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Equity Participation in Texas: A Lender's Dream or a Usurious Nightmare

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Accordingly all the saints and all the angels of paradise cry then against [the usurer], saying, "To hell, to hell, to hell." Also the heavens with their stars cry out, saying, "To the fire, to the fire, to the fire." The planets also clamor, "To the depths, to the depths, to the depths."

Such was the judgment, according to the Roman Catholic Church, against anyone charging usurious interest. Prohibitions against usury date back to ancient times. The earliest recorded usury statutes are found in the laws of Eshnunna, the Code of Hammurabi, and the legal, poetic, and prophetic literature of the Old Testament, thus making usury not only legally but also morally reprehensible. Over the centuries absolute restrictions against usurious interest have been modified, but restraints continue to be imposed in order to protect the unwary and unsophisticated borrower.

3. The interest ceiling prescribed by these laws was 16%. The Laws of Eshnunna §§ 18a & 21 (Goetze trans.), reprinted in Ancient Near Eastern Texts RELATING TO THE OLD TESTAMENT 162 (2d ed. Pritchard 1955).
8. The prohibitions survived with some exceptions until the Reformation, when religious leaders, such as John Calvin, recognized that a limited interest charge was permissible as a normal cost of doing business because of the income-producing capability of money. S. Clough & C. Cole, Economic History of Europe 152 (1952). Pope Nicholas III allowed the Florentine banking families to charge usurious rates and helped them collect on their loans by threatening the borrower with excommunication. Id. at 82.
9. Baske v. Russell, 67 Wash. 2d 268, 273, 407 P.2d 434, 437 (1965) (The Washington Supreme Court expressed the view that usury statutes are "designed to protect those who by adversity and necessity of economic life are driven to borrow money at any cost. The protection granted is based on the fact that many borrowers are powerless to resist the avarice of the money lenders."). Texas usury statutes reflect this view by allowing parties in more sophisticated business deals to charge higher interest rates. See note 31 infra. See also Merriman & Hanks, supra note 2, at 1.
The present advent of high interest rates in a tight money market\(^{10}\) coupled with comparatively low legal maximums have produced a lending atmosphere conducive to finding new methods of obtaining a more profitable return on invested capital while avoiding usury penalties. One such method is equity participation. Although this term encompasses many types of transactions,\(^{11}\) the basic concept involves an advance of money in consideration for some form of ownership position in the borrower’s enterprise given in lieu of or in addition to simple interest. The advantage of equity participation to the lender\(^{12}\) is the possibility of a net return far greater than simple interest. To the borrower\(^{13}\) the advantages are the ability to attract lenders to a high risk venture and, in some cases, to be relieved of paying back the lender should the venture fail.\(^{14}\)

Because of the advantages to both lender and borrower, equity participation transactions have increased in recent years.\(^{15}\) Lenders, accustomed to the secure position of a guaranteed return of principal and interest, have attempted to structure equity participation transactions within the framework of secured lending. At some point, however, this structuring can cause equity participation to become indistinguishable from a simple loan. Once a court deems the transaction to be a loan, an allegation of usury becomes a distinct threat to the lender, especially because equity participation is often designed to allow for a high return. Texas courts may now be even more suspicious of alleged usurious transactions as a result of the holdings in recent cases\(^{16}\) in which the parties resorted to unique methods to circumvent usury prohibitions.\(^{17}\)

This Comment (1) identifies the various forms of equity participation that Texas courts have scrutinized; (2) delineates the elements of a usurious transaction; and (3) applies those elements to equity participation in

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\(^{11}\) See text accompanying notes 18-30 infra.

\(^{12}\) This Comment uses the term “lender” to refer to one who advances capital. The term is not used to imply that the transaction is a loan.

\(^{13}\) This Comment uses the term “borrower” to refer to one who receives capital, or whose enterprise receives capital from a “lender” as defined in note 12 supra. The term is not used to imply that the transaction is a loan.


\(^{15}\) Hershman, *Usury Revisited*, supra note 10, at 1138. See also note 42 infra.


general, thus pointing the way toward equity participation schemes that will survive usury challenges.

I. TYPES OF EQUITY PARTICIPATION

Defining equity participation as a transaction in which the lender advances money to the borrower in consideration for an ownership position in the borrower's enterprise given in lieu of or in addition to a guaranteed percentage of return broadens the traditional definition given by other commentators\(^\text{18}\) who have focused on more typical lending transactions. Numerous Texas usury cases, however, deal with transactions quite unlike a conventional loan. A purchase of stock,\(^\text{19}\) for example, would fit the broadened definition of equity participation. Such a purchase may be found usurious if the elements of usury\(^\text{20}\) underlie the transaction. This Comment approaches the usury implications of equity participation by using the most inclusive definition of equity participation transactions and then analyzing the specific types of transactions within that general definition to determine if they possess the elements of usury.

Conceptually, equity participation transactions fall into two broad categories based on the relative permanence of the lender's ownership position vis-à-vis the borrower's ownership position. The first involves both the borrower's and the lender's owning a share of the enterprise until its termination, with the lender's share determined by a designated formula. In the second broad category, the lender's ownership position or part thereof transfers to the borrower upon the occurrence of a designated condition.

Variations of the first category found in Texas case law include transactions in which the lender's interest in the enterprise is based on a limited partnership agreement;\(^\text{21}\) an option to purchase;\(^\text{22}\) a designated source of income to the enterprise;\(^\text{23}\) or a designated percentage of the enterprise's

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18. E.g., Comment, *The Application of Texas Usury Laws to Equity Participation Agreements*, 48 TEXAS L. REV. 925, 927-28 (1970) ("The basic element inherent in all equity participation agreements is the lender's willingness to subject part of his return to a contingency."). Although contingency may be an element of some equity participation transactions, it is not a necessary element. A sale-leaseback, for example, is an equity participation transaction that often involves no element of contingency. Contingency is only one step of the usury analysis. See notes 34-37 infra and accompanying text. A transaction may have a contingent element, yet a court may find that it does not constitute a loan and, therefore, may never reach a consideration of the effect of the contingency on the question of usury.


20. See text accompanying notes 34-40 infra.


sales, income, or production. The usury implications of these forms of equity participation generally involve questions of whether the transaction was intended to be a loan or merely an advance of working capital and whether the lender's return was subject to risk.

Variations discovered in Texas cases involving the second broad category of equity participation, in which the lender's interest in the enterprise is obtained and subsequently transferred to the borrower, include transactions effected by means of a purchase from a third party and a sale to the borrower, a purchase from and resale to the borrower, a "put and call" agreement between lender and borrower, or a lien or other form of security by the lender against the borrower with a subsequent release. The usury implications of these forms of equity participation generally involve questions of whether the transaction was intended to cloak a loan in the disguise of a sale or an option and whether the sale or option contained sufficient elements of coercion such that the occurrence of either was a virtual certainty.

II. ELEMENTS OF USURY

The Texas Constitution establishes the basis for Texas usury laws. Al-
though the legislature has provided a broad statutory definition of usury,\textsuperscript{32} Texas courts follow the universally recognized elements of usury.\textsuperscript{33} For a transaction to be judicially declared usurious, four elements are essential:\textsuperscript{34} (1) the transaction must involve a loan of money, or something of value, or the forbearance of a debt owed;\textsuperscript{35} (2) the parties must agree that the loan shall be repayable absolutely;\textsuperscript{36} (3) the lender must demand a greater amount of return than is allowed by law; and (4) the lender must intend to violate the law\textsuperscript{37} at the inception of the transaction.

The presence of these four elements in a transaction is conclusive of the issue of usury,\textsuperscript{38} while the absence of one element provides an absolute defense.\textsuperscript{39} An important corollary is that a court will look at the substance of the transaction\textsuperscript{40} in its effort to detect the presence of the four elements and will not be limited to the form of the transaction or to the parties' characterization of it.

four family residence if it is occupied or will be occupied by the obligated party nor to a lien on land intended to be used primarily for agricultural or ranching purposes. Under this amendment, which became effective Aug. 27, 1979, a claim or defense of usury may not be raised. \textit{Id.} art. 5069—1.07(d). This prohibition against raising a claim or defense of usury will undoubtedly be challenged because a borrower is constitutionally protected against usury in Texas. The 1979 legislature also provided for a higher interest rate on loans secured by one-to-four family residential dwellings. The new provision allows for either a 12\% per annum rate or a floating rate based on United States Treasury notes. \textit{Id.; see} Dor-saneo, \textit{Creditor and Consumer Rights, Annual Survey of Texas Law}, 34 Sw. L.J. 253, 266-70 (1980).

\textsuperscript{32} Usury is defined as "interest in excess of the amount allowed by law." \textit{Tex. Rev. Civ. Stat. Ann.} art. 5069—1.01(a) (Vernon 1971). Interest is "the compensation allowed by law for the use or forbearance or detention of money." \textit{Id.} art. 5069—1.01(d).

\textsuperscript{33} \textit{See, e.g.,} Crow v. Home Sav. Ass'n, 522 S.W.2d 457, 459-60 (Tex. 1975); Bexar Bldg. & Loan Ass'n v. Robinson, 78 Tex. 163, 168, 14 S.W. 227, 228 (1890). \textit{See generally} 45 \textit{Am. Jur. 2D Interest and Usury} \S\ 111 (1969); 58 \textit{Tex. Jur. 2D Usury} \S\ 8 (1964).

\textsuperscript{34} \textit{Restatement of Contracts} \S\ 526, Comment b (1932).

\textsuperscript{35} An advance of working capital to a joint venture, for example, is not a loan. Korth v. Tumlinson, 73 S.W.2d 1048 (Tex. Civ. App.—San Antonio 1934, no writ).

\textsuperscript{36} This element requires that the lender be subject to no substantial risk beyond the possibility of the borrower's insolvency.

\textsuperscript{37} Intent, however, need not be specific, willful, or subjective, but is determined from the substance of the agreement itself. \textit{See} notes 145-50 \textit{infra} and accompanying text.

\textsuperscript{38} When a court finds usury, the penalty can be substantial. A person who contracts for, charges, or receives usurious interest shall forfeit to the obligor three times the amount of usurious interest, but in no event shall the amount be less than $2,000 or 20\% of the principal, whichever is smaller, and reasonable attorneys' fees. \textit{Tex. Rev. Civ. Stat. Ann.} art. 5069—1.06(1) (Vernon Pam. Supp. 1971-1979). If the usurious interest is in excess of double the amount of allowable interest, the principal of the loan shall also be forfeited as an additional penalty. \textit{Id.} art. 5069—1.06(2) (Vernon 1971).

\textsuperscript{39} \textit{See} text accompanying notes 33-34 \textit{supra}.

\textsuperscript{40} Where the intent of a party to a bargain is to make a loan of money or an extension of the maturity of a pecuniary debt for a greater profit than is allowed by law, the agreement is illegal though the transaction is put in whole or in part in the form of a sale, a contract to sell or other contract. \textit{Restatement of Contracts} \S\ 529 (1932). "Parties may give the designation of a sale to a transaction which they really intend as a usurious mortgage. And in all cases it is the substance not the form of a transaction which is important." \textit{Id.} Comment g. \textit{See, e.g.,} Sachs v. Ginsberg, 87 F.2d 28, 30 (5th Cir. 1936); Johns v. Jaeb, 518 S.W.2d 857, 859 (Tex. Civ. App.—Dallas 1974, no writ); Campbell v. Oskey, 239 S.W. 332, 334 (Tex. Civ. App.—El Paso 1922, no writ).
III. Elements of Usury Applied to Equity Participation Transactions

With a workable definition of equity participation and a framework for discovering usury, the matter remains to detail how Texas courts have applied the framework to equity participation transactions, and to suggest guidelines for formulating these transactions in the future. To establish whether an equity participation transaction could be regarded as usurious, four questions should be posed: Is the transaction a loan? Is the loan absolutely repayable? Is the maximum legal rate of return exceeded? Did the lender intend a usurious return? The variations of equity participation transactions must be considered in light of these four questions. At one extreme, a lender with an intent to circumvent the usury ceiling could advance funds in return for an unconditional promise to repay the loan at the maximum rate of legal interest plus a participation in the venture's equity. Clearly, such an agreement would be usurious as long as the participation had at least nominal value. At the other extreme, a lender might advance funds with no return promise to pay any amount in exchange for a small participation in a very risky venture. Such an agreement evidences none of the elements of usury. When lenders use an intermediate approach and advance money in exchange for an absolute promise to repay the principal with no interest or a low interest charge plus an equity participation, usury questions arise. Pictured on a continuum, these variations suggest that, as the guaranteed rate of return approaches the legal maximum, the chances of a court finding usury under the four-question analysis increase.

A. Is the Equity Participation Transaction a Loan?

This first question seeks to distinguish between funds advanced as a contribution to the capital of a venture and funds given in exchange for a return of principal plus interest. The former is not a loan; the latter is. In many equity participation transactions, such a distinction is illusory; therefore, the answer to this initial question depends on the factfinder's perception of the transaction's substance. Texas courts have found either

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41. See text accompanying notes 18-20 supra.
42. Since 1950, 14 reported Texas cases have dealt with the subject of usury as it relates to equity participation transactions. Seven of these 14 opinions have been within the last five years. The increase of equity participation litigation is not inconsistent with earlier predictions that such investments in one form or another would become a significant element in lenders' portfolios. Roegge, Talbot & Zinman, Real Estate Equity Investments and the Institutional Lender: Nothing Ventured, Nothing Gained, 39 FORDHAM L. REV. 579, 647 (1971). Only sporadic attention is given to the law of usury; it appears to come before the courts in cyclical periods when interest rates approach the usury ceiling. Merriman & Hanks, supra note 2, at 1.
43. See text accompanying notes 133-35 infra.
46. A difficult case arises when parties structure a transaction other than in the form of
that the following transactions are loans, or that they present for the factfinder a legitimate question of whether or not the transaction is a loan: a sale from the borrower to the lender with an option to repurchase, a purchase by the lender followed by an immediate sale to the borrower, a "put and call" agreement, a limited partnership agreement, a note secured by a deed of trust and by a chattel mortgage lien, a note secured by possession of goods, a vendor's lien, a draft fee agreement, a "grub-stake deal," and a partnership agreement.

Eight situations appeared in these cases that may have been instrumental in convincing the trier of fact that, although the transaction was not structured as a loan, the realities of the transaction supported the contrary conclusion. These situations can be broadly categorized into two groups: (1) the circumstances surrounding the transaction and (2) the relative bargaining positions of the borrower and the lender.

**Surrounding Circumstances.**

**Loan Sought by Borrower.** An obvious indicator that the parties intended the transaction to be a loan is that the borrower originally sought a loan. In *Sudderth v. Howard* the plaintiffs applied for a bank loan and a bank official introduced them to the defendant, Howard. Instead of obtaining a loan, the Sudderths deeded their property to Howard for $17,400 and obtained an option to repurchase the property within five months for $20,010 plus accrued taxes. In the meantime, Howard permitted the Sudderths to remain on the property. When the option period expired, the Sudderths brought suit against Howard, claiming that the combination sale and repurchase option was a subterfuge to evade usury laws. Although the evidence at trial conflicted as to the nature of the transaction, the jury found that the parties intended a loan and not a sale.
Circumstances very similar to Sudderth became the subject of a usury suit in Sachs v. Ginsberg.\(^5\) Having recently contracted to purchase a business for $12,500, Ginsberg applied for a loan of $7,500 from Sachs to supplement his own $5,000 holdings. Sachs agreed to advance $7,500 in return for a bonus of $3,000. The business was conveyed to Sachs for the recited consideration of $12,500, and Sachs executed a contract with Ginsberg to sell him the business for $15,500. Until such sale, Sachs was to receive one-half of all proceeds from the business. The court of civil appeals, in affirming the trial court, viewed this transaction as a colorable device to disguise a loan as an option to buy property that, in fact, had already been bought.\(^6\)

In Johns v. Jaeb\(^6\) Johns applied to Jaeb, a bank president, for a loan. Jaeb declined to make the loan on behalf of the bank, but expressed his personal interest. The parties then formed a limited partnership, with Jaeb contributing $5,000 as the limited partner for a ninety-nine percent share of the profits. In a separate agreement, Jaeb promised to sell his partnership share to Johns for an interest-free $6,500 promissory note and to pass title when the note was paid in full. In the meantime, Johns would draw a salary of not more than $1,000 per month. The trial court held for Jaeb against Johns' charge of usury,\(^6\) but the court of civil appeals reversed and rendered, concluding that the documents on their face showed that the transaction was in substance a loan rather than a true limited partnership.\(^6\)

In Campbell v. Oskey\(^6\) Oskey had arranged to buy diamonds valued at $1,800 for $750. He had applied to Campbell for a $750 loan, but was refused. Campbell did agree, however, to advance the $750 in return for $300 of the profit that Oskey would make on the diamonds. Until the entire $1,050 was paid to Campbell, he kept the diamonds as security. The court of civil appeals, affirming the trial court, found that the transaction was a loan.\(^6\) In all four of the above cases, the fact that the borrower initially applied for a loan may have weighed heavily in both the factfinders' and appellate court’s considerations. In every case in which the lender argued that the advance of funds was a contribution to the capital of a partnership, the court rejected that argument by examining the substance of the transaction rather than accepting its outward form.\(^6\)

**Variance in Value.** A large variance between what the lender advanced

\(^5\) 87 F.2d 28 (5th Cir. 1936).
\(^6\) 518 S.W.2d 857 (Tex. Civ. App.—Dallas 1974, no writ).
\(^6\) 239 S.W. 332 at 334. The court, in finding a loan, was influenced by discovering an absolute obligation to repay. \(^6\) Thus, the answer to the second question in the four-step analysis may influence the answer to the first question.
and the fair market value of what the borrower gave in exchange may indicate a loan. For example, in Sudderth v. Howard the lender "bought" the borrower's property for $87 an acre, a total of $17,400. Testimony adduced at trial placed the value at $200 to $500 per acre, and the lender himself valued the property at $150 to $160 per acre. With this evidence, the jury was unable to characterize the transaction as a legitimate, arms-length sale, especially in light of the option to repurchase.

**Failure of Characterization.** Another situation that might indicate that a transaction is a loan is the failure of the transaction to fit into any category other than a loan. In Johns v. Jaeb the lender argued that the transaction was a limited partnership, evidenced by a signed certificate of limited partnership naming the lender as the limited partner. The court had difficulty fitting the transaction into the limited partnership mold, however, because of its failure to comply with the Uniform Limited Partnership Act. Thus, because of this failure and other factors suggesting this transaction was a loan, the court found for the borrower. Pickrell v. Alpha Pipe & Steel, Inc. involved a similar set of facts. The lender alleged that his transactions with the borrower constituted a joint venture or a temporary partnership. The lender, through several transactions, had advanced a total of $5,700 to the borrower for use in his business. In return, the lender collected $6,700, of which $6,600 was evidenced by a note secured by a deed of trust and a chattel mortgage lien. The court of civil appeals observed that the facts did not reveal the characteristics of a joint venture, nor did they fall within the statutory definition of a partnership. Thus, the court affirmed the trial court's judgment of usury. In Commerce Savings Association v. GGE Management Co. the lender purchased property from one member of a joint venture and immediately transferred it to another member of the joint venture for a $51,000 profit. The court found that the evidence supported a finding that the lender acted solely as a lender and not as a real estate purchaser.

**No Additional Consideration.** The absence of consideration for the advance of funds, other than the normal consideration given for the use of money, constitutes an additional indication that the transaction is a loan.

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67. 560 S.W.2d 511 (Tex. Civ. App.—Amarillo 1978, writ ref'd n.r.e.).
68. Id. at 514 n.2; see text accompanying notes 57-58 supra.
70. Id. at 860. The court found that the transaction failed to comply with TEX. REV. CIV. STAT. ANN. art. 6132a, § 17 (Vernon 1970), which provides that a limited partner shall not receive from a general partner any part of his contribution until all liabilities of the partnership, with certain exceptions, have been paid or can be paid by partnership property.
71. See note 70 supra.
72. 406 S.W.2d 956 (Tex. Civ. App.—Amarillo 1966, writ ref'd n.r.e.).
73. Id. at 958. The court discounted a joint venture because this transaction involved several different loans, whereas, in the court's estimation, a joint venture is usually limited to a single transaction.
74. See note 70 supra.
75. 406 S.W.2d 959.
76. 539 S.W.2d 71 (Tex. Civ. App.—Houston [1st Dist.], modified, 543 S.W.2d 862 (Tex. 1976).
77. 539 S.W.2d at 78.
In *Curnutte v. Houston* the partnership agreement recited that Houston contributed $3,000 to Curnutte's construction company in consideration for a note bearing ten percent interest. In addition, Houston was to receive $.02 per cubic yard for all dirt moved by the company until the note matured. This additional amount was "for value received for services and financial aid rendered." At trial, however, Curnutte testified that the parties had not agreed to any personal services, a fact that led the court of civil appeals to conclude that the $.02 per cubic yard was part of the quid pro quo for the $3,000 advance and provided sufficient evidence of usury to take the case to the jury.

**Immediate Profit.** A final circumstance surrounding the transaction that may lead a court to find a loan occurs when a lender makes a substantial, immediate profit. In *Commerce Savings Association v. GGE Management Co.* the owner of certain real estate and member of a joint enterprise conveyed the property for $349,000 to a savings association that immediately conveyed the property for $400,000 to GGE, whose president was another member of the joint enterprise. Contemporaneously, GGE and its president executed a $600,000 note at twelve percent interest and assigned certain rents to the savings association. The court of civil appeals found the whole transaction to be a disguise to evade the usury laws and held that the $51,000 profit made by the savings association on the real estate transaction was, in fact, front-end interest on the $600,000 note.

**Bargaining Position.** In an attempt to discover the substance of a transaction, courts have not only examined the circumstances surrounding a loan but also have considered the strength of the borrower's bargaining position relative to that of the lender's. If the borrower's bargaining strength is weak, so that the transaction results in little benefit or in substantial risk of loss to the borrower, courts more readily characterize the transaction as a loan. Three final situations illustrate this readiness.

**Ignorant Borrower.** A court may take note of the level of sophistication of the borrower. In *Sudderth v. Howard,* for example, Mrs. Sudderth testified that when she entered into the transaction, she was under the impression that she was obtaining a loan, despite the fact that she executed a deed absolute on its face and an option to repurchase. The court voided

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163 S.W.2d 675 (Tex. Civ. App.—San Antonio 1942, writ ref'd w.o.m.).

Id. at 675.

Id. at 676.

163 S.W.2d 71 (Tex. Civ. App.—Houston [1st Dist.]), modified, 543 S.W.2d 862 (Tex. 1976).

539 S.W.2d at 79. The transaction was complicated. Gertner, president of GGE, received $600,000 from Commerce, evidenced by a note bearing 12% interest. At the same time, Merrill, a joint venturer with Gertner, conveyed property to Commerce who conveyed it to GGE for an immediate $51,000 profit. In collateral agreements, Gertner and Commerce agreed to limit Gertner's personal liability to the unpaid principal, and Merrill and his business associate, Westmoreland, guaranteed GGE's debt up to $600,000. The original loan was later modified by reducing the principal and interest rate and by extending the term of repayment. Id. at 74.

560 S.W.2d 511 (Tex. Civ. App.—Amarillo 1977, writ ref'd n.r.e.).
the deed, finding that a loan was intended.84

Borrower's Need. Another situation affecting the bargaining position of the parties occurs when the borrower has an immediate need for cash. Again in Sudderth, evidence showed that the $17,400 given in exchange for property worth at least twice that value represented the sum that the borrower needed for pressing debts and living expenses. Specifically, the Internal Revenue Service had posted a notice to sell the borrower's property to satisfy a $6,000 tax lien.85 Other cases in which a court has construed the transaction to be a loan also have contained an element of urgency, though motivated more by chance of profit than by risk of loss. In Kollman v. Hunnicutt,86 for example, the borrower needed money to enter the retail automobile business. In Ellis v. Security Underground Storage, Inc.87 the borrowers had a contract with the government whereby they would lease certain property to the government for the storage of liquid fuel. Although the borrowers were guaranteed the full first year's rental of $465,660, they did not have the $365,000 needed to purchase certain equipment and to modify the property. The court observed that the borrowers "were in the position of the man who knows he can make a million dollars if he can get his hands on a quarter of a million dollars to use."88 Similarly, in Sachs v. Ginsberg89 the borrower had a contract to purchase for $12,500 an ongoing business that had an inventory of $30,000. In Campbell v. Oskey,90 the borrower had arranged to purchase diamonds valued at $1,800 for $750. In each of these cases, the borrower's urgent need for adequate funds diluted his bargaining power. Any such need should be noted when deciding whether a particular transaction is a loan or a contribution to capital.

Lender Takes Title. A final indicator of a borrower's meager bargaining position is a lender's requirement of a transfer of title to himself as a condition for making the advance.91 In Sachs v. Ginsberg92 the purchaser of a business concern needed capital for the purchase. The lender advanced a

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84. Id. at 514.
85. Id. at 513-14.
86. 385 S.W.2d 600 (Tex. Civ. App.—Fort Worth 1964, no writ).
87. 329 S.W.2d 313 (Tex. Civ. App.—Fort Worth 1959, no writ).
88. Id. at 315.
89. 87 F.2d 28 (5th Cir. 1936).
91. This type of transaction is normally accompanied by an option to purchase given to the borrower. A similar transaction is the sale-leaseback, in which the borrower "sells" his property to the lender and the lender leases the property back to the borrower. This arrangement provides the borrower with capital up to the fair market value of the property, which is more than could be obtained by conventional financing. The lender is secure because he holds title to the property and receives periodic rental payments from the borrower. Often, the lender also grants the borrower an option to repurchase the property. The sale-leaseback transaction raises the issue of whether the transaction is a legitimate sale or a device to evade usury. For a treatment of this issue, see Marcus, supra note 14; Moewe, Sale and Leaseback Financing of Real Estate as Mortgages Under California Law, 48 CAI. ST. B.J. 554 (1973); Podell, supra note 14, at 145-47; Wilson, Sale and Lease-Back—A Re-Assessment, 4 W. RES. L. REV. 318 (1953); Comment, Real Estate Sale-Leaseback Agreements Under Texas Usury Law: Circumvention or Sale?, 7 ST. MARY'S L.J. 821 (1976).
92. 87 F.2d 28 (5th Cir. 1936).
portion of the needed cash, but also required that the business be conveyed to him. The agreement provided that the lender hold title until the borrower paid him the amount advanced plus a considerable bonus. Sudderth v. Howard\(^93\) involved a similar fact situation because the lender required the borrowers to deed over their property while granting them an option to repurchase the property within five months. In these situations, the lender acts as a conduit through which title may pass. If the transaction is successful, the borrower will ultimately receive title to the property, but if he is unable to obtain the required money, title remains with the lender. Thus, title provides the lender both security in the transaction and leverage over the borrower.

B. *Is the Loan Absolutely Repayable?*\(^94\)

In attempting to discern absoluteness of repayment, commentators make a distinction between the contingency of the principal and the contingency of the interest elements of a loan.\(^95\) The former is known as the “risk of loss” doctrine and the latter as the “contingency” rule. The risk of loss doctrine operates when the lender’s return on the amount advanced is entirely dependent on the success of the enterprise.\(^96\) In that event, no usury will be found no matter how successful the enterprise. The rationale of this doctrine is that any excess return is consideration for the risk undertaken and is independent of any interest charged, which is consideration for the forbearance of the debt. To fall within this exception to usury, however, the risk may need to be substantial enough that a prudent person would not assume it for the legal maximum only.\(^97\) The contingency rule operates when the principal is absolutely repayable, but the interest charged is dependent on some contingency outside the lender’s control, such as enterprise profits.\(^98\) If the interest is subject to a contingency, the loan is unlikely to be held usurious even if the contingency occurs and the enterprise becomes highly profitable. The rationale for the contingency rule is that the lender could have charged the maximum interest allowed

\(^{93}\) 560 S.W.2d 511 (Tex. Civ. App.—Amarillo 1977, writ ref’d n.r.e.).

\(^{94}\) This second question may overlap the first. Because a loan normally contains an absolute promise to repay, a court may look for such an obligation as an indicator that the equity participation transaction is a loan. See note 65 supra.

\(^{95}\) Comment, *Lender Participation In Borrower’s Venture: A Scheme to Receive Usurious Interest*, 8 Hous. L. Rev. 546, 558-59 (1971); Comment, *supra* note 38, at 394-95. This distinction between contingencies may be purely academic, however, because Texas courts have never recognized it. Furthermore, the willingness of a modern investor to receive only contingent payments appears unlikely outside of a joint venture. Podell, *supra* note 14, at 144. In any case, the rationale for both rules is that the lender should receive compensation for the risk taken.

\(^{96}\) The transaction described may not even be a loan, but for the sake of discussion under this step in the analysis, the existence of a loan will be assumed.


by law, but by charging a lesser amount plus some contingent amount, the lender may never realize the legal maximum. Compensation for that risk is not, then, interest on the loan. The contingency rule, like the risk of loss doctrine, may apply only when the risk is substantial.

The rationale of risk compensation is sensible in a situation where the lender exacts an absolute promise only for the return of the principal, leaving any additional return entirely dependent upon some contingency. The rule is questionable, in terms of risk compensation, when the lender is promised a return of the principal plus interest plus a contingency return. One commentator has suggested that the contingency rule may not be appropriate when the fixed sum is close to the statutory ceiling and the contingent sum results in a return substantially in excess of the legal maximum.

In applying the above two principles, a court will closely scrutinize the risk or contingency by distinguishing a real contingency from a theoretical one, or a clearly speculative transaction from a barely speculative one. The degree of uncertainty and speculation, however, must be measured at

99. See Comment, supra note 18, at 929.
102. Compare Beavers v. Taylor, 434 S.W.2d 230 (Tex. Civ. App.—Waco 1968, writ ref'd n.r.e.) with Thompson v. Hague, 430 S.W.2d 293 (Tex. Civ. App.—Fort Worth 1968, no writ). See also Loiseaux, supra note 17, at 433-34. This distinction between degrees of contingency has been explained as follows:

Usury laws do not forbid the taking of business chances in the employment of money. A creditor who takes the chance of losing all or part of the sum to which he would be entitled if he bargained for the return of his money with the highest permissible rate of interest is allowed to contract for greater profit . . . . If the probability of the occurrence of the contingency on which diminished payment is promised is remote, or if the diminution should the contingency occur is slight as compared with the possible profit to be obtained if the contingency does not occur, the transaction is presumably usurious.

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ReSTATEMENT OF CONTRACTS § 527, Comment a (1932).

"The following illustrations explain this concept:

A borrows $5000 from B, promising to repay him in a year with interest at more than the highest permissible rate if A succeeds in marketing his crop of wheat for the ensuing year for a dollar a bushel; otherwise to repay the loan at the end of the year without interest. The bargain is not usurious unless the probability of selling the crop for a dollar is so great as to make the transaction a colorable device for the execution of usury.

A borrows from B $5000, payable in three years. It is provided in the bargain that instead of interest A shall pay B one-tenth of the profits of A's business. Although it is anticipated that this will exceed the amount of interest at the highest permissible rate, the bargain is not usurious in view of the contingency that the anticipation may not be realized.

A borrows from B $5000, payable in three years, secured by mortgage. The contract for the loan provides that if the debtor dies from tuberculosis before the note is due, the debt shall be cancelled. The rate of interest provided for is largely in excess of that permitted by the local usury law. A does not have tuberculosis at the time of the loan and there is no probability that he will acquire the disease. The provision is inserted as a device to evade the usury law. The loan is usurious.

Id. Illustrations 2-4 (emphasis added).
the time of entering the transaction. Furthermore, a distinction may be made between a contingent occurrence and contingent value. When an occurrence is contingent, the lender receives nothing if the contingency does not occur. When the value is contingent, the lender is guaranteed a return, but its value is speculative. A contingent occurrence appears to involve more risk than a contingent value because the latter guarantees at least some return. In addition, valuing a contingency may present a difficult determination for the trier of fact, whereas the occurrence of a contingency can be easily determined.

Texas courts have faced the problem of deciding whether the lender in a given transaction was subject to a sufficient contingency or risk such that the loan was not usurious. Since contingency and risk are rather subjective, relative, and dependent on a given fact situation, no absolute test provides an easy solution. A comparison of court decisions, however, suggests an analysis based on a continuum that may be used to guide parties seeking to construct an equity participation loan agreement. At one extreme is guaranteed repayment for the lender and at the other extreme is complete uncertainty of repayment. As one moves from certainty to uncertainty on the continuum, the following are encountered, in order: (1) a secured lender's position; (2) a binding promise by the borrower to repay; (3) a lack of perceptible risk to the lender; (4) unpredictable market conditions affecting the success of a venture; (5) a choice in the hands of a disinterested third party; and (6) a decision totally under the borrower's control.

A transaction guaranteeing a return occurs when the lender provides himself with adequate security to ensure repayment by the borrower, as in Woodman v. Bishop. Bishop desired to purchase a parcel of land for $21,140. He had already paid $1,000 earnest money and an additional $1,000 for an extension on the contract of sale. Bishop also contracted to sell a small portion of the land to another party for $15,000. Needing an additional $20,000, Bishop approached Woodman, promising to split evenly the $60,000 expected profits from the sale of the land in exchange for a $20,000 advance. Woodman declined, but offered to advance $20,000 for a return of $40,000. The ultimate transaction was multifaceted. The seller conveyed the property to Bishop, who conveyed the property, less a portion he had already contracted to sell, to Woodman, who reconveyed the property to Bishop while retaining a vendor's lien of $40,000 bearing interest at ten percent per annum. Bishop also executed a deed of trust securing the payment of the $40,000. The court was not fooled by this property shuffling and found a usurious loan based on an absolute obliga-

106. The facts do not clearly reveal why Bishop needed $20,000, because he had already received partial payment on the $15,000 tract. Id. at 978.
A transaction only slightly more risky than the above is one in which the lender exacts from the borrower a binding promise to repay. In *Skeen v. Slavik*\(^{108}\) the lender purchased $300,000 of stock in the borrower’s business under a “put and call” agreement\(^{109}\) by which the lender could require the borrower to repurchase the stock at any time for $360,000. In carrying out this transaction, the borrower later paid $50,000 and issued a note to the lender for $310,000. The court of civil appeals reversed and rendered the trial court’s judgment for the lender, construing the transaction as a loan made absolutely repayable by the initial payment plus the note.\(^ {110}\) *Johns v. Jaeb*\(^{111}\) also involved a promissory note. In that case the lender advanced $5,000 and received a note for $6,500 without interest, payable in six months. The court of civil appeals found an absolute obligation to repay and therefore reversed the trial court’s judgment for the lender.\(^ {112}\) The court reached a similar result in *Campbell v. Oskey*,\(^ {113}\) in which the lender advanced $750 in exchange for a $150 payment and a $900 note.

The next step on the continuum towards uncertainty of repayment involves a transaction in which the lender exacts no security ensuring payment nor binding promise of repayment, but in which, nevertheless, no perceptible risk is identified. In *Thompson v. Hague*\(^ {114}\) the lender advanced $40,000 in exchange for a five-year interest-free note in that amount. In lieu of interest on the note, the borrower assigned his interest in lease revenues from a business property, such assignment to terminate when the $40,000 note was paid. The expected lease revenues amounted to nearly $8,000 per month. The court found that, although payments in lieu of interest would be made by lessees rather than by the borrower and no proof of the present market value of the right to collect further rents existed, the value of the lease assignment was nonetheless not contingent or speculative.\(^ {115}\) The court in *Johns v. Jaeb*\(^ {116}\) used similar language regarding lack of perceptible risk, noting that, despite the lender’s claim that the advance of funds was a contribution to a limited partnership, the amount invested was not subject to the risk of the enterprise because the borrower had made an absolute promise to return the funds advanced even if the venture failed.\(^ {117}\)

Even further removed from absoluteness of repayment is a transaction

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\(^{107}\) Id.

\(^{108}\) 555 S.W.2d 516 (Tex. Civ. App.—Dallas 1977, writ ref’d n.r.e.).

\(^{109}\) A “put and call” agreement is one by which the seller can force the sale (or “put”) on the buyer, and the buyer can force the seller to sell (or “call”) at a price and under conditions previously arranged. See note 29 supra.

\(^{110}\) Id. at 522.

\(^{111}\) 518 S.W.2d 857 (Tex. Civ. App.—Dallas 1974, no writ).

\(^{112}\) Id. at 860-61.


\(^{114}\) 430 S.W.2d 293 (Tex. Civ. App.—Fort Worth 1968, no writ).

\(^{115}\) Id. at 296.


\(^{117}\) Id. at 860.
in which repayment is contingent upon unpredictable market conditions affecting the success of a venture. At this point along the continuum, a court is less likely to find an absolute obligation for repayment. For example, in *Beavers v. Taylor*\textsuperscript{118} the lender advanced $5,000 for a note in that amount bearing no interest. In lieu of interest, the borrower agreed to pay a graduated percentage of gross monthly sales of his business. This requirement resulted in a twenty percent return on the lender's investment. The court found no usury, however, because the consideration given in lieu of interest was contingent upon the enterprise's making sales, and the amount of those sales was highly uncertain.\textsuperscript{119} A nearly identical case is *Pansy Oil Co. v. Federal Oil Co.*,\textsuperscript{120} in which payments on the loan were to be made only out of oil to be produced from wells that were not drilled at the time the lender advanced the funds.

When the contingency controlling repayment depends not on general market conditions, but rests solely in the hands of a disinterested third party, the repayment is even less absolute. In *Wagner v. Austin Savings & Loan Association*\textsuperscript{121} the lender advanced $50,000 for a note of that amount bearing 7\% interest. The borrower also assigned to the lender a refund contract that the borrower contemplated would be executed in his favor by a municipality. Under the refund contract, the borrower, a developer, would receive eighty percent of the amount he expended in constructing a water system. In rejecting an allegation of usury, the court noted that the refund contract was not executed until eleven months after its assignment to the lender, and that even after execution, the city was not obligated to pay until several contingencies had occurred.\textsuperscript{122} Thus, even though the refund contract was eventually worth $12,000, its value at the time of assignment could not be determined.\textsuperscript{123}

The closest step toward total uncertainty of the lender's return involves the situation in which the contingency of repayment depends on the borrower's free choice, as illustrated by *Korth v. Tumlinson*.\textsuperscript{124} Tumlinson needed funds to pay off a debt on real property. Korth advanced the needed funds under an agreement that stipulated that if the land was sold within twelve months, Korth would receive ten percent of the money advanced plus a specific share of the proceeds. If the land was not sold within twelve months, Korth would receive seventy of the 270 acres in consideration for his advance of funds. The court found no usury, reasoning that Tumlinson made no absolute promise to repay and that any consideration to be received by Korth was of uncertain value.\textsuperscript{125}

\textsuperscript{118} 434 S.W.2d 230 (Tex. Civ. App.—Waco 1968, writ ref'd n.r.e.).
\textsuperscript{119} Id. at 232.
\textsuperscript{120} 91 S.W.2d 453 (Tex. Civ. App.—Texarkana 1936, writ ref'd).
\textsuperscript{121} 525 S.W.2d 724 (Tex. Civ. App.—Beaumont 1973, no writ).
\textsuperscript{122} Id. at 731.
\textsuperscript{123} Id. at 727. This case involved, at the beginning of the transaction, both a contingent occurrence and a contingent value.
\textsuperscript{124} 73 S.W.2d 1048 (Tex. Civ. App.—San Antonio 1934, no writ).
\textsuperscript{125} Id. at 1049-50.
C. Is the Maximum Legal Return Exceeded?

Once a transaction has been identified as a loan with an absolute obligation to repay, the next question to be examined is whether the return on the advance of funds exceeds the amount allowed by law. Two considerations are important in determining the answer to that question. First, courts spread the amount of return over the entire term of the loan in ascertaining whether usury has been exacted. Secondly, courts may include other charges made for the advance of funds as part of the consideration for the use of money.

Before a court will conclude that a loan is usurious, the legal maximum must be exceeded over the entire term of the loan, and not just in one given year. This principle is important in equity participation transactions, especially when the equity interest is in the profits of a new venture. In the beginning years when the likelihood for high profits is small, the balance on the principal is large, whereas in later years the loan balance is small, but the potential earnings may be substantial. The low return in early years may offset the higher return in later years and save the transaction from being usurious. This principle may also save an equity participation transaction in which the lender receives a substantial and immediate profit. For example, in *Commerce Savings Association v. GGE Management Co.* the lender "purchased" property from a joint venture and immediately "sold" it to another member of the joint venture for a $51,000 profit. The court held that the $51,000 constituted additional interest on a ten-year $600,000 note bearing twelve percent interest. When the $51,000 was spread over ten years and added to the twelve percent interest, however, the return was still within the statutory maximum.

In spreading the return over the entire period of an equity participation loan, two problems may be encountered: valuation of a contingent return and determination of the loan period. *Gulf Atlantic Life Ins. Co. v. Price* illustrates the first problem. The lender advanced $260,000 for a term of two years at ten percent. The agreement further provided an option to the lender to purchase twenty-five percent of the borrower's enterprise for the

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126. For the applicable Texas usury statutes, see notes 31, 32 & 38 supra.
127. Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 781-87 (Tex. 1977); Nevels v. Harris, 129 Tex. 190, 102 S.W.2d 1046 (1937).
129. Commerce Sav. Ass'n v. GGE Management Co., 539 S.W.2d 71 (Tex. Civ. App.— Houston [1st Dist.], modified, 543 S.W.2d 862 (Tex. 1976). But see Comment, Usury in Texas: Spreading Interest Over the Entire Period of the Loan, 12 HOUS. L. REV. 159 (1974). See also TEX. REV. CIV. STAT. ANN. art. 5069—1.07(a) (Vernon Pam. Supp. 1971-1979), which provides that determination of interest on any loan secured by real property shall be made by amortizing, prorating, allocating, and spreading all interest over the full term of the loan.
131. 539 S.W.2d 71 (Tex. Civ. App.—Houston [1st Dist.], modified, 543 S.W.2d 862 (Tex. 1976).
132. 539 S.W.2d at 82.
133. 566 S.W.2d 381 (Tex. Civ. App.—Tyler 1978, writ ref'd n.r.e.).
sum of $1,000. At trial, special issues were submitted to the jury in an effort to determine the value of the option. The answers, however, were irreconcilable. In one special issue, the jury determined that the option had a value of $31,000 on the day it was granted. In another issue, the jury answered that on the same date, the value of the option was uncertain or speculative. In the face of these inconsistent findings, the court of civil appeals remanded the case\(^\text{134}\) so that the question of usury could be concluded depending on the outcome of the fact findings.\(^\text{135}\)

A second problem in spreading the return over the entire term of the loan is determining the loan period. An equity participation agreement could be found to be a loan with an absolute obligation to repay a high return, but with no identifiable period of return. For example, consider the following facts.\(^\text{136}\) The borrower needs capital to enter a retail business. The lender puts $10,000 into a bank account under an agreement whereby the borrower can withdraw funds in any amount at any time up to the $10,000 limit. The borrower must repay the withdrawals within sixty days and, in addition, pay a "draft fee" determined by a graduated scale, the fee being higher the longer the money is outstanding. The borrower makes frequent small withdrawals and holds them for the sixty-day maximum, thereby incurring many draft fees at the highest amount. After six months the borrower has withdrawn $5,000 and paid $5,700. Realizing that at this rate he will use the $10,000 in one year at a cost of $1,400, the borrower brings suit, alleging that the lender is charging greater than ten percent interest on the $10,000. This transaction is clearly a loan\(^\text{137}\) with an absolute promise to repay, but the court now must determine the period of the loan.\(^\text{138}\) If the borrower had continued making similar withdrawals, indeed the return would have been usurious. The borrower may have had less need for cash in the ensuing months, however, and could have taken an additional year to use up the $10,000. Assuming withdrawals of a similar denomination, the draft fees of $1,400 would now cover a period of a year and a half and be within the legal maximum. Thus, spreading the return over the entire term of the loan, normally a simple mathematical calculation, may require a legal determination of the loan period in some equity participation transactions.\(^\text{139}\)

\(^{134}\) Id. at 384. But cf. Thompson v. Hague, 430 S.W.2d 293 (Tex. Civ. App.—Fort Worth 1968, no writ) (value found to be certain despite no proof of amount), discussed at text accompanying notes 114-15 supra.

\(^{135}\) The jury’s conflicting findings reflect the tension between the second and third questions in the usury analysis. Once the trier of fact determines that the obligation is absolute, the valuation step must follow. Declaring an obligation sufficiently absolute may be comparatively easy, but translating that obligation into dollars and cents is difficult.

\(^{136}\) These facts are a variation of those in Kollman v. Hunnicutt, 385 S.W.2d 600 (Tex. Civ. App.—Fort Worth 1964, no writ), the main difference in that case being that the borrower had withdrawn all of the funds at the time the suit was brought.

\(^{137}\) Id. at 602.

\(^{138}\) Though the Texas Supreme Court has addressed this problem in W.E. Grace Mfg. Co. v. Levin, 506 S.W.2d 580 (Tex. 1974), the full principal plus interest had been paid when suit was brought.

\(^{139}\) Another example of the problem in determining the period of return is suggested by Sachs v. Ginsberg, 87 F.2d 28 (5th Cir. 1936). A borrower needs $8,000 to supplement his
When a court is determining whether the legal maximum rate has been exceeded, items that the parties did not deem to be interest may be included. In *Cochran v. American Savings & Loan Association* the loan agreement granted the lender an option to buy a portion of the borrower's property for $80,000 plus ten percent interest from the date of the loan commitment. When the agreement was later modified, the option price was reduced by deleting the interest, which amounted to $4,000. When the borrower later brought suit against the lender, the jury found that the option itself constituted interest, but that it had no money value to the lender beyond the $80,000 purchase cost. The $4,000 deletion from the purchase price, however, also constituted additional interest in the jury's opinion. Since the lender was already charging the maximum rate on the principal of the loan, the $4,000 deletion proved to be fatal to the lender's defense.

### D. Did the Lender Intend a Usurious Return?

Once an affirmative answer is given to each of the first three questions, courts experience little difficulty in finding usurious intent. Intent to charge usury need not be subjective in the sense that the lender cognitively knew that the return would exceed the legal maximum. Neither is specific intent required, but only an intent to receive the amount of interest charged. Intent may be evidenced by the attending circumstances.

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141. 568 S.W.2d 672 (Tex. Civ. App.—Waco 1978, no writ).
142. *Id.* at 675.
143. *Id.* at 674. The court appeared perplexed by the jury findings and commented that if the option had no value to the lender without the added interest, it could have no money value to the lender with the added interest. *Id.* at 675.
144. The case was remanded to the trial court in its entirety, giving the lender a chance to prove that the usurious charge was the result of accidental and bona fide error. *Id.* at 676.
147. Actual receipt of the interest is not necessary. A usury action can be based on a
but the transaction documents themselves are the most important indicator. Apart from the possibility of mistake, the intent of the parties is presumed to be reflected in the documents.

In the absence of documentation or in addition to it, a court may find intent from the entire transaction. In *Ellis v. Security Underground Storage, Inc.*, the lender advanced money to the borrower for use in improving his property in order to qualify for a government leasing program. Under the terms of the agreement, the lender would receive six percent interest on the principal and a percentage of the lease revenues, plus an additional amount if the government cancelled the lease. Because the length of the lease and the revenues from the lease could not be ascertained in advance, the lender could not have intended to collect an identified sum. When the borrower filed suit alleging usury, however, the lawful maximum had been exceeded. Based on that excess and on other evidence, the court concluded that the evidence raised the ultimate issue of whether the lender intended to charge usury.

The amount of interest actually received may also be considered as evidence of intent. In *Thompson v. Hague* the lender advanced $40,000 in exchange for an interest free note in that amount plus an assignment of lease revenues as a bonus in lieu of interest that would expire when the note was paid. The lease revenues amounted to $8,000 per month, or twenty percent of the principal advanced. The court commented that the amount of return was "so palpably in excess of legal interest as to show an intent to evade usury law."

Finally, the circumstances and negotiations that preceded the transaction may be material to intent. The characterization of the loan by the parties and testimony from the parties, however, carry very little weight.

IV. Conclusion

As long as equity participation transactions appear attractive to lenders and borrowers, they will be used. Basically, an equity participation transaction involves an advance of money in consideration for some form of ownership position in the borrower's enterprise given in lieu of or in addi-

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148. Imperial Corp. of America v. Frenchman's Creek Corp., 453 F.2d 1338, 1344 (5th Cir. 1972).
149. Cochran v. American Sav. & Loan Ass'n, 568 S.W.2d 672, 676-77 (Tex. Civ. App.—Waco 1978, no writ); TEX. REV. CIV. STAT. ANN. art. 5069-1.06(1) (Vernon Pam. Supp. 1971-1979) ("there shall be no penalty for any usurious interest which results from an accidental and bona fide error"). See also Hershman, *Usury, supra* note 2, at 336.
151. 329 S.W.2d 313 (Tex. Civ. App.—Fort Worth 1959, no writ).
152. *Id.* at 318.
154. *Id.* at 296.
156. See Kollman v. Hunnicutt, 385 S.W.2d 600 (Tex. Civ. App.—Fort Worth 1964, no writ).
tion to simple interest. The lender's ownership position might be co-owners-
ship with the borrower or sole ownership that is later transferred to the
borrower. In either case, equity participation is designed to give the lender
a high return on the investment, often in excess of the maximum legal rate
allowed on a simple loan. Such a return raises a question of usury that,
until recently, Texas courts have infrequently addressed.

For an equity participation transaction to be declared usurious, the trier
of fact must affirmatively answer four questions. Is the transaction a loan?
Is the loan absolutely repayable? Is the maximum legal return exceeded?
Did the lender intend a usurious loan? The first two questions receive the
most attention in equity participation cases.

In determining whether or not the transaction is a loan, a court may
consider eight situations. The first five relate to the circumstances sur-
rounding the transaction and the last three to the relative bargaining posi-
tion of the borrower and the lender. These situations occur when: the
borrower had originally sought a loan; the amount advanced and the con-
sideration given in exchange greatly varied; the transaction failed to fit into
another category; evidence supporting any independent consideration was
lacking; the lender made a substantial and immediate profit; the borrower
lacked sophistication; the borrower needed immediate cash; and the lender
required a transfer of title to himself.

When deciding whether or not the loan is absolutely repayable, a court
examines the risks to which the lender subjected the return. If the return is
subject to a substantial contingency, a court is unlikely to find an absolute
obligation to repay. By viewing absoluteness of repayment and total un-
certainty as opposite extremes on a continuum, a court can chart various
positions between them. Scanning from absoluteness to uncertainty, one
observes the following: a secured lender's position, a binding promise by
the borrower to repay, a lack of perceptible risk to the lender, unpredict-
able market conditions affecting the success of a venture, a choice in the
hands of a disinterested third party, and a decision totally under the bor-
rower's control.

The third and fourth questions are more easily answered. In determin-
ing whether the legal maximum was exceeded, a court will spread the re-
turn over the entire term of the loan and will include all charges that it
construes to be interest. Although this task is relatively simple, it may
raise problems of valuation and timing. Finally, unless the lender is able
to show a bona fide mistake, the court will easily find usurious intent from
various sources.

With these facts and observations in mind, parties to an equity partici-
pation transaction should be able to structure the transaction to minimize
the risks of usury. Simply stated, by avoiding the eight factors that tend to
evidence a loan and by confining transactions to the uncertainty end of the
contingency continuum, each transaction should withstand an allegation
of usury. Careful planning may allow a lender's dream to come true.