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Usury Implications Of Alternative Mortgage Instruments: The Uncertainty In Calculating Permissible Returns

I. Introduction

When inflation reached double digit figures in late 1979, usury laws presented lenders with a dilemma: Either they could stop making loans, or they could make loans at rates below inflation which would result in negative real returns.[1] Federal and state legislatures responded to this dilemma by adopting one or more of three solutions: (1) raising usury rate ceilings;[2] (2) exempting certain types of loans from usury coverage;[3] or (3) adopting a floating usury rate ceiling.[4]

Although these solutions eliminated usury problems for federally insured banks, savings and loans, and credit unions making fixed-rate intrastate loans, neither state nor federal reforms have adequately addressed nontraditional lenders, interstate loans or adjustable rate loans. Furthermore, federal and state reforms were not passed as consistent, interlocking pieces of a comprehensive nationwide usury framework. As a result, many lenders are unable to determine whether their "alternative mortgage instruments" are usurious.

This note first reviews the inconsistency between federal and state usury legislation and then addresses the unresolved problem of how current usury law should be applied to adjustable rate and wraparound mortgages. This note concludes that if federal usury laws are going to pre-empt some state usury limits, then they should pre-empt all state usury limits, and they

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1. Negative real return occurs when the rate of inflation is higher than the nominal rate of interest. The lender effectively loses money on the loan, since the repaid principal plus interest is worth less than the money originally loaned out.

2. *See, e.g.*, Cal. Civ. Code §§ 1916-1 to -3, -5 (West 1985); D.C. Code Ann. §§ 28-3301 to 3305, -3309 (1981); S.D. Codified Laws Ann. §§ 54-3-1 to -9, -12 to -15 (1980 & Supp. 1986).

3. *See, e.g.*, Md. Com. Law Code Ann. §§ 12-101 to -105, -108, -114 (1983); Mich. Comp. Laws § 438.31, .31C, .32, .61 (West 1978 & Supp. 1986).

4. A floating usury rate ceiling is a usury rate that varies over time, usually by reference to an index such as the consumer price index. *See, e.g.*, Fla. Stat. Ann. §§ 687.01 to .04 (West 1966 & Supp. 1986); Ga. Code Ann. §§ 57-101, -101.1, -102, -112, -113, -118, -119 (Harrison 1977 & Supp. 1986); Haw. Rev. Stat. § § 478-1 to -8 (1976 & Supp. 1984).

should be drafted so as to place limits on returns to lenders rather than rates charged by lenders.

II. The Present State of Usury Law

Traditionally, usury has been an area of the law regulated by the states.[5] However, in 1980 Congress passed the Depository Institutions Deregulation and Monetary Control Act.[6] Depending upon the particular transaction, the provisions of this Act pre-empt, supplement, or leave unchanged many state usury laws. The result, compounded by haphazard amendments to many state usury laws, is that lenders often find it difficult or impossible to determine whether the loan will be usurious.

Section 501 of the Deregulation Act[7] pre-empts state laws that limit the rate of interest, discount points, finance charges, or other charges made by traditional institutional lenders[8] with respect to any loan, mortgage, credit sale or advance which is secured by a first lien on residential real property, a first purchase money lien on stock allocated to a dwelling unit in a residential cooperative housing corporation, or a first lien on a residential manufactured home.[9] States are given the right to opt out of section 501 by enacting superseding legislation. But it is not clear whether section 501 applies to a lender in a state that has opted out if the borrower is in a state that has not opted out, or vice versa. Lenders and borrowers are left to wonder which law applies.

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5. Federal usury laws, however, have been in existence since the federal banking laws were enacted in the 1800s. *See* National Bank Act, ch. 106 § 30, 13 Stat. 108 (1864) (codified at 12 U.S.C. § 86 (1983)).

6. Pub. L. No. 96-221, 94 Stat. 132.

7. 12 U.S.C § 1735-37 (1982).

8. Traditional institutional lenders include: (1) any lender whose deposits or accounts are insured by a federal agency; (2) any lender regulated by any federal agency; (3) any lender approved by the Secretary of Housing and Urban Development (HUD) for participation in any mortgage insurance program under the National Housing Act; (4) any lender making a loan which is made, insured, guaranteed, supplemented or assisted by the Secretary of HUD or any other federal office or agency; (5) any lender making a loan under or in connection with a housing or urban development program administered by the Secretary of HUD or any other agency of the federal government; (6) any lender making a loan that is eligible for purchase by the Federal National Mortgage Association (FNMA), the Government National Mortgage Association (GNMA), the Federal Home Loan Mortgage Corporation (FHLMC), or any financial institution from which it could be purchased by the FHLMC; and (7) any "creditors" under the Truth in Lending Act. *Id.*

9. If the loan is not a first lien loan, federal law pre-empts low interest ceilings in some state usury laws, but does not eliminate usury restrictions altogether.

If state usury laws are created to protect borrowers, then logically, the laws of the borrower's state should apply. If this is true, however, borrowers in states that opt out and that have lower usury ceilings will find it difficult to borrow money within their state because in-state lenders will have an incentive to make out-of-state loans that are subject to higher usury ceilings. These borrowers will also find it difficult to borrow from out-of-state lenders because such lenders will not want to be subjected to lower usury ceilings. However, if the laws of the state of the lender control, then it becomes futile for a state to opt out of section 501 since out-of-state banks subject to the higher section 501 usury ceiling can make loans in the opt-out state.[10]

The result is that in states that opt out of section 501, lenders face unfair competition from lenders located in states where section 501 has been adopted because section 501 has a high usury ceiling. Furthermore, lenders not covered by section 501 face unfair competition from lenders that are covered. Thus, if Congress is serious about raising interest rate ceilings in order to allow the market to set rate levels, it should expand section 501 to cover all similarly situated lenders and should pre-empt state legislation by disallowing states to opt out of the provision.

III. Usury Limits Applied to Adjustable Rate Mortgages (ARMs)

In addition to the inequities caused by the haphazard application of section 501, a mortgagee who makes an adjustable rate loan has problems in determining whether a loan is usurious. An adjustable rate mortgage is one with an interest rate that increases or decreases periodically by reference to a fluctuating index.[11] Most federal and state laws fix a rate limit for any given

10. One might ask who would borrow from an out-of-state bank with higher rates when an in-state bank has lower rates. The answer is that if usury laws are keeping interest rates in a state lower than the free market supply and demand equilibrium, demand for funds will be greater than the supply of funds, creating a ready market for out-of-state banks with higher rates.

11. *See infra* note 15 and Comptroller Regulations, Adjustable Rate Mortgages, 12 C.F.R. § 29.5 (1986). Federal regulation requires that the chosen index reflect inflation or changes in consumer disposable income and not just interest rate changes. 12 C.F.R. 545.33(e)(1) (1986). By contrast, the Comptroller regulations (controlling the practices of national banks) require that one of three indices be used, each of which is variable and outside the lender's control. 12 C.F.R. § 29.4 (1986). *See infra* note 14.

It would be unconscionable to allow a lender to influence or manipulate the index since interest is such a large component of lending agreements. Hence, lender manipulation of the index would probably be an unlawful unilateral change in the lending con-

loan.[12] Although many of these laws allow the legal rate ceiling to vary over time, the ceiling in effect at the time the loan was created is usually the maximum rate allowed for that particular loan. Hence, upward movement of the ceiling is not an adequate defense to a usury violation if the contractually established index increases beyond the ceiling that existed when the loan was created.[13]

Arguably, an upward movement of the ceiling should be an adequate defense when the loan agreement contains an adjustable rate provision. Each adjustment period would be regarded as a separate contract, and thus if the rate as adjusted falls within the statutory maximum in effect at the time of the adjustment it satisfies the usury laws. In states where usury maximums are indexed, this approach could resolve some of the problems of adjustable rate provisions while preserving rate flexibility.

The separate contract approach contradicts most federal and state laws, however. Typically, ARM adjustable rate clauses do not contain language creating a separate contract for each adjustment period. The lender is usually required to leave the loan in place (with the right to increase the rate as the index changes) and the borrower does not make a new agreement to repay the loan when the rate is revised. Even if language adequate to support a separate contract interpretation were included in an ARM instrument, lenders could still be subject to usury liability because the indices used for adjustable rate provisions are often different from those controlling the usury rate.[14]

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tract. *See* RESTATEMENT (SECOND) OF CONTRACTS § 208 (1979).

12. For example, California provides for a 10% usury limit. CAL. CONST. art. XV, § 1. (A 1979 amendment excluded non-consumer loans from the 10% limit.). Texas provides for a 10% usury limit in the absence of specific state legislation to the contrary. TEX. CONST. art. XVI, § 11.

13. *See, e.g.*, Garrett v. Citizens Sav. Ass'n., 636 S.W.2d 104 (Mo. Ct. App. 1982) (an increase in the usury maximum has no application to a loan entered into prior to the increase).

14. For example, the Comptroller of the Currency requires one of the following indices:

(1) the monthly average contract interest rate charged by all lenders on mortgage loans for previously occupied homes, published in the FHLBB Journal;

(2) monthly average yield on U.S. Treasury securities adjusted to a constant maturity of three years, published in the Federal Reserve Bulletin;

(3) monthly average of weekly average auction rates on U.S. Treasury bills with a maturity of six months, published in the Federal Reserve Bulletin.

Adjustable Rate Mortgages, 12 C.F.R. § 29.4 (1986). *See* Browne, *The Development and Practical Application of the Adjustable Rate Mortgage Loan: The Federal Home Loan Mortgage Corporation's Adjustable Rate Mortgage Loan Purchase Program and Mort-*

Therefore, a violation could still occur if the index used for rate adjustment moved higher than the usury rate index.[15] In such a case the lender would be deprived of the benefits of a relatively high usury limit in existence at the time of the making of the loan. As a result, even lenders are hesitant to support the view that each adjustment is a separate contract.

If the separate contract approach is not applied to interpret the rate maximum,[16] and if the usury rate at the time of contract is the maximum rate for that loan, it is possible for a lender to assess potential usury exposure.[17] Whether the return violates usury laws depends upon which of the following analyses a particular court uses to compute the lender's return.[18]

A. *The Aggregate Approach to Usury Computation of ARM Devices*

The upward adjustment of an ARM interest rate above the

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gage Loan Instruments, 47 Mo. L. Rev. 179, 199-200 (1982).

15. Adjustable rate loans that are tied to some index which does not move as rapidly as the federal index, or which has limits on the amount of adjustment at any given adjustment point, might carry an interest rate in excess of either standard even if adjusted.

16. Some authority suggests that lenders protected by the pre-emptive federal statutes may "borrow" at a higher state rate, but are not bound by state law directing how the rate should be computed. *See* Evans v. National Bank of Savannah, 251 U.S. 108 (1919) (discount not to be taken into account by National Bank in measuring compliance with usury even when required by state law would and when the lender is relying upon the state rate under the "most favored lender" provision of the National Bank Act). *Evans*, however, has been construed narrowly by subsequent courts. *See* First Nat'l Bank in Mena v. Nowlin, 509 F.2d 872, 876 (8th Cir. 1975) (*Evans* read to apply only to short-term, noninstitutional credit). The Comptroller of the Currency has taken the position that a lender relying on a "most favored lender" borrowing rate must also use state law on questions affecting computation. *See* 12 C.F.R. § 7.7310 (1986). *See generally* Arnold & Rohner, *The "Most Favored Lender" Doctrine for Federally Insured Financial Institutions—What Are Its Boundaries?*, 31 CATH. U.L. REV. 1 (1981).

17. Assume, for example, that a loan is made in April of 1982 containing an adjustable rate provision and initial interest rate of 16 ½%. Assume also that the rate ceiling for the loan will be established as of the time of origination. If the loan is a Utah second mortgage or deed of trust, and if the lender qualifies under the Deregulation Act, which triggers the pre-emptive federal rate where applicable, the maximum usury rate will be the higher of the Utah rate (18%), or the federal usury rate.

In later months, the indices by which the "market rate" or "federal rate" are determined may move up or down. Neither upward nor downward movement, however, would alter the ceiling in effect for the loan in question. If the index by which the loan is measured should move up more than 350 points (3.5%), and the interest on the loan is adjusted accordingly, the usury ceilings would be exceeded regardless of the status of the market rate or federal indices at the time of such adjustment.

18. *See generally*, Bosko, *Usury Computation: A Primer*, 51 CAL. ST. B.J. 383 (1976).

initial usury ceiling may not automatically render an ARM agreement usurious. Some state courts have established that in order to determine whether an obligation is usurious, a court must spread the total amount of interest received by the lender over the full term of the loan and compute the average return.[19] The loan is usurious only if the aggregate return computed exceeds the usury limit. Prepayment or default by the borrower will not shorten the loan term for purposes of this computation.[20] Conceivably, then, an ARM could require an adjusted interest rate in excess of the legal rate for intermittent periods of the loan's term yet not be usurious if the aggregate return to the lender, when averaged over the entire term, is under the legal limit.[21]

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19. California generally uses the aggregate approach. *See, e.g.*, Lewis v. Pacific States Sav. & Loan Co., 1 Cal. 2d 691, 37 P.2d 439 (1934); Haines v. Commercial Mortgage Co., 200 Cal. 609, 254 P. 956 (1927); White v. Sweeney, 138 Cal. App. 2d 199, 291 P.2d 77 (1955); Otis v. I. Eisner Co., 7 Cal. App. 2d 496, 46 P.2d 235 (1935).

Florida has adopted the aggregate rule by statute. *See* FLA. STAT. ANN. § 687.03 (West Supp. 1986); 94 Op. Att'y Gen. 278 (Fla. 1974). Any payments in money or property chargeable as interest are to be spread over the term of the loan.

Texas has two separate lines of cases with contrary results. However, a statute enacted in 1975 allows the aggregate method in real estate loans. *See* TEX. REV. CIV. STAT. ANN. art. 5069-1.07(a) (Vernon Supp. 1986). The statutory wording does not deal with the problems of acceleration of maturity or application to amortized loans. *See generally*, St. Claire, *The "Spreading of Interest" Under the Actuarial Method*, 10 ST. MARY'S L.J. 753 (1979).

A California court observed:

> Whether a transaction is usurious is determined by the total amount of interest required to be paid under the terms of the agreement between the date of execution and the date of maturity. If the interest for the full period of the loan exceeds the maximum rate allowed, then the obligation is usurious.

Penzner v. Foster, 170 Cal. App. 2d 106, 109, 338 P.2d 533, 535 (1959); *accord* Easton v. Butterfield Live Stock Co., 48 Idaho 153, 159-60, 279 P. 716, 718 (1929).

20. *See* Ware v. Traveler's Indem. Co., 604 S.W.2d 400 (Tex. Civ. App. 1980) (loan transaction was not rendered usurious by requiring debtor to pay interest that would have accrued until next semi-annual prepayment date, if such loan rate was not usurious for the full term, even though payment of this interest exceeded the lawful rate); Pacific Fin. Corp. v. Crane, 131 Cal. App. 2d 399, 280 P.2d 502 (1955).

21. The usurious nature of the loan agreement will be apparent from the point at which charging no interest for the remainder of the term will still result in an unlawful aggregate interest return. The more the rate being charged exceeds the legal limit, the sooner the usurious nature will be manifest. There is at least some authority to indicate that the crossing of the "usury threshold" is an act that cannot be undone. Usury cannot be cured by offering to remit interest. Habach v. Johnson, 132 Ark. 374, 377, 201 S.W. 286, 287 (1918) states that "if the contract was usurious in its inception, no subsequent offer to remit the usury can give it validity." This rule is cited with approval by the Arkansas Supreme Court in Brooks v. Burgess, 228 Ark. 150, 152-53, 306 S.W.2d 104, 106 (1957) and Ford Motor Credit Co. v. Catalani, 238 Ark. 561, 564, 383 S.W.2d 99, 101 (1964).

In states where courts apply aggregate analysis to ARMs, lenders will be able to chart their return against the applicable usury limit over the life of the loan and maximize their return without violating any usury laws.[22] Thus, the ARM loan creates the possibility of incremental increases in the lender's return spread over a substantial period of time. Although the number or size of these increases cannot be predicted in advance, since it is possible for the interest rate to decrease as well as increase in accordance with the movement of the index, any present increases over the original rate may be offset by later downward movement.

Unlike single payment cases, the aggregate analysis of an ARM instrument prevents any final computation of interest return until near the end of the contracted loan term. In order to prove a usury violation, the borrower must show that over the contract term of the loan the lender extracted interest in excess of the legal rate. Purchase money home loans typically have terms of twenty-five to thirty-five years but usually are prepared or foreclosed much sooner. Therefore, most borrowers (i.e. those that prepay) will be unable to demonstrate a usury violation.[23] Courts that have found the aggregate approach acceptable in the single payment cases may feel otherwise when borrowers are ef-

22. Because the legal limit is fixed at the beginning of the loan, *see infra* note 23, it is not difficult at that time to figure the maximum dollar amount of interest legally collectible. Because of the time value of money, a shrewd lender might charge the maximum possible under an ARM until the legal limit is reached and then charge no interest the rest of the term. Fluctuations in payment (prepayment or missed payment) or the option of spreading out interest increases or negative amortization make the analysis more difficult, but such problems could readily and efficiently be handled by computer. If the usury violation is triggered by "payment or collection" this tactic will work smoothly for creditors since the creditor avoids receipt of the prohibited return. If the usury violation is triggered by "contracting" for excessive interest, the creditor must use a savings clause to avoid contracting for excessive returns.

23. The question often arises whether prepayment penalties, loan charges, or other costs are exacted from the borrower in order for the borrower to obtain the loan. Courts usually amortize such payments over the life of the loan to determine whether the lender has exacted a prohibited rate. Usually a fee charged by the lender for a specific service incidental to the loan is not interest, while charges for non-specific items are considered interest. *See, e.g.*, Julian v. Burrus, 600 S.W.2d 133 (Mo. Ct. App. 1980) (bonus or commission exacted by agent and ratified by creditor); Grundel v. Bank of Craig, 515 S.W.2d 177 (Mo. Ct. App. 1974) (requirement that borrowed funds be deposited with lender in interest free certificates); Security Thrift Syndicate v. Tidwell, 190 Okla. 377, 123 P.2d 955 (1942) (purchase of no interest corporate bonds). *See generally* Monning, *Usury Implications of Front-End Interest and Interest in Advance*, 29 Sw. L.J. 748 (1975); Sintenis, *Current Treatment of the Non-Refundable Commitment Fee and Related Problems*, 86 BANKING L.J. 590 (1969).

fectively deprived of a remedy merely because they prepaid a long-term loan. At least one court has identified this problem and denied aggregate treatment to an adjustable rate loan.[24]

One solution to the ARM borrower's plight of high interest with no remedy would be to determine the interest return to the lender on the basis of the actual, rather than on the contracted term of the loan. This solution would more accurately reflect the return to the lender and would be a more effective deterrent to usury violations.[25]

On the other hand, a rise or fall in the interest rate may be beyond the control of the lender who should not be charged with usury because of a fortuitous movement in an independent index coupled with a prepayment initiated by the borrower. To find such an usury violation as a result of the borrower's prepayment would leave the ARM lender at the mercy of the borrower, who could time the prepayment to maximize his damage claim or threaten to do so in exchange for concessions from the lender.[26] The aggregate analysis approach, then, leaves much to be desired from both the borrower's and the lender's point of view.

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24. In Sailboat Apartment Corp. v. Chase Manhattan Mortgage & Realty Trust, 363 So.2d 564 (Fla. Dist. Ct. App. 1978), a Florida court held that an adjustable rate provision in a five-year note which was tied to the prime rate violated the Florida usury law at the point when the rate per annum exceeded the usury maximum. The court expressly rejected the lender's argument that the interest should be averaged over the life of the note. *Id.* at 568.

Similar concerns were expressed by the California courts in two recent opinions: McConnell v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 21 Cal. 3d 365, 578 P.2d 1375, 146 Cal. Rptr. 371 (1978), and Arneill Ranch v. Petit, 64 Cal. App. 3d 277, 134 Cal. Rptr. 456 (1976). Both cases involved "open end" floating rate accounts, under the terms of which the lender could call the loan at regular intervals, but if it continued the loan, the lender could charge a rate based upon an index. In both cases, the courts rejected the aggregate analysis and held that the relevant rate for usury purposes was the actual rate during each "period of forbearance." An important element in the courts' rejection of the aggregate analysis was the concern that usury violations effectively could not be proven because the deferral of the issue brought about by the usury analysis.

25. Arguably, at a minimum, the lender should be aware or capable of knowing that the interest collected does equal a return at a given rate.

26. For example, assume a statutory usury ceiling of 10% is in effect at the time a loan is made. The loan has a 30-year term, is adjustable, and begins at 10%. If the index by which the rate is adjusted moves to 15% after the first year and remains at 15% for the next 10 years, and the borrower then pays off the loan, she could arguably sue the lender for a usury violation. If the loan is not repaid at the end of 11 years, the index used for reference drops to 5% and remains there for the duration of the loan, the borrower arguably has no usury cause of action because the interest charged for the loan would average less than 10%.

B. The "Rate" Approach to Usury Computation

In some jurisdictions courts have applied usury laws to ARMs by focusing on the rate being charged at the particular time, rather than on the aggregate return collected over the life of the loan.[27] Under this method, if the interest portion of any payment exceeds the maximum usury rate, then the usury laws are violated, even if earlier or subsequent interest charges are substantially below the maximum rate.

There are several pragmatic reasons for a court to adopt the rate approach. First, it eliminates the need to wait until late in the life of the loan to determine a usury violation. Second, it avoids the undesirable result of permitting the borrower to establish a usury violation by timing repayments. Third, it facilitates predictability because the lender can always avoid a usury violation by setting a maximum rate equal to the prevailing usury ceiling at the time of the loan origination.

The rate approach is not without weaknesses. At the present time, the rate approach cannot be adopted by some state courts because focusing on the rate and not the return is inconsistent with the wording of their state usury statutes.[28] Courts may also be reluctant to apply the rate approach because it would not protect against usury in other contexts, such as when a wraparound mortgage is used and the return is excessive even when the rate is within allowable limits.[29]

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27. *See, e.g.*, Commerce Trust Co. v. Ramp, 135 Tex. 84, 138 S.W.2d 531 (1940) *overruled*, Tanner Dev. Co. v. Ferguson, 561 S.W. 2d 777 (Tex. 1977); Shropshire v. Commerce Farm Credit Co., 120 Tex. 400, 30 S.W.2d 282, (1930); Southwestern Inv. Co. v. Hockley County Seed & Delinting, Inc., 511 S.W.2d 724 (Tex. Civ. App. 1974), *disapproved Tanner* Dev. Co. v. Ferguson, 561 S.W.2d 777 (Tex. 1977).

28. Most usury laws are worded so as to restrict the *rate* charged rather than the *return* received. *See, e.g.*, CALIF. CONST. art. XV § 1; TEX. REV. CIV. STAT. ANN. art. 5069-1.01 to -1.09 (Vernon Supp. 1986).

29. One court used a modified rate approach by aggregating the interest paid in a specific one-year period in order to establish the interest rate per annum. *See* Sailboat Apartment Corp. v. Chase Manhattan Mortgage & Realty Trust, 363 So.2d 564 (Fla. Dist. Ct. App. 1978).

The existence of a third approach to valuation should be noted—the "good faith" approach. One commentator has suggested that the adjustable rate lender should be able to avoid a usury charge if the lender can establish that he did not have the requisite intent to exact usurious interest when it entered into the adjustable rate arrangement. Walleser, *Balancing the Interest: The Changing Complexion of Home Mortgage Financing in America*, 31 DRAKE L. REV. 1, 43-45 (1981-82). *Cf.* Federal Trust Co. v. Nelson, 221 Iowa 759, 266 N.W. 509 (1936) (agreement that borrower pay mortgage taxes in addition to interest does not lead to usury when amount of taxes is unforeseeable at time of agreement). The lender would merely have to show that the initial rate was within the

1. *Special Problems Presented by Wraparound Mortgages*

Wraparound mortgages present unique problems in determining whether a loan is usurious. A wraparound mortgage is actually a second mortgage in which the secured indebtedness is stated as the total of both the first and second mortgage. The mortgagor makes payments on the total amount of both mortgages directly to the second mortgagee who then pays a portion of the payment to the first mortgagee as payments become due.[30] The interest rate is much higher on the second mortgage, but the wraparound mortgage states a combination of the lower first mortgage and higher second mortgage rates as the wraparound interest rate. Consequently, the actual return to the creditor is the higher second mortgage rate which is usually well above the prevailing market rate.

Wraparound mortgages are only attractive to mortgagors when existing rates are above the rate of their first mortgage because wraparound mortgages are marketed to look like a single new loan below the prevailing rate. In reality, a wraparound mortgage is a new mortgage at or above the market rate combined with the existing mortgage which is below the market rate. The average or combined rate of the new and existing mortgages appears attractive because it is still below the market rate. Wraparound mortgages are not popular when interest rates drop

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usury ceiling at the time the loan was made. Since future adjustments are uncertain, the lender cannot be said to intend that the interest will later exceed the usury level. Although some cases have identified "intent" as a necessary allegation in a charge of usury, the required objective intent is inevitably only the intent to receive the interest due under the terms of the bargain. The subjective intent of the lender is irrelevant. *See, e.g.*, Cochran v. American Sav. & Loan Ass'n, 586 S.W.2d 849 (Tex. 1979); Miller v. First State Bank, 551 S.W.2d 89 (Tex. Civ. App. 1977), *aff'd*, 563 S.W.2d 572 (Tex. 1978); Terry v. Teachworth, 431 S.W.2d 918 (Tex. Civ. App. 1968); Rossberg v. Holesapple, 123 Utah 544, 551, 260 P.2d 563, 566 (1953); Mathis v. Holland Furnace Co., 109 Utah 449, 457-58, 166 P.2d 518, 522 (1946). *But see* Comment, *Usury's Intent Requirement: Should There be a Good Faith Defense?*, 1985 B.Y.U. L. Rev. 789 (suggesting that a good faith defense should be available in all transactions); *cf.* McConnell v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 21 Cal. 3d 365, 578 P.2d 1375, 146 Cal. Rptr. 371 (1978). Unless the lender has placed a cap on the interest return, it is apparent that the lender objectively intends to receive the total interest payable under the contract, thereby satisfying any intent requirement under state law.

30. The borrower usually is not primarily liable on the part of the loan that is wrapped, but takes subject to it. *See, e.g.*, Mayers v. Groves Bros., 22 S.W.2d 174 (Mo. Ct. App. 1929); Zastrow v. Knight, 56 S.D. 554, 229 N.W. 925 (1930).

Some sellers will not be personally liable because they either acquired the property without assuming an earlier indebtedness or because they executed a novation when selling, with all parties agreeing to substitute the purchaser in the place of the seller.

below the first mortgage rate because the mortgagor can simply refinance the existing mortgage at the lower market rate.

The important usury question in a wraparound transaction is whether the second mortgagee is receiving interest on funds not actually advanced since the amount of the first mortgage was never actually given to the second mortgagor.[31] There are several ways a court may determine the amount loaned. The method chosen will often determine whether the lender is in violation of usury law.

a. Actual cash advanced method. This method computes interest on the actual sum advanced from the date of advancement. For example, consider a $100,000 wraparound transaction where the unpaid balance on the first mortgage is $60,000. Under the actual cash advanced analysis, a court would find that only $40,000 had been advanced by the wraparound lender. The $60,000 representing the existing mortgage is immediately owing as part of the wraparound transaction but has not actually been advanced.[32] Under this analysis courts would often find usury violation since the total return would be computed on a small $40,000 loan amount.

b. Face amount method. The "full use of the property" and the "sale of credit" rationale have been used to justify viewing the interest charge as based upon both the underlying mortgage and the wrap amount.

The "full use of property" rationale suggests that even though the funds represented by the underlying mortgage were not actually received, the wraparound mortgagor has the benefit

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31. *But cf.* Ferguson v. Tanner Dev. Co., 541 S.W.2d 483 (Tex. Civ. App. 1976) (taking all the interest into account in determining penalties for usury on the second mortgage), *rev'd on other grounds*, 561 S.W.2d 777 (Tex. 1978). *See generally* Note, *Wrap-Around Financing: A Technique for Skirting the Usury Laws?*, 1972 DUKE L.J. 785; Comment, *The Wrap-Around Deed of Trust: An Answer to the Allegation of Usury*, 10 PAC. L.J. 923 (1979).

32. This view concentrates on what the creditor receives. The wraparound creditor, whether seller or third party, has not paid off the existing deed of trust and thus is receiving interest on money that he has not advanced. An "actual cash advanced" rule is stated in Penziner v. West American Fin. Co., 133 Cal. App. 578, 24 P.2d 501 (1933) in which the lender charged interest on the full principal even though it was disbursed in segments. This situation is, however, very different from the wraparound loan when considered from the borrower's point of view. The court in Mindlin v. Davis, 74 So.2d 789 (Fla. 1954) held that a lender making monthly advancements on a loan could charge interest only on the amount of the advancements rather than the total amount for which it was ultimately committed. *See also* Note, *supra* note 31, at 797-810; Comment, *supra* note 31, at 923, 935-37; Comment, *The Wrap-Around Mortgage: A Critical Inquiry*, 21 UCLA L. REV. 1529, 1531-35 (1974) [hereinafter Comment, *A Critical Inquiry*].

of that amount as if it had been received. This argument stresses that the wraparound mortgagor has full use of the property which is worth at least the amount of both the underlying mortgage and the wrap amount.[33] This rationale breaks down under close scrutiny, however, because there is no logical reason why "full use of the property" should be viewed as being made possible by the wraparound mortgage. For example, if the first mortgagor had obtained an ordinary second mortgage rather than a wraparound mortgagee, the second position mortgagee would not be able to average the returns of both mortgages for usury purposes, yet such mortgagee would occupy the same position as the wraparound mortgagee with respect to "full use of the property."

C. *The "Sale of Credit" Method*

The "sale of credit" rationale stresses that it is the wraparound mortgagee's good credit which allows the wraparound mortgagor to obtain the financing. Under this theory, the wraparound transaction actually amounts to a sale or credit, and to that extent it is exempt from most usury laws.[34] The wraparound mortgagee is advancing his equity as credit plus cash for the balance of the debt. Thus, the wraparound mortgagor receives the full economic benefit of both mortgage amounts. The wraparound mortgagee is viewed as assisting the wraparound mortgagor not merely by making a loan, but by using the strength of his good credit. Because he is rendering this valuable assistance to the wraparound mortgagor, the mortgagee should be able to charge a reasonable sum for the use of his credit which makes the transaction possible.[35]

The sale of credit analysis makes sense only when the wraparound mortgagee is personally liable on the wrapped first mort-

33. Note, *supra* note 31, at 802; Comment, *supra* note 31, at 937-38; Comment, *A Critical Inquiry*, *supra* note 32, at 1537.

34. One case that lends support to this analysis is Tobin v. Neuman, 271 S.W. 842 (Mo. Ct. App. 1925) in which a loan broker borrowed money on his own credit to relend to his clients at the maximum rate. The broker exacted a commission from the borrowers and thus arguably pushed the effective rate over the usury maximum. However, the court found there was no usury violation because the commission was exacted for the broker's pledge of his own credit—in effect a sale of credit—and was not part of the interest charge for the funds advanced.

35. The sale of credit falls within the time price exception established in Hogg v. Ruffner, 66 U.S. (1 Black) 115 (1861) because the sale of credit is not a loan of money or forbearance of debt.

gage because when the wraparound mortgagee is not liable it cannot be said that the wraparound mortgagee extended its credit for the benefit of the wraparound mortgagor. Most wraparound mortgagees do remain personally liable on the first mortgage. Although assumption of the first mortgage by the wraparound mortgagor does not ordinarily release the wraparound mortgagee from liability on the first mortgage, the wraparound mortgagee becomes only a surety for repayment of the obligation. If sued on the obligation by the first position mortgagee, the wraparound mortgagee has full recourse against the wraparound mortgagor.[36] The same result occurs where the parties involved execute a novation in which the original mortgagee expressly agrees to look only to the wraparound mortgagor for payment. The wraparound mortgagee is thereby released from any liability on the first mortgage.[37]

Where the wraparound mortgagee is not personally obligated to the underlying mortgagor for payment, but only covenants with the wraparound mortgagor to pay the obligations under the first mortgage, the wraparound mortgagee should be viewed as having loaned only the cash advanced.[38] Otherwise the wraparound mortgagee would be receiving interest on a greater amount than what has been advanced or borrowed on credit.

The case law dealing with wraparound mortgages generally favors applying the interest to both the first and second mortgage amounts.[39] This allows lenders to earn actual returns well in excess of usury limits.

IV. A Proposal

In recent years, when volatile interest rates were the rule rather than the exception, the United States Congress and many state legislatures enacted usury reforms that unfortunately do

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36. *See* Comment, *Assumption of Mortgages in Missouri,* 47 Mo. L. Rev. 251, 259 (1982) and cases cited therein.

37. *See* G. Osborne, G. Nelson & D. Whitman, Real Estate Finance Law 278-92 (1979); Comment, *supra* note 36, at 259.

38. If the wraparound mortgagee is not personally obligated to pay the first position mortgagee, then the wraparound mortgagor is relying on the first position mortgagor to keep up payments so that the wraparound mortgagee will be able to pay. The wraparound mortgagee is only facilitating the financing to the extent of cash actually advanced—there is no sale of credit—and thus the wraparound mortgagee should be limited to collecting interest on cash actually advanced. *See also* Comment, *supra* note 31, at 935-37.

39. *See supra* note 31.

not adequately address non-traditional lenders, interstate loans and adjustable rate loans. One solution to this problem is for Congress to enact legislation similar to the Depository Institutions Deregulation and Monetary Control Act covering all lenders, or at the very least, all similarly situated lenders. Such legislation should be designed to pre-empt all state usury laws, and it should place a limit on the maximum rate a lender may charge at any given point in time. This legislation would allow courts in every jurisdiction to use the pragmatic "rate approach" in determining whether usury laws have been violated, rather than the problem-riddled "aggregate analysis approach." States should not be given the opportunity to opt out of such legislation because of the inherent unfairness involved where interstate loans are involved. With the rapid emergence of true interstate banking, allowed by recent deregulation, the inherent unfairness of current laws will be multiplied as the level of interstate transactions increase.

V. Conclusion

Although recent reforms have reduced or eliminated usury problems for some lenders, the reforms are inconsistent in wording and scope because they were not passed as part of a comprehensive usury framework. As a result, lenders are often unable to determine which usury law is applicable to a particular transaction.

The Depository Institutions Deregulation and Monetary Control Act was intended to supersede state legislation and ease usury problems for federally insured lenders. However, in many instances, the Act has created more problems than it has solved. In states that took the opportunity to opt out of the Act, problems have arisen when out-of-state lenders subject to the Act make loans within the state. In states where the Act applies, federally insured lenders are subject to the Act while other lenders are not.

Further problems occur for ARM instrument lenders in jurisdictions where courts utilize the "aggregate analysis approach" to determine usury violations. In those jurisdictions, in order to prove a usury violation the borrower must show that over the contract term of the loan the lender received interest in excess of the legal rate. Since purchase money home loans typically have terms of twenty-five to thirty-five years, most borrowers will be unable to demonstrate a usury violation.

If Congress is serious about solving usury problems, it should enact legislation similar to the Depository Institutions Deregulation and Monetary Control Act which would cover all lenders and show its intent to pre-empt state legislation by disallowing states to opt out. The legislation should be worded to place a limit on the maximum rate a lender may charge at any given point in time. This would allow courts in every jurisdiction to use the "rate approach" rather than the "aggregate analysis approach" in determining whether usury laws have been violated. Only then can usury laws be uniformly applied to similarly situated lenders throughout the nation.

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