TEXAS COMMERCIAL LENDING USURY LAW UPDATE (2006)

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The Regular Session of the 79th Texas Legislature enacted several pieces of legislation, including House Bill 955, Senate Joint Resolution 21, and House Bill 3428, which significantly modified the Texas Finance Code.

Senate Joint Resolution 21 would have granted the Texas Legislature constitutional authority to grant exemptions from the maximum interest rate otherwise applicable to loans governed by Texas law. The constitutional amendment was rejected by Texas voters on November 8, 2005, and, as a result, Sections 2.09, 2.10 and 2.11 of House Bill 955, which would have amended the definition of "qualified commercial loans" under the Texas Finance Code and created a new class of commercial loans totally exempt from Texas interest limitations, did not go into effect.

The balance of House Bill 955, which went into effect September 1, 2005, makes numerous changes to the Texas Finance Code. Many of the changes to commercial lending are found in Article 2, which is captioned "Usury Reform." This paper focuses primarily on the amendments found in Article 2 that impact commercial loans, excluding those relating to specialized lending, for example manufactured home loans. However, where I felt a consumer law matter was significant to understanding the overall impact of recent modifications to the Finance Code, I also cover certain issues relating to consumer loans. In some cases, preexisting or related law is briefly summarized to establish a framework to better understand the changes made by the 79th Texas Legislature.

House Bill 955 also addresses many aspects of Texas lending law that are not covered in this paper. If you have a special interest in consumer lending or administration of the Department of Savings and Mortgage Lending, you should review the other articles of House Bill 955 in detail.[1]

House Bill 3428 amended the current law relating to usury and compensating balances or deposits.

I use the terms "creditor" and "lender" interchangeably and the terms "obligor" and "borrower" interchangeably.

The opinions expressed in this paper are my own and not those of my Firm.

1. COMMERCIAL LOANS

The term "commercial loan" is defined in Section 306.001 (5) of the Texas Finance Code and means a loan primarily for business, commercial, investment, agricultural or similar purpose. Although Section 303.017, which was added to the Finance Code by House Bill 955, contains the words "consumer loan" in its caption, there is no definition of that term in Title 4 of the

[1] Article 5 of House Bill 955 adds Section 59.011 to the Texas Finance Code exculpating lenders regulated under the Texas Finance Code from liability for home construction defects and extends the protection to builders hired to complete construction of a home, at least with respect to prior defects of which the builder had no knowledge.

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Finance Code. Title 4 often refers to loans "primarily for personal, family, or household use", which seems a little cumbersome. I sometimes refer to these loans as "consumer loans" or "non-commercial loans."

Creditors[2] holding "qualified commercial loans" receive additional rights and protections. However, a conflict has existed in the definition due to the adoption by an earlier Texas Legislature of two conflicting definitions of the term "qualified commercial loan."[3] The definition of "qualified commercial loan" now reads, in pertinent part:

> (9) "Qualified commercial loan":
>
> (A) means:
>
> (i) a commercial loan in which one or more persons as part of the same transaction lends, advances, borrows, or receives, or is obligated to lend or advance or entitled to borrow or receive, money or credit with an aggregate value of:
>
> (a) $3 million or more if the commercial loan is secured by real property; or
>
> (b) $250,000 or more if the commercial loan is not secured by real property and, if the aggregate value of the commercial loan is less than $500,000, the loan documents contain a written certification from the borrower that:
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> (1) the borrower has been advised by the lender to seek the advice of an attorney and an accountant in connection with the commercial loan; and
>
> (2) the borrower has had the opportunity to seek the advice of an attorney and accountant of the borrower's choice in connection with the commercial loan; and
>
> (ii) a renewal or extension of a commercial loan described by Paragraph (A), regardless of the principal amount of the loan at the time of the renewal or extension; . . .[4]

In most cases, the maximum rate of interest that may be charged on any loan governed by Texas law is 10 percent per annum, except as otherwise provided in the Texas Finance Code.[5] There are some exceptions in connection with certain specialized loans.[6] Commercial creditors and borrowers may agree to apply the optional rate ceilings set out in Chapter 303 of the Texas

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[2] Tex. Fin. Code §301.002 (a) (3).

[3] *See* 76th Legislature Senate Bill No. 172 and House Bill 2781.

[4] Tex. Fin. Code § 306.001 (9).

[5] Tex. Fin. Code § 302.001 (b).

[6] *E. g.,* Tex. Gov. Code Chapter 1204 [public securities]; Tex. Health Code §221.664 [certain health industry development corporations].

Finance Code to contract for, receive or charge in excess of ten percent per annum.[7] Commercial loan alternative rate ceilings are set out in Section 303.009 (c) of the Texas Finance Code.

The optional rate ceilings range from a lower ceiling of 18 percent per annum up to 28 percent per annum on commercial loans depending on the fluctuations in "auction" rate of interest for the 26-week Treasury bills.[8] The effective ceiling has remained at the nominal rate of 18 percent per annum for many years. The current ceiling for all types of loans subject to the Texas Finance Code is 18 percent per annum and is published in the Texas Credit Letter, which may be found under the "Interest Rates" folder at the web site of the Office of Consumer Credit Commissioner.[9] This is the lowest rate the ceiling can go under the Finance Code for either commercial or non-commercial loans. A creditor in connection with a commercial loan is expressly authorized to contract for, charge, and receive a rate or amount of interest permitted under Chapter 303 of the Finance Code.[10]

All commercial loan creditors are accorded certain rights under the Finance Code not granted to other lenders. A creditor and obligor[11] under a commercial loan may agree to:

(a) Compute the term and rate of a commercial loan on a 360-day year consisting of twelve 30-day months.[12] This is a common convention used by many commercial lenders, sometimes without having provided for it in their loan documents. In turn, this has lead to usury problems when a creditor used a 360-day year but charged 365 days' worth of interest.[13] For the purposes of all commercial loans, each rate ceiling expressed as a rate per year may mean a rate per year consisting of 360 days and twelve 30-day months.[14] However, prudent creditors should still use actual calendar days for their usury analysis.[15]

(b) A delinquency charge and a prepayment premium, both of which are discussed below more fully.

Drafting suggestion: If a lender wants to use a 360-day year and twelve 30-day months in connection with a commercial loan, it must include a provision to that effect in its loan documents. Far too many lenders use the 360-day convention but fail to include a specific provision permitting this to be done. Section 306.003 allows the creditor and obligor to agree to the convention. The Section does not allow the creditor to use the convention unilaterally.

As noted above, if a "qualified commercial loan" exists, the creditor is also authorized to charge "equity kickers" under Section 306.101 of the Texas Finance Code and these are deemed

[7] Tex. Fin. Code § 303.001(a).
[8] Tex. Fin. Code §§ 303.003, 303.005, 303.008 and 303.009.
[9] http://www.occc.state.tx.us/pages/Legal/Laws/fcode/FCall.html.
[10] Tex. Fin. Code §306.002.
[11] Tex. Fin. Code § 301.002(a) (13).
[12] Tex. Fin. Code § 306.003.
[13] *Lawler v. Lomas & Nettleton Mortgage Investors*, 691 S.W. 2d 593 (Tex. 1985).
[14] Tex. Fin. Code § 306.003.
[15] *Lawler v. Lomas & Nettleton Mortgage Investors*, 691 S.W. 2d at 596.

not interest.[16] This provision was already in the Finance Code prior to 2005, but the 2005 amendment to the definition of "interest" favorably impacts Section 306.101(c).

2. **"INTEREST" REDEFINED**

It is well settled law that the Texas Legislature has the power to set the maximum rate[17], but it does not have the authority to designate a charge as not being interest if that charge otherwise fits within the definition of "interest".[18] In *Gonzales*, the lender claimed that a loan fee was a "premium" under the Texas Savings and Loan Act[19], which provided that such premiums were not interest.[20] The Texas Supreme Court rejected this contention:

> "The Legislature has attempted to exclude from consideration as interest a charge which would otherwise plainly fit within the definition of 'interest' as set out in Article 5069 – 1.01(a). . . . With reference to 'premiums', Section 5.07, of Article 852a does not purport to define interest and cannot be regarded as an attempt by the Legislature to fix maximum rates of interest. . . . *In the absence of* language setting a maximum rate for such charges or *an appropriate modification of the definition of 'interest,'* such 'premium' charges will be deemed to constitute interest when seeking to determine the existence or nonexistence of usury.[21] (emphasis added)

Section 301.002 (4) of the Finance Code was amended under Section 2.01 of House Bill 955 to read as follows:

> (4) "Interest" means compensation for the use, forbearance, or detention of money. The term does not include time price differential, regardless of how it is denominated. *The term does not include compensation or other amounts that are determined or stated by this code or other applicable law not to constitute interest or that are permitted to be contracted for, charged, or received in addition to interest in connection with an extension of credit*.[22] (emphasis added)

The 79th Legislature took the Texas Supreme Court's suggestion in *Gonzales* to re-define "interest" and, by doing so, authorize charges that would be deemed not interest when seeking to determine the existence or nonexistence of usury. Among the problems this change should remedy are:

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[16] Tex. Fin. Code § 306.101 (c).

[17] "The Legislature shall have authority to define interest and fix maximum rates of interest; provided, however, in the absence of legislation fixing maximum rates of interest all contracts for a greater rate of interest than ten per centum (10%) per annum shall be deemed usurious; provided, further, that in contracts where no rate of interest is agreed upon, the rate shall not exceed six per centum (6%) per annum." Tex. Const. art. 16, § 11.

[18] *Gonzales County Savings and Loan v. Freeman*, 534 S.W.2d 903, 908 (Tex. 1976).

[19] Tex. Rev. Civ. Stat. Ann. art. 852a, § 5.07 (repealed by Acts 1997, 75th Leg., Ch. 1008, sec 6(a), effective Sept 1, 1997).

[20] *Gonzales County Savings and Loan v. Freeman*, 534 S.W.2d at 905.

[21] *Gonzales County Savings and Loan v. Freeman*, 534 S.W.2d at 908.

[22] Compare other definitions of interest or "finance charge" for certain consumer loans. Truth-in-Lending, Regulation Z, 12 C.F.R. §226.4 (2003). Federal law will, of course, control over a Texas definition where Federal applies.

(i) As noted above, "equity kickers" authorized to be charged by lenders in connection with "qualified commercial loans" under Section 306.101 of the Texas Finance Code.[23] Section 306.101 (c) provides that these are not "interest." Examples of "equity kickers" include:

- a discount or commission that an obligor has paid or agreed to pay to one or more underwriters of securities issued by the obligor;
- an option or right to exchange, redeem, or convert all or a portion of the principal amount of the loan, or interest on the principal amount, for or into capital stock or other equity securities of an obligor or of an affiliate of an obligor;
- an option or right to purchase capital stock or other equity securities of an obligor or of an affiliate of an obligor;
- an option or other right created by contract, conveyance, or otherwise, to participate in or own a share of the income, revenues, production, or profits:
    - of an obligor or of an affiliate of an obligor;
    - of any segment of the business or operations of an obligor or of an affiliate of an obligor; or
    - derived or to be derived from ownership rights of an obligor or of an affiliate of an obligor in property, including any proceeds of the sale or other disposition of ownership rights;
- compensation realized as a result of the receipt, exercise, sale, or other disposition of an option or other right described by this subsection.

(ii) Prepayment premiums, make-whole premiums, or similar charge, whether voluntary or involuntary, acceleration of maturity, or other cause that involves premature termination of the loan, that may be agreed to by a creditor and obligor in connection with commercial loans.[24] Section 306.005 Finance Code provides such fee or charge is not interest.

(iii) Reinforces defense Tex. Fin. Code § 306.007 against usury claims based on the assumption or guaranty of third party indebtedness or the so-called "*Alamo Lumber"* claims.

[23] Texas common law has excluded contingent or speculative payments for the purpose of usurious interest calculations. *Beavers v. Taylor,* 434 S.W.2d 230 (Tex. Civ. App. — Waco 1968, writ ref'd n.r.e.); *Wagner v. Austin Sav. & Loan Ass'n*, 525 S.W.2d 724 (Tex. Civ. App.—Texarkana 1936, writ ref'd).

[24] Tex. Fin. Code § 306.005.

The mere statement that equity kickers, prepayment premiums, and assumption of third party obligations are not "interest" might not have passed muster under the *Gonzales* court analysis.

3. "AFFILIATE" DEFINITION EXPANDED

Section 306.001(2) of the Texas Finance Code has been amended to expand the scope of entities that fall within the definition of "affiliates", which are contemplated by the commercial loan equity kicker provision, Section 306.101 (c). Section 306.001(2) now reads as follows:

> (2) "Affiliate of an obligor" means a person who directly or indirectly, or through one or more intermediaries or other entities, owns an interest in, controls, is controlled by, or is under common control with the obligor, or a person in which the obligor directly or indirectly, or through one or more intermediaries or other entities, owns an interest. In this subdivision "control" means the possession, directly or indirectly, or with one or more other persons, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

4. DELINQUENCY CHARGES

Lenders and borrowers in connection with commercial loans were already permitted to agree to a "reasonable delinquency" charge of five percent of amounts in default for a period of not less than 10 days. The Legislature apparently wants to avoid "reasonability" issues in connection with such charges and has revised Section 306.006 to delete that concept.

> Sec. 306.006. CERTAIN AUTHORIZED CHARGES ON COMMERCIAL LOANS. In addition to the interest authorized by this chapter, the parties to a commercial loan may agree and stipulate for:
>
> > (1) a delinquency charge on the amount of any installment or other amount in default for a period of not less than 10 days in an amount not to exceed five percent of the total amount of the installment; and . . .

Recall that after September 1, 2005, "interest" no longer includes ". . . compensation or other amounts . . . that are permitted to be contracted for, charged, or received in addition to interest in connection with an extension of credit."[25] Accordingly, if a late charge satisfies the requirements of a delinquency charge permitted under Section 3.06.006, it is not interest. Late changes that do not qualify under Section 306.006 continue to be relevant to any usury analysis, whether with regard to commercial and residential loans.[26]

It is not clear the Section 306.006 excludes charging default interest or other forms of late charges on delinquent amounts. The statute does not address the questions raised by use of a shorter grace period, for example a 5-day period rather than a 10-day period. Common law has

[25] Tex. Fin. Code § 301.002(4).

[26] *Dixon v. Brooks*, 678 S.W.2d 728 (Tex. App.—Houston, [14th Dist.] - 1984, writ ref'd n.r.e.).

permitted creditors to charge interest on matured principal or interest on a loan.[27] The most reasonable interpretation is that Section 306.006 permits other delinquency or late charges provided that, when taken together with other interest charges, they do not exceed the maximum amount or rate of interest provided under Chapter 306. Unfortunately, neither Texas case law nor any opinions by the Texas Consumer Credit Commission afford any guidance as to the issue.

The Texas Supreme Court has stated in *dicta* that late charges are required to pass a reasonableness test, stating—in a case involving a loan fee called a "premium"—that "penalties need bear some relationship to the amount of loss or inconvenience suffered by the lender due to prepayment or late payment by the borrower."[28] A 5 percent late charge after a five-day grace period may be reasonable, but given the dearth of case law on, the issue is unclear. To be sure, the "reasonableness" test as applied to late charges has been brought into question by the elimination of the word "reasonable" with respect to Section 306.006 delinquency charges.[29] Texas courts must clarify this issue and it is possible they will be influenced by the changes the Texas Legislature has made in this area as part of House Bill 955.

Drafting suggestion: Commercial loan creditors should incorporate the 10-day grace period delinquency charge provision into their loan documents and take advantage of Section 306.006. Other late charges should be used only to the extent that they do not result in the total amount of interest or interest rate exceeding the allowable maximum for the type of loan in question.

5. PREPAYMENT PREMIUMS

Texas courts do not favor penalties.[30] Section 306.001(8) of the Texas Finance Code, which had authorized prepayment penalties in connection with commercial loans, was amended by House Bill 955 to change the word "penalty" to "premium." The definition now reads:

> "Prepayment *premium* " means compensation paid by or that is or will become due from an obligor to a creditor *solely as a result or condition of* the payment or maturity of all or a portion of the principal amount of a loan before its stated maturity or a regularly scheduled date of payment, as a result of the *obligor's election to pay* all or a portion of the *principal* amount *before its stated maturity* or a regularly scheduled date of payment. (emphasis added)

Note that prepayment in the context of a commercial loan continues to mean a payment of principal resulting from the *obligor's* election to pay before the stated maturity date of the payment in question. These are sometimes referred to as "voluntary prepayments."

This has lead to concerns about the risk of exacting "prepayment premiums" when the charge is not the result of "obligor's election to pay all or a portion of the principal amount before its stated maturity or a regularly scheduled date of payment", but the result of the *creditor's* election to accelerate the maturity of the debt and demand payment of some form of charge

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[27] *Crider v. San Antonio Real-Estate, Building & Loan Ass'n,* 35 S.W. 1047 (Tex. 1896).
[28] *Gonzales County Savings and Loan v. Freeman*, 534 S.W.2d at 908.
[29] Tex. Fin. Code § 306.006.
[30] *Stewart v. Basey*, 245 S.W.2d 484 (Tex. 1952).

following such acceleration. Such involuntary prepayment penalties have been held to constitute interest and to create potential usury issues.[31] To remove this concern, the Texas Legislature amended Tex. Fin. Code § 306.005 to provide that the parties to a commercial loan could agree to the payment of a prepayment premium, make-whole premium, or similar fee or charge, whether payable in the event of voluntary prepayment, involuntary prepayment, acceleration of maturity, or other cause that involves premature termination of the loan. The Section now reads:

> Sec. 306.005. PREPAYMENT PREMIUMS AND SIMILAR AMOUNTS. With respect to a loan subject to this chapter, a creditor and an obligor may agree to a prepayment premium, make-whole premium, or similar fee or charge, *whether payable in the event of voluntary prepayment, involuntary prepayment,* acceleration of maturity, or other cause that involves premature termination of the loan, *and those amounts do not constitute interest.* (emphasis added)

This Section's caption is a bit misleading. The Section actually addresses all types of creditor charges made following acceleration of the maturity of a commercial loan. If a creditor and an obligor in a commercial loan agree to the payment of any fee or charge, whether involuntary or voluntary, in connection with an involuntary prepayment or acceleration of maturity of principal, that charge or fee is not interest.

There are significant differences between the definition of the term "prepayment premium" and "prepayment penalty", which are triggered by an election of an obligor to pay a loan amount before maturity, and the exaction of a post-maturity premium, fee or charge under Finance Code § 306.005, which is triggered by an election of a commercial loan creditor due to an involuntary prepayment or acceleration of maturity. Charges permitted under Section 306.005 are much broader in scope than merely prepayment premiums. Moreover the prepayment penalties have never been considered interest under Texas common law[32], while the post-maturity charges have.[33] The result is that commercial creditors have extremely wide discretion to charge commercial obligors back-end early termination fees and those will not be deemed to be interest. This is major change from prior law.

Care must be also be taken not to confuse the terms "prepayment premium", which relates to commercial loans, and "prepayment penalty", which relates to non-commercial loans. Creditors in non-commercial loan transactions in particular would be prudent to avoid the risks attendant to prepayment premiums or similar fees or charges levied after the acceleration by a creditor of the maturity of any payment, which are sometimes referred to as an "involuntary prepayment." Involuntary prepayment premiums and similar post-maturity loan charges in non-commercial loan transactions continue to be subject to the interest rate limitations under the Finance Code. For loans that do not qualify as "commercial loans" under Tex. Fin. Code § 306.101(9), the definition of "prepayment penalty" continues to be:

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[31] *In re Abramoff v. Life Insurance Company of Georgia*, 92 B.R. 698 (Bkrtcy W. D. Tex. 1988).

[32] *Vela v. Shacklett*, 12 S.W.2d 1007, 1008 (Tex. Comm'n App. 1929, judgm't adopted); *Bearden v. Tarrant Savings Assn.*, 643 S.W.2d 247, 249 (Tex. App.—Ft. Worth 1982, writ ref'd n.r.e.); *C. C. Port, Ltd. v. Davis-Penn Mortg. Co.*, 61 F.3d 288, 289 (5th Cir. 1995).

[33] *In re Abramoff v. Life Insurance Company of Georgia*, 92 B.R. at 705.

> "Prepayment penalty" means consideration agreed on and contracted for a discharge of a loan, other than a loan governed by Chapter 306, before its maturity or a regularly scheduled date of payment, *as a result of an obligor's election to pay all of the principal amount before its stated maturity* or a regularly scheduled date of payment.[34] (emphasis added)

Note that "prepayment premium" is defined as compensation due solely as a result of an obligor's election to pay principal before its stated maturity.[35] If a post-maturity loan charge is imposed at the creditor's election in connection with a non-commercial loan, it is almost certainly going to be interest and subject to usury analysis if litigation ensues. If the post-maturity charge imposed at the creditor's election, when taken together with other interest charges, exceeds the maximum rate permitted by applicable law, the non-commercial creditor risks being subject to Finance Code Chapter 305 penalties.

In addition, if the interest rate on a residential homestead loan is greater than 12 percent per year, a prepayment penalty may not be collected unless required by an agency created by federal law.[36]

As a result, non-commercial loan creditors are not authorized by the Texas Finance Code to charge "involuntary" prepayment penalties or any prepayment penalty for loans in excess of 12 percent per year with respect to loans secured by a borrower's homestead.[37] This does not prevent the charging of a voluntary prepayment penalty for loans bearing interest rates below 12 percent per year. As noted above, voluntary prepayment premiums are not considered interest under Texas common law.[38] If a non-commercial lender charges an involuntary prepayment penalty or similar fee, it should be prepared to defend the charge if the obligor asserts that it exceeds the maximum interest applicable law permits when taken together with other interest charges.

DIDMCA did not preempt state law with regard to prepayment premiums.[39] Accordingly, even if a non-commercial loan is otherwise subject to the usury preemption protection afforded by DIDMCA, a creditor may still contract for, charge or receive usurious interest in the form of any prepayment penalty that amount, when taken together with other interest, exceeds the amount permitted under the Finance Code.

Prepayment and similar charges may be subject to a "reasonableness" test in addition to a usury test.[40] Until the Texas Supreme Court or Legislature either define a "reasonable" prepayment penalty or obviate the need for a "reasonable" test in connection with prepayment penalties and similar charges, creditors must continue to consider the risk that a charge, though not usurious, may still be determined by a Texas court to be "unreasonable."

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[34] Tex. Fin. Code §301.002(a) (15).
[35] Tex. Fin. Code § 306.101 (8).
[36] Tex. Fin. Code § 302.102.
[37] *Id*.
[38] *Vela v. Shacklett*, 12 S.W.2d at 1008.
[39] *Seiter* v. Veytia, 756 S.W.2d 303, 305 (Tex. 1988).
[40] *Gonzales County Savings and Loan v. Freeman*, 534 S.W.2d at 908; *contra Bearden v. Tarrant Savings Assn.*, 643 S.W.2d at 250.

6. ASSUMPTION OR GUARANTY OF THIRD PARTY LOAN - *ALAMO LUMBER* ISSUES

Texas common law has been if a lender requires an obligor to assume or guaranty a debt owed to that lender or such lender's alter ego by a third party as a condition of obtaining a loan from that lender, the debt so assumed or guarantied will be treated as interest on the new loan.[41] Section 306.007 has been added to the Texas Finance Code to reverse common law with respect to commercial loans. The new Section reads:

> Sec. 306.007. GUARANTY, ASSUMPTION, PAYMENT, OR OTHER AGREEMENT. With respect to a *commercial loan*, an obligor may be required to assume, pay, or provide a guaranty of another person's existing or future obligation as a condition of the obligor's own use, forbearance, or detention of money. *The amount of the other person's obligation required to be assumed, paid, or guaranteed does not constitute interest with respect to any obligation of the obligor*. (emphasis added)

As of September 1, 2005, commercial loan creditors need no longer be concerned about potential usury issues if they require a borrower to assume or guaranty another person's existing debt as a condition to the extension of new credit. *Alamo Lumber* continues to apply to non-commercial loan transactions.

7. LENDER'S EXPENSES

Creditors got a wake up call from a Dallas bankruptcy court several years ago when it ruled that numerous charges by third parties that had been thought to exempt from inclusions as interest in Texas usury analysis were interest, including attorneys' fees and expenses.[42] Although the U. S. District Court reversed the Bankruptcy Court's ruling that attorney's fees paid to outside counsel were interest, the original decision apparently remained a concern to the Texas Legislature. New Section 303.017 of the Texas Finance Code negates the impact of the original decision with respect to some non-commercial loans but not with respect to commercial loans. Section 303.017 reads:

> Sec. 303.017. VARIOUS CHARGES ON CONSUMER LOANS MADE BY PARTICULAR LENDERS. Notwithstanding Section 342.005[43], a bank, savings association, savings bank, or credit union making a loan *primarily for personal, family, or household use* under authority of this chapter may charge all *reasonable* expenses and fees incurred in connection with making, closing, disbursing, extending, readjusting, or renewing a loan not secured by real property, whether or not those expenses or fees are paid to third parties. *Those reasonable expenses and fees paid to third parties are not interest*. (emphasis added)

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[41] *Alamo Lumber Co. v. Gold*, 661 S.W.2d 926 (Tex. 1984); *Laid Rite, Inc. v. Texas Industries, Inc.*, 512 S.W.2d 384 (Tex. Civ. App. — Fort Worth 1974, no writ).

[42] *In re Auto International Refrigeration*, 275 B. R. 789 (Bkrtcy. N.D. Tex. 2002), reversed in part and affirmed in part, *Mims v. Fidelity Funding et al*, 307 B. R. 849 (N. D. Tex. 2002).

[43] This Section describes loans subject to Finance Code Chapter 342 (Consumer Loans).

This statute authorizes a limited group of non-commercial creditors to charge expenses. In order to qualify under this statute, the expenses must meet four conditions. The expenses must be for a non-commercial loan, reasonable, paid to third parties, and not be secured by real property. Expense charges paid to the creditor that are not for third party expenses apparently continue to be considered interest, which is consistent with existing common law.[44] The term "reasonable" is not defined in the statute, and the courts will have to continue to make the determination of what is reasonable on a case-by-case basis.

Commercial lenders receive no protection under Section 303.017. *International Refrigeration* is not as great a concern as it was before the U. S. District Court's reversal of portion of the Bankruptcy Court's decision, however, it is difficult to see much logic in excluding such charges by consumer lenders from the definition of interest and not excluding them with respect to commercial loans.

Only banks, savings associations, savings banks, and credit unions making consumer loans receive the protection of Section 303.017. Other creditors are not protected and, arguably, are at greater risk than prior to enactment of House Bill 955.

Implicit in the statute is that such expenses, but for the last sentence of Section 303.017, are interest. The next time a commercial loan creditor argues that *bona fide* expenses paid to third parties in a loan transaction are not interest citing the *Nevels* case, the borrower may ask: "Then why is the last sentence of Section 303.017 necessary?" Relying upon the canon of statutory construction *expressio unius est exclusio alterius* that borrower may successfully argue that, except with respect to charges addressed by Section 303.017, expenses are interest.

Although the risk is certainly lower in view of the District Court's decision to reverse part of *In re Auto International Refrigeration*, the Texas Legislature needs to clear up this issue by extending the protection of Section 303.017 to commercial creditors, at least as to third party expenses. It should also define the term "reasonable" or delete it to avoid unnecessary litigation with regard to what is or is not "reasonable." After all, the majority of Texas legislators, if asked, would almost certainly claim they oppose legislation by the courts.

8. **COMPENSATING BALANCES**.

Under Texas common law, if a lender requires that a portion of the funds loaned to a borrower be advanced and held in a deposit account subject to the control of the lender, the principal of the loan will be reduced by an amount equal to the funds in such account.[45] To alleviate the problem of reduction of the principal of the amount of loan proceeds required to be held by the lender and subject to lender's control, the 79th Texas legislature enacted House Bill 3428 creating Section 276.003 of the Texas Finance Code. The new section reads:

> § 276.003. USE OF PROCEEDS OF EXTENSION OF CREDIT FOR FINANCIAL INSTITUTION ACCOUNT.

[44] *Nevels* v. *Harris*, 102 S.W.2d 1046 (Tex. 1937).
[45] *First State Bank v. Miller*, 563 S.W.2d 572 (Tex. 1978).

(a) An obligor may use proceeds of an extension of credit made by a financial institution for business, commercial, investment, or similar purposes to establish collateral for the extension of credit by:

(1) making deposits;

(2) purchasing certificates of deposit; or

(3 establishing other accounts at the financial institution.[46]

(b) The amount of the proceeds used as provided by Subsection (a) is not considered a reduction in the amount of the proceeds of the extension of credit for purposes of Title 4 or for any other purpose.

(c) A determination by the obligor that it is beneficial to use proceeds of an extension of credit in the manner described by Subsection (a) is conclusive.

(d) This section may not be construed to imply a contrary rule for transactions not covered by this section.

Note that the statute relates only to loans for business, commercial, investment, or similar purposes and not to consumer loans.

Drafting suggestion: Loan documents should contain a statement, warranty or representation by the obligor that it has determined that it is beneficial to use proceeds of the loan in the manner described by Texas Finance Code § 276.003 (a).

9. CREDITOR'S CURE RIGHTS MODIFIED

A borrower that believes it has a usury claim or defense under Texas law has been obligated to give the lender notice and opportunity to cure the alleged violation.[47],[48] Prior to September 1, 2005, the statute did not require notice in cases involving "receiving" usurious interest or in cases where a defendant/obligor filed a counterclaim against a creditor alleging usurious interest. House Bill 955 remedies these deficiencies by modifying Section 305.006 to require, as a condition to alleging usury in any action, that the borrower give the creditor 60 days' notice and opportunity to correct any violation of applicable usury law. In the case of a counterclaim, the action is abated during the 60-day cure period. The revised provisions of Section 305.006 read as follows:

(b) Not later than the 61st day before the date an obligor files a suit seeking penalties for a transaction in which a creditor has contracted for, charged, or received usurious interest, the obligor shall give the creditor written notice stating in reasonable detail the nature and amount of the violation.

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[46] "'Financial institution' means a bank, savings association, or savings bank maintaining an office, branch, or agency office in this state." Tex. Fin. Code § 31.002 (a) (25).

[47] Tex. Fin. Code §305.006.

[48] Creditors have additional cure rights under Section 305.103 of the Texas Finance Code.

. . .

> (d) With respect to a defendant filing a counterclaim action alleging usurious interest in an original action by the creditor, the defendant shall provide notice complying with Subsection (b) at the time of filing the counterclaim and, on application of the creditor to the court, the action is subject to abatement for a period of 60 days from the date of the court order. During the abatement period the creditor may correct a violation. As part of the correction of the violation, the creditor shall offer to pay the obligor's reasonable attorney's fees as determined by the court based on the hours reasonably expended by the obligor's counsel with regard to the alleged violation before the abatement. A creditor who corrects a violation as provided by this subsection is not liable to an obligor for the violation.

10. **USURY PENALTIES**

Any violation of the interest rate and other charge limitations under the Texas Finance Code, as amended, would subject the lender to the penalties provided for under Chapter 305 of the Texas Finance Code. However the risks to commercial lenders has been greatly reduced.

Simple Usury

Section 305.001 of the Texas Finance Code has been amended to limit the minimum penalty for contracting, charging or receiving interest greater than permitted by the Code of the lesser of $2,000 or 20 percent of the principal to transactions for personal, family, or household use.

A new Section 305.001(a-1) has been added that will govern penalties with respect to commercial loans:

> (a-1) A creditor who *contracts for or receives* interest that is greater than the amount authorized by this subtitle in connection with a commercial transaction is liable to the obligor for an amount that is equal to three times the amount computed by subtracting the amount of interest allowed by law from the total amount of interest contracted for or received. (emphasis added)

A commercial loan creditor is not subject to the minimum penalties to which a consumer loan lender is subject.

More importantly note that the word "charges", which appears in subparagraph (a) of Section 305.001 relating to non-commercial loans, does not appear in the remedies new Section 305.001 (a-1) with respect to penalties in commercial loan transactions. As a result, what would be usurious in the context of a non-commercial loan, the *charging* of interest greater than permitted by law, would not be usurious in the context of a commercial loan. A commercial lender that only *charges* interest greater than authorized by applicable law does not violate the Texas Finance Code. This should cure the usury charging problems of the past[49], at least for

[49] *E. g., Danziger v. San Jacinto Savings Ass'n*, 732 S.W.2d 300 (Tex. 1987) (statement of account,

commercial creditors. Other creditors must continue to avoid such charging interest in excess of the amount allowed by applicable law.

Really Bad Usury

Section 305.002 of the Texas Finance Code has been amended to limit the penalty for charging more than twice the rate or amount of interest permitted by the Texas Finance Code to loan contracts or transactions for non-commercial loans. The big news is that the usury "death penalty" no longer applies to any commercial loan.

Section 305.002, as amended, reads:

> 305.002. Additional Liability for More Than Twice Authorized Rate of Interest
>
> (a) In addition to the amount determined under Section 305.001, a creditor who *charges and receives* interest that is greater than twice the amount authorized by this subtitle is liable to the obligor for:
>
> (1) the principal amount on which the interest is charged and received; and
>
> (2) the interest and all other amounts charged and received.
>
> (b) *This section applies only to a contract or transaction for personal, family, or household use* subject to this subtitle. (emphasis added)

It is interesting to note that the Section limits the penalties to creditors that *charge* ***and*** *receive* more than twice the interest allowed by law. A creditor has to do both to get the usury "death penalty." Merely *contracting* for more than twice the amount authorized by the Texas Finance Code is not a violation of the Code. This little gem was not in House Bill 955; it slipped in without much controversy in 1999. This could lead to some odd results. For example, a consumer lender that *contracts for* or *charges* usurious interest greater than twice the amount allowed but does not *receive* it, would not be liable for the penalties under Section 305.002, but would be liable for the penalties under Section 305.001.

Query: What result if the creditor *received* the more than twice interest permitted by applicable law but did not *charge* it?

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affidavit, pleadings); *Williams v. Back*, 624 S.W.2d 272 (Tex. App. — Austin 1981, no writ) (correspondence not received by the borrower claiming usurious interest); *Moore v. Sabine Nat'l Bank of Port Arthur*, 527 S.W.2d 209 (Tex. Civ. App. — Austin 1975, writ ref'd n.r.e.) (unilateral demand); *Windhorst v. Adcock Pipe & Supply*, 547 S.W.2d 260 (Tex. 1977), reversing 542 S.W.2d 222 (Tex. Civ. App. — Waco 1976) (creditor unilateral charge); *Butler v. Wrightway Spraying Service*, 683 S.W.2d 823 (Tex. App. San Antonio 1984, rev'd on other grounds), 743 S.W.2d 304 (Tex. 1987) (unilateral adding to account).

11. **DISCLAIMER OF SECTION 346 OF THE TEXAS FINANCE CODE NO LONGER REQUIRED**

Prior to the enactment of House Bill 955, Chapter 346 of the Texas Finance Code, which is intended to govern credit card debt, applied to both consumer and business debt. Chapter 346 imposed a number of requirements, including various charge limitations and mandatory disclosures that had to be disclaimed or complied with in commercial loan documentation. House Bill 955 modified Section 346.004 to limit Chapter 346's applicability to loans for applicable personal, family or household use unless the loan documents expressly provided otherwise. Section 346.004, as amended, reads:

> Sec. 346.004. APPLICATION OF CHAPTER TO REVOLVING CREDIT ACCOUNTS.
>
> (a) Unless the contract for the account provides otherwise, this chapter applies to a revolving credit account described by Section 346.003 if the loan or extension of credit is primarily for personal, family, or household use.
>
> (b) Unless the contract for the account provides that this chapter applies, this chapter does not apply to a revolving credit account described by Section 346.003 if the loan or extension of credit is for business, commercial, investment, or similar purposes.

Creditors extending revolving credit in commercial loan transactions no longer need to disclaim the applicability of Chapter 346 to such loans.

TABLE OF AUTHORITIES

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