S.W.2d 129 (Tex. Civ. App. 1953) dism. by agr. (after the Supreme Court granted application for writ of error).

[7] Id. at 134.

[8] Letter from J. Fred Jones, Assistant Attorney General, Feb. 7, 1956. There was an earlier request for an opinion made by the Banking Commissioner on Nov. 27, 1953, but this request was withdrawn on Dec. 21, 1953.

> shall be treated separately is within the power of the Legislature. If these two transtctions are in fact related and common to each other and the legislative direction to the contrary is merely a dodge for circumventing the constitution, the Act will be struck down.[9]

Judge Ocie Speer, Office Counsel of the Department of Banking, in an administrative opinion dated August 16, 1951, addressed to Banking Commissioner J. M. Falkner, condemned the act as unconstitutional on at least four different grounds.[10] Judge Speer's opinion was written before the effective date of the act for the purpose of making suggestions as to legal procedure in the department should a question of the validity of the act arise. The Department of Banking has not approved a plan of lending under the act for any company because of the feeling that its provisions are unconstitutional, nor has it officially authorized any company to transact business under the act or given its approval to any proposed "investment" certificates under the act.[11]

PURPOSE OF THIS ARTICLE

The purpose of this Article is to reveal as clearly as possible the true nature of the act in the hope that there will be no doubt in the minds of readers that the legislative authorization granted to lending companies in this act is unconstitutional.

It is *not* the purpose of this Article to criticize or condemn lending companies who do business under the authorization of the Texas Certificate Plan Act, nor is it the purpose of this Article to suggest that the owners of these companies do not have the honest and sincere desire to operate legitimately under the laws of Texas and to earn only a reasonable profit. It is not the purpose of this Article to indicate that these companies may not perform a service and help fulfill a definite economic need for the citizens of Texas. The writer does not espouse any plan for the regulation of the Texas small loan and consumer finance industry nor attempt to pass judgment on

[9] "A Survey of the Small Loan Field," Address by Attorney General Will Wilson, Dallas Chapter of Credit Unions, Oct. 17, 1957.

[10] Department of Banking, Op. No. 939, Aug. 16, 1951.

[11] Letter from Sam O. Kimberlin, Jr., Counsel, Department of Banking, Aug. 23, 1957. This letter in part states: "Mr. Bengtson [Deputy Commissioner of Banking] informs me that this Department has not officially authorized any company to transact business under Article 1524a-1; however, it is not our position that such authorization is necessary except insofar as we have the duty to approve proposed installment certificates under Section 1(d) of said Article. We have given our approval of proposed installment certificates but this was done under the authority out of Section 7 of Article 1524a, rather than Section 1(d) of Article 1524a-1." The history and effect of said § 7 are discussed in "History of the Act," infra.

what would be reasonable limitations on the compensation they should receive for the use of their money.

This Article *does* take the position that the basic and fundamental law of Texas in our constitution limits interest charges (compensation for the use of money) to ten per cent per annum and that this limitation legally cannot and should not be circumvented indirectly by legislative sanction. All good citizens of Texas, including those in the loan business, can agree that Texas is in need of some sort of comprehensive and effective small loan and consumer finance law. But many disagree on the proper means to effectuate such a law. It is the belief of the writer that such a law should not be achieved by permitting the legislature to exercise unconstitutional powers or by upholding its exercise of unconstitutional powers as has been done with the Texas Certificate Plan Act. Section 11 of article XVI of the constitution should be amended so that the legislature may enact a valid small loan and consumer finance law designed to permit legitimate lenders to operate at a reasonable profit without the necessity of resorting to fictitious devices such as the certificate plan.

History of the Act

The first attempt to get legislative sanction for the certificate plan for lenders other than "Morris Plan" banks,[12] commercial banks, and building and loan associations[13] apparently was in 1945 when an amendatory act to section 7 of article 1524a[14] was passed. Article 1524a sets up regulations for corporations lending money and dealing in bonds and securities without banking and discount privileges. None of the provisions of that article deals with the business of lending money or attempts to regulate interest charges, as its purpose is regulation and not authorization.

Section 7 of article 1524a was designed to protect investors in certain types of securities by requiring that securities sold be secured by collateral of equal face value held in deposit by the State Treasurer or a trust company. The 1945 amendment added a proviso to

[12] The statute which formerly regulated "Morris Plan" banks was Tex. Rev. Civ. Stat. Ann. arts. 542-48 (1935). It was repealed by the Texas Banking Code of 1943, Tex. Rev. Civ. Stat. Ann. arts. 342-101 to 342-911 (1947). A case arising under the "Morris Plan" bank statutes was Citizens Industrial Bank v. Schmidt, 112 S.W.2d 513 (Tex. Civ. App. 1937) error dism., where it was held that the certificate plan used by the lender was merely a disguise to conceal usury in the transaction. The lender deducted 10% interest in advance rather than 6% as authorized by the statute so the court was not called upon to pass on the constitutionality of the "Morris Plan" bank statute.

[13] As this Article deals specifically with the constitutionality of the Texas Certificate Plan Act, no attempt will be made to consider the constitutional aspects of the statutes under which commercial banks and building and loan associations operate.

[14] Tex. Rev. Civ. Stat. Ann. art. 1524a (1947).

section 7 to the effect that no such collateral security would be required of corporations having a minimum capital of $50,000 making sales of certificates only to borrowers of the issuing corporations, who borrowed as much as or more than the face amount of the certificate, so long as the certificate sold to the borrower matured at a date not later than the maturity date of the last installment of the debt of the purchaser-borrower to the issuing corporation. The emergency clause of the amendatory act reads as follows:

> Whereas the Act as same now exists would seem to require the collateralizing of certificates sold to borrowers though, by virtue of the offset liability between debtor and issurer, in truth and in fact no indebtedness to be secured by collateral exists, thus creating an undue hardship and burden both to issuer and debtor. . . .[15]

This emergency clause is very revealing as to the purpose of the amendatory act as well as to the true nature of the certificate plan. Its purpose is to permit certain corporations to engage in the loan business, using the certificate plan without having the obligation to put up collateral security every time a loan is made. The small loan business is a high-volume business, and as a practical matter such procedure would be highly inconvenient. But more important, it would be a useless procedure, for the borrower is not an "investor" who needs such protection. As the emergency clause points out: "by virtue of the offset liability between debtor and issuer [lender], in truth and in fact no indebtedness [to borrower] to be secured by collateral exists." The clause, in effect, says that the borrower is making no "investment" in the "investment certificate," therefore there is no need for the lender to put up collateral security to protect a nonexistent investment. The clause all but says that in truth and in fact the sale of "investment certificates" by lenders to borrowers is but a paper transaction. A reasonable conclusion is that the authorization of such a paper transaction is to enable lending companies to obtain greater compensation than the constitutional limit of ten per cent for the use of their money. The reasoning behind this conclusion is set forth below.[16]

A loan transaction employing the certificate device using article 1524a as authority was held valid in *Reams v. Community Finance & Thrift Corp.*[17] This appears to have been a "test" case. Although the defense of usury was pleaded there was no jury trial, no fact dispute, and no transcript of evidence. The judgment for the plain-

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[15] Tex. Sess. Laws 1945, c. 194, § 2.
[16] Under "Analysis of the Act," infra.
[17] 236 S.W.2d 185 (Tex. Civ. App. 1951).

tiff lending company, the defendant's Request for Finding of Fact and Conclusion of Law, and the eight-page Findings of Fact and Conclusion of Law were all filed the same date, October 13, 1950.

Without burdening this Article with a detailed analysis of the record of the opinion in the *Reams* case, it is sufficient to point out that the decision was based solely upon several prior decisions in building and loan cases, the opinion stating: "No material distinction can be perceived between the building and loan plan commonly practiced in Texas and the one here under review."[18] Consideration of the building and loan cases and the very material distinction between the building and loan "sinking fund loan"[19] plan and the "investment" certificate will be made *infra.*[20] However, it is unfortunate that the court was led to believe that the building and loan plan is "commonly practiced" in Texas, for at the present time no building and loan associations in Texas are making this type of real estate loan.[21] The main reason the building and loan associations voluntarily discontinued using the plan was that "borrowers were often times misled into believing that they enjoyed a lower rate of interest than was actually the case."[22]

ANALYSIS OF THE ACT

Although, as indicated above,[23] the act may be unconstitutional on several grounds, this article will be confined to an analysis of the act with reference to the constitutional limitation on interest charges. The proper background for analysis of the statute is to consider the pertinent provision of the Texas Constitution and the principles that apply to it. Section 11 of article XVI of the Constitution of Texas provides:

> All contracts for a greater rate of interest than ten per centum per annum, shall be deemed usurious, and the first Legislature after this amendment is adopted, shall provide appropriate pains and penalties to prevent the same; but when no rate of interest is agreed upon, the rate shall not exceed six per centum per annum.

This section is self-executing to the extent that it renders all contracts for a greater rate of interest than ten per cent per annum

[18] Id. at 186.

[19] This is the term used by the building and loan industry (now called savings and loan industry) to describe this now defunct type of real estate mortgage loans. "Sinking fund loans" were involved in all the cases relied upon in the Reams case.

[20] Under "The Building and Loan Plan . . . ," the next subdivision of this Article.

[21] Letter from Jack W. Cashin, Executive Secretary, Texas Savings and Loan League, Austin, Texas, Feb. 18, 1958.

[22] Quotation, letter from Jack W. Cashin, Feb. 27, 1958.

[23] See text accompanying note 10 supra.

illegal[24] and leaves to the legislature only the remaining duty of saying what penalties shall be imposed upon those who violate the section.[25] This section is a mandate to the legislature to enact proper legislation to prevent usury,[26] and is a limitation on the power of the legislature to enact legislation to permit usury either directly or indirectly.[27]

Section 1 of the act is entitled "Powers"; it confers upon a certain class of lending companies a number of special and unusual powers. Their unusual nature will become more apparent when considered in the light of the duty placed upon the legislature to provide appropriate "pains and penalties" to prevent usury. As will be seen, the only reasonable explanation for granting these unusual powers to the lending companies is to enable them to obtain more than ten per cent interest per annum for the use of their money under statutory authorization and immunity.[28]

Subsections (a) and (c) of section 1 are as follows:

> (a) To lend money and to deduct interest therefor in advance at a rate not to exceed ten (10%) per cent per annum, and in addition to require and receive uniform weekly or monthly installments by the borrower simultaneously with the loan transaction, or otherwise, and as a condition to said loan, and pledged with the lender as security for said loan. . . .
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> . . . .
>
> (c) The making of said loan and the sale of said investment certificate, though done at the same time and as a condition to the granting of the loan, shall nevertheless be considered as two separate and distinct transactions. The periodic payments required on the installment investment certificates, hypothecated as security for the loan, shall not be considered as a periodic repayment of the loan; and payments, when, as, and if received, shall be applied as a credit to the installment investment certificates and shall not be applied as a credit upon the loan. . . .

First, some observations will be made as to the general nature of

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[24] Hemphill v. Watson, 60 Tex. 679 (1884); Watson v. Aiken, 55 Tex. 536 (1881); Watts v. Mann, 187 S.W.2d 917 (Tex. Civ. App. 1945) error ref.

[25] Hemphill v. Watson, 60 Tex. 679, 681 (1884).

[26] Parks v. Lubbock, 92 Tex. 635, 51 S.W. 322 (1899); Watts v. Mann, 187 S.W.2d 917 (Tex. Civ. App. 1945) error ref.

[27] Dunman v. Harrison, 41 S.W. 499 (Tex. Civ. App. 1897). See also Thompson v. Kay, 124 Tex. 252, 77 S.W.2d 201, 214 (1934).

[28] This is also true of subsections (e) and (i) of the act which authorize the lending companies to charge, in addition to interest, certain expenses, with a limitation of 3½% of the face amount of the loans. The Attorney General's office has ruled that such authorization is valid only if the charges authorized plus the interest do not exceed 10% per annum. 5 Ops. Att'y Gen. 109 (1943). Many cases have held expenses or service charges against borrowers to be interest. Glenn v. Ingram, 133 Tex. 431, 126 S.W.2d 951 (1939); Baltimore Trust Co. v. Sanders, 105 S.W.2d 710 (Tex. Civ. App. 1937) error dism.; Forreston State Bank v. Brooks, 51 S.W.2d 645 (Tex. Civ. App. 1932).

the powers of the lending companies as authorized by subsections (a) and (c).

The law is clear and settled that where interest at the highest constitutional rate (ten per cent per annum on the total amount and term of the loan) is deducted in advance and the borrower is required to repay the loan in installments, the loan is usurious.[29] This is because interest must be computed only on the unpaid balance of the loan, with the interest being compensation for the use of money.[30] But these subsections attempt to authorize this exact result under the guise that the installment payments are for certificates rather than payments on the loan.[31] Lending companies are given powers whereby borrowers are compelled to "buy" certificates that are of no value or of only nominal value[32] and to make periodic installment payments before the maturity date of the loans. Thus the borrowers are required to pay the maximum interest rate on the entire amount of the loans for the full loan period but get the use of only the last installment for the full period.

The act decrees that the installment payments shall be applied on the certificates and shall not be applied on the loans. The lending companies are given the power to retain the certificates,[33] and the power to declare the loan repaid and retire the certificates when all installment payments have been made.[34] The end result is that the act gives lending companies powers to do acts whereby the borrowers begin with no certificates, retain no certificates, and end up with no certificates, although obligated to pay loans where the interest at the highest constitutional rate of ten per cent per annum for the

[29] Schmid v. City Nat'l Bank, 132 Tex. 115, 114 S.W.2d 854 (1938); Sprolle v. McFarland, 56 S.W.2d 693 (Tex. Civ. App. 1900).

[30] Galveston & Houston Inv. Co. v. Grymes, 94 Tex. 609, 635 S.W. 860 (1901); Dulaney v. Jackson, 162 S.W.2d 142 (Tex. Civ. App. 1942); Cain v. Bonner, 149 S.W. 702 (Tex. Civ. App. 1912), aff'd, 108 Tex. 399, 194 S.W. 1098 (1917).

[31] The act further attempts to establish the fiction that installment payments by borrowers are for payments on certificates rather than on the loans by declaring in § 2 that the issuance and sale of certificates (the money paid for the certificates) shall not be construed as borrowed money.

[32] The act does not require that the certificates return any interest or any consideration of any nature to borrowers.

[33] The act describes this as a pledge with the lender as security for the loan, but as it is worth nothing at the outset and theoretically worth the value of installment payments made up to any given date, it is no security at all. See "History of the Act," supra, quoting and discussing the effect of § 7 of art. 1524a.

[34] Subsection (d) of the act provides that each installment certificate shall contain a provision that at maturity it may at the option of the holder be converted into a fully paid certificate. But for typical or realistic borrowers who may be aware of this option it is an illusion. Having to make their payments in installments, they normally would be financially unable also to make a cash payment equal to the amount of their loan plus interest. Those relatively few who are able to do so possibly would not consider it to be the best investment at the interest rates that prevail for such certificates.

total amount and time of the loan may be deducted in advance, and yet the borrowers are required to repay in installments. The result is that certain lending companies have been given statutory powers enabling them to obtain more than ten per cent per annum for the use of their money. Therefore, by these provisions the legislature has attempted to grant certain lending companies power to make usurious loans under statutory sanction. When the true effect of the powers given these lending companies is seen, the above conclusion becomes obvious. Just as obvious is the further conclusion that the legislature has no authority under the constitution to grant such powers to lending companies. And not only does the legislature lack such authority, it is charged by the constitution with the affirmative duty to prevent usury by prescribing appropriate pains and penalties.[35]

None could deny that the act would be unconstitutional if, by its express terms, it attempted to authorize certain lending companies to charge more than ten per cent interest per annum. None can with validity deny that the act is unconstitutional in attempting indirectly to accomplish the same result.[36]

Second, a detailed analysis of subsections (a) and (c) reveals more clearly the unconstitutional aspects of the act.

The very first sentence of subsection (a) gives certain lending companies the power "to lend money and to deduct interest therefor in advance at a rate not to exceed 10% per annum." The rule permitting banks to collect interest in advance at the highest constitutional rate has been labeled as difficult to sustain in reason, illogical, and sustainable now only because it has become a rule of property.[37] The Texas Supreme Court has said of the rule that "Common sense counsels against extension of a rule not entirely defensible on principle. No less urgent is the protest of common sense against allowing a thing to be done indirectly which the law forbids being done directly."[38]

It will be seen that the act ignores or attempts to override the common sense admonition of the Supreme Court, for subsection (a)

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[35] Notes 24 and 25 supra and accompanying text. See also Carder v. Knippa Mercantile Co., 1 S.W.2d 462 (Tex. Civ. App. 1927) error dism.

[36] For cases declaring acts of the legislature unconstitutional for attempting by indirection to avoid provisions of the constitution, see Jones v. Ross, 141 Tex. 415, 173 S.W.2d 1022 (1943); Cramer v. Sheppard, 140 Tex. 271, 167 S.W.2d 147 (1943); Morrow v. Corbin, 122 Tex. 533, 62 S.W.2d 641 (1933); Powell v. State, 17 Tex. Ct. App. 345 (1884); Keller v. State, 87 S.W. 669 (Tex. Crim. 1905).

[37] Bothwell v. Farmers & Merchants State Bank & Trust Co., 120 Tex. 1, 30 S.W.2d 289 (1930).

[38] Id. at 291.

attempts to authorize an extension of the rule. And in conjunction with other subsections, particularly (c), it attempts to authorize a thing to be done indirectly which the law forbids being done directly.

Subsection (a) gives the lending companies the power to compel borrowers to make uniform installment payments; to compel borrowers to purchase "certificates" simultaneously with loan transactions; to compel borrowers to pledge the "certificates" with the lending companies as security on the "certificates." There can be no question that subsection (a) attempts to authorize compulsory tie-in sales by lending companies of "certificates" to borrowers as part of the consideration for the use of the lending companies' money. If the result of such compulsory tie-in sales is to authorize the lending companies to receive greater compensation for the use of their money than ten per cent per annum it follows inevitably that it is an unconstitutional authorization.

However, subsection (c), bolstered by section 2, attempts to avoid by legislative fiat the consequences of the constitutional limitations on interest. For convenience of the reader, subsection (c) of section 1 is again set out, together with section 2.

> (c) The making of said loan and the sale of said investment certificate, though done at the same time and as a condition to the granting of the loan, shall nevertheless be considered as two separate and distinct transactions. The periodic payments required on the installment investment certificates, hypothecated as security for the loan, shall not be considered as a periodic repayment of the loan; and payments, when, as, and if received, shall be applied as a credit to the installment investment certificate and shall not be applied as a credit upon the loan. . . .
> Section 2. The issuance and sale of certificates of investment in the transaction of the business of corporations organized hereunder shall not be construed to be borrowed money.

The first sentence of subsection (c) defies the laws of mathematics and physics as well as logic. Subsection (a) gives lending companies such authority that it is impossible for borrowers to obtain loans without being compelled at the same time to purchase certificates. Subsection (c) confirms this but states that the loan and its compulsory tie-in sale "shall nevertheless be considered as two separate and distinct transactions." It is obvious that such compulsive sales to borrowers in order to obtain loans are not separate and distinct transactions from the loan transactions. There are no governmental metaphysics by which the legislature has the power to pronounce that one is in reality two. The act is saying on one hand that in order for the borrowers to obtain loans they are compelled to buy certificates; but on the other hand, the fact that borrowers are compelled to buy certificates in order to obtain loans really has nothing to do with the loans. This, of course, is absurd. It is an attempt to establish a conclusive presumption of something that is not true. Such an attempt to establish a conclusive presumption is in direct conflict with many Supreme Court decisions establishing that all contemporaneously executed documents will be considered as a single transaction in determining whether the transaction is valid or is usurious.[39] And most of these decisions dealt with fact situations in which the agreements to sign the various documents were voluntary. How much more certain is the fact that it is a single transaction when the borrower is forced to buy a certificate in order to obtain a loan.

This analysis reveals that the act is unconstitutional as a legislative attempt to usurp a judicial function and to foreclose judicial inquiry as to the true nature of the certificate plan.[40]

The attempt of the act to usurp the judicial function is even more apparent in the remaining sentences of subsection (c) and section 2. Subsection (c) directs that the installment payments "shall be applied" as credits to certificates and "shall not be applied" as credits to the loans and "shall not be considered" as periodic repayments of the loan. Section 2 says that the money the borrowers pay to the lending companies shall not be construed as borrowed money. Even in the transactions where the intent of borrowers in making installment payments is to repay the loans and the intent of lending companies in receiving the payments is to have the loans repaid, the act by fiat says such payments "shall not" be so considered and "shall not" be so applied. If the act is to be followed the courts may not, under these provisions, determine the true facts in a given loan transaction, and where important may not even determine the intention of the parties.

But even more apparent is the unconstitutionality of the act on the ground that the legislature does not have the power to declare that one transaction shall be considered as two transactions for the purpose of authorizing lending companies to circumvent the constitution. The analysis of the act above reveals that it authorizes the

[39] Nevels v. Harris, 129 Tex. 190, 102 S.W.2d 1046 (1937); Braniff Inv. Co. v. Robertson, 124 Tex. 524, 81 S.W.2d 45 (1935); Shropshire v. Commerce Farm Credit Co., 120 Tex. 400, 30 S.W.2d 282 (1930).

[40] For cases holding the legislature has no power to foreclose judicial inquiry either by its fiat or by an attempt to change the meaning of words used in the constitution, see Clem v. Evans, 291 S.W. 871 (Tex. Comm. App. 1927); Powell v. State, 17 Tex. Ct. App. 345 (1884); Keller v. State, 87 S.W. 669 (Tex. Crim. 1905); Ex Parte Anderson, 81 S.W. 973 (Tex. Crim. 1904).

compulsory tie-in sales of certificates in the loan transactions, and then states the fiction that the sales of certificates are separate transactions from the loan transaction. Regardless of the intent of the legislature, the result of declaring the fiction of two transactions is to give statutory sanction to lending companies to receive more than ten per cent per annum for the use of their money. Although the lending companies receive back their money in periodic installment payments from the borrowers throughout the loan periods, the act authorizes the lending companies to charge interest on the money they have received back. The borrowers no longer have the use of this money, yet the act authorizes the lending companies to charge interest on it.

THE BUILDING AND LOAN PLAN IS NOT LEGALLY ANALOGOUS TO THE CERTIFICATE PLAN

The decisions in *Reams v. Community Finance & Thrift Corp.* and *Steiner v. Community Finance & Thrift Corp.* were primarily based on what were said to be controlling decisions of the Supreme Court in certain building and loan cases. The *Steiner* opinion quotes and relies to a great extent upon a statement in the *Reams* opinion that there is no material distinction between the building and loan plan and the certificate plan. The only justification given in the *Reams* opinion for this conclusion was that "Appellee company sold certificates to both borrowers and non-borrowers, just as the building and loan associations sold shares."[41] But this overlooks, and apparently the *Steiner* opinion also overlooks, the fact that the act authorizes lending companies to compel their borrowers to take certificates of no value or of whatever value the lending companies choose. Nonborrowers certainly would not voluntarily purchase certificates that would return no interest or only nominal interest.

The above quotation from the *Reams* case appears to be no justification whatsoever for the conclusion that there is no material distinction between the two plans, for there are very material distinctions between the two plans as authorized by their respective statutes. The decisions in the *Reams* and *Steiner* cases are incorrect in this regard for at least the following two reasons:

(1) The Supreme Court and Commission of Appeals cases cited in those cases do not hold that loans made in conformity with the building and loan statutes may not be shown to be usurious.[42] But

[41] 236 S.W.2d 185, 186 (1951).

[42] In fact the opinions state that usury may be shown. The leading case, Interstate Bldg. & Loan Ass'n v. Goforth, 94 Tex. 259, 59 S.W. 871 (1900), expressly stated at

the effect given these decisions by the *Reams* and *Steiner* cases is that compliance with the statutes forecloses the question of usury. Consequently that was the effect given them in those two cases when the business records presented showed compliance with statutes claimed to authorize the certificate plan.

The *Reams* opinion, after stating that the lending corporation had complied with the provisions of article 1524a, then went on to hold:

> [W]e regard the same as being controlled by the decision of the Supreme Court in the building and loan cases, such as *Wood v. Continental Savings & Bldg. Ass'n,* Tex.Com.App., 56 S.W.2d 641; *Hatcher v. Continental Southland Savings & Loan Ass'n,* 124 Tex. 601, 80 S.W.2d 299; and *Interstate Bldg. & Loan Ass'n v. Goforth,* 94 Tex. 259, 59 S.W. 871. No material distinction can be perceived between the building and loan plan commonly practiced in Texas and the one under review. Each required installment payments which were credited not to the principal, but in the one case, to the purchase of shares, and, in the other, to the purchase of a certificate.[43]

The *Steiner* opinion held on this point:

> Although *Reams v. Community Finance & Thrift Corp.* . . . is not a specific ruling as to the constitutionality of Art. 1524a-1, the case does decree the legality of a loan and investment certificate proceeding directly exemplifying the power authorized by such statute. Under prior rulings of the Supreme Court decreeing the legality of procedure like that here in issue and the above directed ruling of the Court of Civil Appeals pronouncing the legalities of the procedure as to issuance of investment certificates at the time of making a loan, it appears to be a sound proposition of law that a statute authorizing and outlining the same procedure would be a legal and constitutional enactment of law.
>
> The concept here as to the constitutionality of Art. 1524a-1 is based on the principle that the Supreme Court of Texas has placed its sanction of constitutionality on this type of loan procedure under the theory that the execution of a note to a corporation and the simultaneous purchase of stock issued by the corporation as a prerequisite to obtaining such loan are two separate and distinct transactions and that the monthly payments on the stock are not payments on the loan which reduce the principal of the debt and the corresponding interest collectable there on. [citing the cases cited in the *Reams* opinion, above, and *Gregg v. North Texas Bldg. & Loan Ass'n,* 82 S.W.2d 1093 (Tex. Civ. App. 1935)]. . . .[44]

p. 874: "If, however, upon another trial, Goforth and his wife shall produce evidence that the terms of this contract were adopted as a device for evading the usury laws of the state, it will be proper for the trial court to submit to the jury the question whether the contract is tainted with usury. . . . "

[43] 236 S.W.2d 185, 186 (1951).

[44] 258 S.W.2d 129, 131 (1953).

But under the constitution every case, regardless of whether a statute is involved, turns upon its own facts as to whether the transaction is usurious.[45] This was true even in the cases cited as authority in the *Reams* and *Steiner* cases. It is true that the facts as presented to the courts in the *Steiner* and *Reams* cases were such that the courts could hardly avoid a holding of constitutionality. But the holding in those cases was not on a determination from the facts whether the loan and the sale of the certificates was one or two transactions or was in fact usurious, but whether the form of the transactions complied with the statutes.

Another way of stating the results of the *Steiner* and *Reams* cases is that the courts felt they were bound to look to the form of the transaction rather than to the substance. However, due respect must be given to the *Steiner* opinion in that, while the holding was based on precedents considered binding with regard to the points of error raised, the court further stated:

> That provision of Art. 1524a-1 which declares that the making of loans and the selling of certificates of investment are two separate and distinct transactions and that periodic payments required on the certificates of investment shall not be considered as periodic payments on the loan is pure fiction. . . .
> Without reference to the authorities cited above, which we consider controlling as to rulings heretofore made on the issues before the court by point of error, under the facts shown in the paragraph above, the opinion is here expressed that Art. 1524a-1 is merely a legislative provision authorizing the charging of interest in excess of 10% and such statute should be held in violation of Sec. 11, Art. 16 of the constitution. Further the practices authorized thereby should likewise be declared in violation of the same constitutional provision. The principles here expressed are not without precedent in Texas. *Cotton State Bldg. Co. v. Reily,* Tex.Civ.App. 50 S.W. 961; *People's Building, Loan and Savings Ass'n v. Rising,* Tex. Civ. App., 34 S.W. 147 (writ refused);

[45] Temple Trust Co. v. Sewell, 133 Tex. 417, 126 S.W.2d 943 (1939); Schmid v. City Nat'l Bank, 132 Tex. 115, 114 S.W.2d 854 (1938); Walker v. Temple Trust Co., 124 Tex. 575, 80 S.W.2d 935 (1935); Graham & Locke Inv. Co. v. Madison, 295 S.W.2d 234 (Tex. Civ. App. 1956) error ref. n.r.e.; Sledge v. Murphy, 284 S.W.2d 938 (Tex. Civ. App. 1955); Auto-credit of Ft. Worth, Inc. v. Pritchett, 223 S.W.2d 951 (Tex. Civ. App. 1949) error dism.; Donoghue v. State, 211 S.W.2d 623 (Tex. Civ. App. 1948) error ref. n.r.e.; Standard Supply and Hardware Co. v. Christian-Carpenter Drilling Co., 183 S.W.2d 657 (Tex. Civ. App. 1944) error ref.; Glenn v. McCarty, 130 S.W.2d 295 (Tex. Civ. App. 1939), aff'd, 137 Tex. 608, 155 S.W.2d 912 (1941); Glover v. Bushman, 104 S.W.2d 66 (Tex. Civ. App. 1937) error dism.; Commerce Trust Co. v. Best, 54 S.W.2d 1037 (Tex. Civ. App. 1932), judgm. reformed and aff'd, 124 Tex. 583, 80 S.W.2d 942 (1935); Joy v. Provident Loan Soc'y, 37 S.W.2d 254 (Tex. Civ. App. 1931) error dism.; Federal Mortgage Co. v. State Nat'l Bank, 254 S.W. 1002 (Tex. Civ. App. 1923) error dism.; Henry v. Sanson, 21 S.W. 69 (Tex. Civ. App. 1893). Some cases involving the Building and Loan statutes are Mack v. North Am. Bldg. & Loan Ass'n, 60 S.W.2d 1099 (Tex. Civ. App. 1933); and Hampton v. Guaranty State Bldg. & Loan Ass'n, 63 S.W.2d 873 (Tex. Civ. App. 1933).

People's Building, Loan & Savings Ass'n v. Marston, Tex. Civ. App., 69 S.W. 1034 (writ refused).[46]

(2) The Supreme Court and Commission of Appeals cases cited are not controlling, and are not really applicable, because the building and loan plan as authorized by the statutes was held valid on principles that cannot apply to the certificate plan as authorized by the act. The relationship between borrowers and lending building and loan associations who sell an interest in their business[47] and said borrowers is vastly different from the relationship of borrowers and lending companies who are authorized to sell worthless certificates[48] and their said borrowers. The building and loan statutes have been held valid on the ground that they authorize an actual dual relationship,[49] and that such dual relationship is actually created.[50] A borrower who is also a shareholder actually has a dual relationship. He is a borrower from the association, and he is a part owner of the association by virtue of his purchase of stock and as such has a voice and vote in the management of the corporation. As a shareholder he shares in the expenses of the business, and in profits and losses just as a non-borrowing shareholder and just as a shareholder of any other corporation.[51]

None of these things is true as to the status of borrowers who must purchase certificates under the act. The act does not authorize an actual dual relationship because the borrowers do not become part owners of the corporation; they have no voice or vote in the management of the corporation; they do not share in the expenses of the corporation; they do not share in the profits and losses. In fact, the act specifically provides in subsection (j) that on voluntary or involuntary liquidation borrowers' payments on the certificates are to be applied to their loan debts and they shall have the same time for payment at the same rate of interest as would be required

[46] 258 S.W.2d 129, 132-33 (1953).

[47] The transaction is so described by the Supreme Court in Interstate Bldg. & Loan Ass'n v. Goforth, 94 Tex. 259, 59 S.W. 871 (1900).

[48] See note 32 supra.

[49] If the borrower does not actually become a shareholder and his payments are ostensibly applied to stock subscription as a device to obtain greater compensation than 10% it is usury. American Mut. Bldg. & Sav. Ass'n v. Cornibe, 80 S.W. 1026 (Tex. Civ. App. 1904) error ref.; American Mut. Bldg. & Sav. Ass'n v. Daugherty, 66 S.W. 131 (Tex. Civ. App. 1901) error ref.; Interstate Bldg. & Loan Ass'n v. Crawford, 63 S.W. 1071 (Tex. Civ. App. 1901); Peightal v. Cotton States Bldg. Co., 61 S.W. 428 (Tex. Civ. App. 1901); Cotton States Bldg. Co. v. Jones, 60 S.W. 587 (Tex. Civ. App. 1900), rev'd on other grounds, 94 Tex. 497, 62 S.W. 741 (1901); Cotton States Bldg. Co. v. Reily, 50 S.W. 961 (Tex. Civ. App. 1896); People's Bldg. Loan & Sav. Ass'n v. Rising, 34 S.W. 147 (Tex. Civ. App. 1896) error ref.

[50] Prudential Bldg. & Loan Ass'n v. Shaw, 119 Tex. 228, 26 S.W.2d 168 (1930); Wood v. Continental Sav. & Bldg. Ass'n, 56 S.W.2d 64 (Tex. Comm. App. 1933).

[51] Prudential Bldg. & Loan Ass'n v. Shaw, 119 Tex. 228, 26 S.W.2d 168, 172 (1930).

if there were no liquidation. Thus their status under subsection (j) is simply that of borrowers and this in itself indicates quite clearly the fiction of subsection (c) in describing the loan transaction as two separate and distinct transactions.

Every building and loan case cited in the *Reams* and *Steiner* opinions is actually authority against the certificate plan as authorized by the act. This can be seen in the case that established the constitutionality of the plan authorized by the building and loan statutes, *Wood v. Continental Sav. & Bldg. Ass'n.*[52] Most of the opinion in the *Wood* case is devoted to a discussion and citation of authority in Texas and other states that a borrowing member of a building and loan association occupies a dual relationship with the association, and that the terms of the contract by which he becomes a borrower are wholly distinct and separate from the terms of the contract by which he also becomes a purchaser of shares of the association. It was emphasized that he achieves the same status as a non-borrowing shareholder by his purchase of stock and thereby becomes a part owner in the assets of the corporation, with a right to the benefits that accrue to such owners if the corporation prospers, but also with the liability of suffering the losses should the value of the assets decline. Should the association become insolvent, he bears his share of the losses equally with the nonborrowing stockholder and may not have the payments made on his stock applied to his mortgage debt.[53]

The case of *Fidelity Bldg. and Loan Ass'n v. Thompson*[54] is a very important one dealing with the status and the nature of a borrowing shareholder in a building and loan association both before and after the adoption of article 881a-39[55] in 1929 and its amendment in 1930.[56] The building and loan association involved had become insolvent and brought suit against the borrowing shareholders, in which suit nonborrowing shareholders intervened. As to the borrowing shareholders it was held that they could not set off the value of their shares against their loans, which were made prior to the enactment of the above statutes. The 1930 amendment to the above statutes provides in effect that if an association is in process of either voluntary or involuntary liquidation the payments made by the

[52] 56 S.W.2d 641 (Tex. Comm. App. 1933). Even though this case in effect held the building and loan statutes constitutional, it did not hold that compliance with the statutes foreclosed proof that a particular transaction was usurious. See note 45 supra.

[53] Citing and quoting at length as authority for this point Prudential Bldg. & Loan Ass'n v. Shaw, 119 Tex. 228, 26 S.W.2d 168 (1930).

[54] 45 S.W.2d 167 (Tex. Comm. App. 1932).

[55] Tex. Rev. Civ. Stat. Ann. (1947).

[56] Tex. Sess. Laws 1930, C. 51, § 1.

borrower, plus credited dividends, less any lawful fees, fines, penalties, or advances owing on his shares of stock, shall be applied on the indebtedness owing by such borrower, and the borrower shall have the same time for payment at the same rate of interest as would have been required if the association were not in liquidation.

The main argument by the borrowing shareholders was that this amendment was merely procedural and therefore applied to their contract with the building and loan association even though said contracts were in existence before the statute was passed. The Commision of Appeals held, however, that the statutes went far beyond any mere rule of procedure and directly and vitally affected the contracts involved because it effected an alteration of the contract. The amendment was intended to relieve the borrowing shareholder of any losses suffered by the association and also to relieve him of his liability immediately to repay his debt to the association when it became insolvent. Therefore the amendment could not apply because it would alter the obligations of the borrowing shareholder under his contract. The court said that under the law as it existed prior to the statutes, borrowing and nonborrowing shareholders stood on the same basis, that is, their rights and liabilities as shareholders were equal. The Commision spelled out the status of borrowing shareholders in the following language.

> Also at the time mentioned a borrowing shareholder occupied a dual relationship to the association. As a shareholder he was a member of, and participated in, the management of the association. In such capacity he shared in the expenses, losses, and profits of the association just as did a nonborrowing shareholder. Also, prior to the effectiveness of the above-mentioned statutes, when a building and loan association became insolvent and went into liquidation, it became the duty of the borrowing shareholder to at once pay his debt to the association. In such event, he was not entitled to offset dividends coming to him on his stock on his debt, for the very simple reason that it would be impossible to accurately ascertain the value of the stock until the association had been completely liquidated and the amount of the receipts and expenses fully and accurately ascertained. In other words, the insolvency and liquidation of a building and loan association put an end to its operations for the purposes contemplated by its charter. To a certain extent this event also ended the contract between the association and its members, and it became necessary to wind up its affairs in such a manner as to do equity to creditors and between its members. In order to do this, it was held necessary to require the borrower to at once pay his debt to the association. After he had done this, he was entitled to his pro rata dividend with the nonborrowing shareholders for what he had paid upon his stock. In the manner above detailed, the borrowing and nonborrowing shareholders were placed upon an equal basis, and each, as

a shareholder, required to bear his proportionate part of the losses. *Prudential Building and Loan Ass'n v. Shaw,* 119 Tex. 228, 26 S.W. 2d 168 (Com. App. opinion adopted); *Cocke v. Wright* (Tex. Com. App.) 39 S.W.2d 590.[57]

It was also pointed out that the right of a nonborrowing shareholder to compel a borrowing shareholder to pay his debt to an insolvent association in liquidation, and stand his share of the losses, was a valuable and substantial right and that to apply the statutes to these prior contracts would enable the borrowing shareholder to escape responsibility for his share of the losses and would leave such losses to be borne by the nonborrowing shareholder.

In denying a motion for rehearing[58] the Commission of Appeals re-emphasized that the rights and liabilities of all shareholders as such, both borrowing and nonborrowing, were equal, and in case the association suffered losses the stock of borrowing shareholders shared in such losses just as did that of nonborrowing shareholders. In answering the argument that there was authority in the statutes for charging all losses to nonborrowing shareholders the court said that the articles when construed together did not authorize preference of the stock of a borrowing shareholder over that of a nonborrowing shareholder since article 859 plainly provided that the borrower "shall be given credit for the withdrawal value of his shares pledged as security," and article 860 defined "withdrawal value." The court reasoned that if the legislature had intended for the borrowing shareholder's stock to be charged with no losses of the association it would have said so in unmistakable language, but instead it provided that he should be given credit for the withdrawal value, which certainly meant the actual or real value; further, article 869 only had application to going concerns and not to insolvent associations in liquidation.[59]

The decision in this case was one of the reasons that Texas building and loan associations stopped making this type ("sinking fund") of real estate loan.[60] As above noted,[61] the 1930 amendment to article 881a-39 is intended to relieve borrowing shareholders of

[57] 45 S.W.2d 167, 170 (1932).

[58] 51 S.W.2d 578 (Tex. Comm. App. 1932).

[59] Id. at 582.

[60] Letter from Jack W. Cashin, Feb. 27, 1958. Mr. Cashin, in stating why the "sinking fund" plan was discontinued, wrote in part: "Secondly, we had, at one time, a court decision which related to the liquidation of an association that held, in effect, that a borrower would be able to offset only the current market value of his accumulated shares against his loan. This was clearly an inequity and further discouraged use of the 'sinking fund plan.' "

[61] See text accompanying note 56 supra.

their obligations as shareholders and to give them the status of borrowers whenever the associations become insolvent. In this respect it is analogous to subsection (j) of the act.[62] No case has passed on the question of whether the 1930 amendment changed the dual relationship status of borrowing shareholders to the status of being simply borrowers.[63] It is readily apparent that such may be its effect. If so, the rule of the building and loan cases cited in the *Reams* and *Steiner* cases would be reversed.

THE ACT IS ANALOGOUS TO THE TEXAS CREDIT INSURANCE ACT

The Texas Certificate Plan Act is analogous to the Texas Credit Insurance Act[64] which the writer believes to be unconstitutional also.[65] Both are authorization acts for the benefit of small loan lenders and lending companies. Both authorize lenders to require borrowers, as a condition of the loan, to purchase something that ordinary small loan borrowers neither need nor want, and cannot afford. The purpose of such authorization of both acts is to enable the lenders to receive compensation for the use of their money over and above that permitted by the constitution. Both acts declare in effect by legislative fiat that such additional compensation received is bona fide and is not usurious interest. In doing so, both usurp the function of the judiciary; both attempt to authorize lenders, by indirection, to circumvent the constitution, and both are unconstitutional.

CONCLUSION

Does the Texas Certificate Plan Act "legalize" usury? The answer is *no*. But it attempts to do so. And in practical effect it has done so to date, for lending companies utilize the plan with the stamp of legality given it by the *Reams* and *Steiner* decisions. But the answer is still no, because our constitution contains a self-executing mandatory prohibition against usury and the legislature has no power to "legalize" usury in any manner. There seems to be no real argument that the ten per cent interest limitation in our constitu-

[62] See text accompanying note 51 supra.

[63] On motion for rehearing of Prudential Bldg. & Loan Ass'n v. Shaw, 27 S.W.2d 157 (Tex. Comm. App. 1930), the association complained that the original opinion (at 26 S.W.2d 168) did not define the right of borrowing shareholders as affected by the 1930 amendment to art. 881-39. The Commission of Appeals pointed out that they did not do so because the amendment had not been passed at the time their original opinion had been prepared.

[64] Tex. Ins. Code Ann. art. 3.53 (1956 Supp.).

[65] See Davis, Does The Texas Credit Insurance Act "Legalize" Usury?, 11 Sw. L.J. 139 (1957).

tion is too low to permit the small loan business to operate at a reasonable profit. But it does not follow that the legislature should attempt to authorize special groups to violate that limitation in our basic law. Nor does it follow that the courts should be lenient with such unconstitutional legislation. Winking at unconstitutional acts in any field weakens our entire legal and social structure. There is particular danger in legislative violation of constitutionality in the small loan field where special groups stand to profit by such violation.

Should the constitutionality of the Texas Certificate Plan Act come before a Texas appellate court again it is hoped that what has been written will help persuade the court that it has the duty to invalidate the act and make it clear that the legislature has no power to legislate validity into such transactions as authorized by the act and by the Texas Credit Insurance Act. Such action by our courts would clear the way for a vote to amend section 11 of article XVI of the constitution so as to enable the legislature to enact a valid, modern, and comprehensive small-loan law that will permit legitimate lenders to operate at a reasonable profit and, by strict regulation and punitive provisions, eliminate all illegal devices now in use.

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