Usury—Stated Principal of Vendor's Lien Note Is True Principal In Test For Usury, And Prepaid Interest Is To Be Spread Over Entire Period Of Loan. *Tanner Development Co. v. Ferguson,* 561 S.W.2d 777 (Tex. 1977).

On November 8, 1973, Tanner Development Company conveyed ten acres of land in Harris County to Robert B. Ferguson and Twelve Ferguson Ltd., a partnership.[1] As partial consideration for the conveyance Ferguson gave a promissory note in the amount of $226,388.77, payable over a five-year period at a stated interest rate of nine and one-half percent per annum.[2] The note required payments during the first year as follows: November, 1973-one year's interest in advance (21,506.93); January 20, 1974-¼ year's interest ($5,376.73); April 20, 1974-¼ year's interest (5,376.73); July 20, 1974-¼ year's interest ($5,376.73); and October 20, 1974-¼ year's interest ($5,376.73).[3] Quarterly interest payments in like amounts were to continue until July 20, 1977, at which time interest payments were to cease until all prepaid interest had been credited to the note. The first principal payment of $2,800.00 became due October 20, 1977, with identical installments on the principal due quarterly thereafter until November 8, 1978, the maturity date of the remaining balance. The agreement also provided that Tanner would look only to the land involved for satisfaction of the debt.[4] In July, 1975, Ferguson defaulted on the loan and, exercising an option to accelerate the maturity of the balance, Tanner served notice of foreclosure on the vendor's lien retained in a deed of trust. Ferguson then filed a suit alleging that the contract was usurious and seeking to recover usury penalties,[5] interest, and attorney fees. In addition, the plaintiff sought a permanent injunction against foreclosure of the vendor's lien.[6] The trial court sitting without a jury determined that the note was not usurious and rendered a judgment in favor of Tanner.[7] The Houston Court of Civil Appeals (1st District) re-

1. Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777 (Tex. 1977).
2. *Id.* at 779.
3. *Id.*
4. *Id.* The contract also provided for acceleration of the principal amount upon default and, in such a case, the crediting of any unearned interest as payment on the principal. *Id.*
5. TEX. REV. CIV. STAT. ANN. art. 5069-1.06(1971).
6. Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 779(Tex. 1977) Tanner filed a counterclaim seeking judgment on the debt and foreclosure of the lien. The trial court awarded this relief, but the court of civil appeals reversed this judgment. The Texas Supreme Court affirmed the trial court's judgment on the counterclaim. *Id.* at 787.
7. *Id.* at 779.

versed the trial court and awarded the plaintiffs the statutory penalties for usury.[8] The Texas Supreme Court, reversing the court of civil appeals, affirmed the trial court's judgment.[9] In so doing the court held that in a test for usury (1) the true principal is the stated principal of a vendor's lien note[10] and (2) prepaid interest is to be spread over the entire term of indebtness.[11]

In *Tanner Development Co. v. Ferguson*[12] the Texas Supreme Court considered the issues of true principal and spreading for the first time since the 1930's.[13] Addressing the issue of true principal,[14] the supreme court observed that the trial court's and court of civil appeals' differing results in the *Tanner* case stemmed from the application of the usury law to different principal amounts.[15] According to the court, the trial court had calculated the lender's compensation based on the stated principal of the note, $226,388.77, while the court of civil appeals had reduced this principal by the initial advance interest payment of $21,506.93.[16] Having determined that the true principal of the loan was $204,881.00, the appeals court calculated that Tanner had contracted for $5,077.75 in interest

8. Ferguson v. Tanner Dev. Co., 541 S.W.2d 483 (Tex. Civ. App.—Houston [1st Dist.]1976), *rev'd*, 561 S.W.2d 777 (Tex. 1977). The award to Ferguson by the court of civil appeals included $202,865.74 (twice the amount of interest contracted for) plus $59,144.04 (interest already paid to Tanner) plus $28,000.00 (attorney's fees). *Id.*

9. Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 787 (Tex. 1977).

10. *Id.* at 782.

11. *Id.* at 786-87. The supreme court also held that the voluntary nature of the advance interest payment was irrelevant in a test for usury. The trial court had concluded that the fact that Ferguson, the borrower, had insisted upon prepayment of interest removed the taint of usury and cited Velva v. Shacklett, 12 S.W.2d 1007 (Tex. Comm'n App. 1930, jdgmt adopted) as authority. The court of civil appeals had rejected this argument. Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 781-82 (Tex. 1977).

12. 561 S.W.2d 777 (Tex. 1977).

13. *Id.* at 783. In 1972 in Southwestern Inv. Co. v. Hockley County Seed & Delinting, Inc., 516 S.W.2d 136 (Tex. 1974), the supreme court, in a per curiam opinion refusing a writ of error, refrained from expressing an opinion on the question of spreading because it was not an issue in the case. Although litigation of the usury laws was sparse between 1940 and the late 1960's, with the tightening of the money market the courts began to see increased concern with the usury laws. *See generally* Loiseaux, SOME USURY PROBLEMS IN COMMERCIAL LENDING, 49 TEXAS L. REV. 419 (1971) (hereinafter cited as Loiseaux); Monnig, USURY IMPLICATIONS OF FRONT-END INTEREST AND INTEREST IN ADVANCE, 29 SW. L.J. 748 (1975) (hereinafter cited as Monnig).

14. True principal is a judicially determined amount that represents the benefit derived by the borrower. Adleson v. B.F. Dittmar Co., 120 Tex. 564, 80 S.W.2d 939, 940 (Tex. Comm'n App. 1935, opinion adopted). This amount is utilized by the courts in calculating the maximum amount of interest a contract can yield without violating the laws of usury.

15. Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 781 (Tex. 1977).

16. *Id.* at 781.

above the maximum legal amount of $101,442.67.[17] The supreme court conceded that if fees, commissions, or interest are withheld from money loans, reduction of the principal is proper;[18] however, the advance interest payment in this case was not analogous to these front-end fees.[19] The court distinguished the Ferguson note from contracts subject to judicial reduction on the basis of three factors: (1) the Ferguson transaction was a conveyance of real estate secured by a vendor's lien note; (2) the lender did not retain any of the consideration but instead allowed Ferguson full use of the land during the term of indebtedness, and (3) the lender agreed to look only to the consideration, the land, for satisfaction in case of default.[20] Thus, the court reasoned that this note was clearly distinguishable from a loan for money and that there was no equitable reason for a judicial reduction of the stated principal.[21]

In its second holding, the court approved the spreading of prepaid interest over the entire period of the loan.[22] The court examined the development in Texas case law of two conflicting theories, one that spreads all compensation over the entire period of the loan and the second that determines usury by interest paid in any one year.[23] Conceding that its previous decisions on the issue were inconsistent, the court observed that these earlier cases predated the charging of points,[24] tax benefits from prepaid interest,[25] and the current severe statutory penalties for usury.[26] Because these penalties applied to the entire contract, the court concluded that equity required that

17. The calculations utilized by the court of civil appeals are attached in an appendix to that court's opinion. Ferguson v. Tanner Dev. Co., 541 S.W.2d 483 (Tex. Civ. App.—Houston [1st Dist.] 1976), *rev'd*, 561 S.W.2d 777 (Tex. 1977).

18. Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 787 (Tex. 1977).

19. These fees have been termed "front-end" fees and are amounts charged by the lender at the inception of the loan in addition to stipulated interest. *See* Monnig, *supra* note 13.

20. Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 787-88.

21. *Id.* at 782.

22. *Id.* at 787.

23. *Id.* at 783-85.

24. The term "point" is used in the lending industry to denote a fee equivalent to one percent of the stated principal of the loan. Thus a charge of three points on a ten thousand dollar loan would cost the borrower $300.00. This fee is collected by the lender when the loan is made, either by retaining the amount from the stated principal or asking the borrower to tender cash. The fee is in addition to the stated interest due on the debt. *See generally* Monnig, *supra* note 13, at 752 n.32.

25. The 1976 Tax Reform Act amended section 461(g) of the Internal Revenue Code to make interest deductible only in the year earned. This effectively destroyed the enormous tax benefits gained by prepaying large interest obligations. I.R.C. § 461(g)(i).

26. TEX. REV. CIV. STAT. ANN. art. 5069-1.06 (1971).

it test the total interest against the entire period of the loan.[27] Although Ferguson's interest payments in the first year of the note far exceeded the statutory permissible rate,[28] the total amount called for under the terms of the note did not, in the aggregate, exceed the amount authorized by law.[29] Thus, the court held that the note was not usurious and expressly overruled the theory of annual determination.[30]

Finally, the court expressly refrained from distinguishing between judicially determined interest and stipulated interest or between front-end fees and advance interest.[31] The court also limited the option to

> contracts covered by Article 5069-1.06(1), wherein the stated rate of interest on the principal debt does not exceed 10% per annum and wherein all consideration (contracted for and judicially determined) for use, detention or forbearance of the principal debt is a sum no greater than such principal debt would produce at 10% per annum during the full time that the payor has use of the principal debt or the consideration (such as land) which is represented by the principal debt.[32]

The law of usury at issue in *Tanner Development Co. v. Ferguson*[33] has developed from the medieval moral condemnation of money lending. However, modern usury law condemns only the charging of interest in excess of amounts established by statute.[34] The Texas constitution delegates to the legislature the authority to define interest and fix maximum permissible rates.[35] Acting on this

27. Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 787 (Tex. 1977).

28. Two full years of interest were paid within the first twelve month period. This amounted to 19% of the stated principal. See text accompanying note 3 *supra*.

29. Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 782 (Tex. 1977).

30. *Id.* at 787.

31. *Id.* at 785.

32. *Id.* at 787.

33. 561 S.W.2d 777 (Tex. 1977).

34. The law of usury has its historical roots in the philosophy and religion of the western world. The moral taint associated with money lending has affected judicial and legislative decisions and the application of penalties. *See generally* Pearce & Williams, PUNITIVE PAST TO CURRENT CONVIENANCE—A STUDY OF THE TEXAS LAW OF USURY, 22 SW. L.J. 233, 233-34 (1968)(hereinafter cited as Pearce & Williams).

35. The legislature shall have authority to classify loans and lenders, license and regulate lenders, define interest and fix maximum rates of interest; provided, however, in the absence of legislation fixing maximum rates of interest all contracts for a greater rate of interest than ten per centum (10%) per annum shall be deemed usurious; provided, further, that in contracts where no rate of interest is agreed

authority, the Texas legislature has defined interest as "the compensation allowed by law for the use or forebearance or detention of money"[36] and has defined usury as the charging of "interest in excess of the amount allowed by law."[37] The legislature also has established ten percent per annum as the legal maximum.[38] These legislative definitions have required further interpretation by the courts when applied to specific fact situations. Two particularly troublesome terms are *compensation* and *per annum*.

In construing the word *compensation,* the courts have considered as immaterial the language used by the parties.[39] Regardless of the actual name applied to any lender's charge, the courts have deemed the charge to be interest if it effectively adds to the borrower's cost.[40] Thus, the courts have treated service charges,[41] commissions,[42] and commitment fees[43] as judicially determined interest. These charges are considered to be for the lender's service, and the value of this service is deemed to be included in the legally permissible interest.[44] However, charges by a third party, such as an attorney

---

upon, the rate shall not exceed six per centum (6%) per annum.
TEX. CONST. art. XVI, § 11.

36. TEX. REV. CIV. STAT. ANN. art. 5069-1.01(a)(1971).

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

38. "Except as otherwise fixed by law, the maximum rate of interest shall be ten percent per annum. A greater rate of interest than ten percent per annum unless otherwise authorized by law shall be deemed usurious." TEX. REV. CIV. STAT. ANN. art. 5069-1.02(1971). The legislature has created two exceptions to this rule. Borrowing corporations may agree to a maximum rate of one and one-half percent per month, TEX. REV. CIV. STAT. ANN. art. 1302-2.09, (Supp. 1978) and consumer credit loans are regulated by TEX. REV. CIV. STAT. ANN. art. 5069-2.01—50.06 (1971) in the Consumer Credit Code.

39. Deming Inv. Co. v. Giddens, 41 S.W.2d 260, 262 (Tex. Civ. App.—Dallas 1931, writ dism'd).

40. *Id.* The Beaumont Court of Civil Appeals has held that "points" are not interest but a premium allowed to savings and loan companies under TEX. REV. CIV. STAT. ANN. art. 852a, § 5.07 (1971). Wagner v. Austin Sav. & Loan Ass'n, 525 S.W.2d 724, 728 (Tex. Civ. App.—Beaumont 1975, no writ). *See generally* Monnig, *supra* note 13, at 758 n.80. However, in 1976 in Gonzales County Sav. & Loan Ass'n. v. Freeman, 534 S.W.2d 903 (Tex. 1976), the Supreme Court discussed the "premium statute" and stated: "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." *Id.* at 908. The 1976 Tax Reform Act, however, specifically exempts points from the general disallowance of prepaid interest as a tax deduction. I.R.C. § 461(g)(2).

41. Terry v. Teachworth, 431 S.W.2d 918 (Tex. Civ. App.—Houston [14th Dist.]) 1968, writ ref'd n.r.e.).

42. Deming Inv. Co. v. Giddens, 41 S.W.2d 260 (Tex. Civ. App.—Dallas, 1931, writ dism'd).

43. Imperial Corp. of America v. Frenchman's Creek Corp., 453 F.2d 1338 (5th Cir. 1972).

44. Greever v. Persky, 140 Tex. 64, 165 S.W.2d 709, 711 (1942).

or surveyor, may be added to the borrower's cost over and above the legal interest. This addition is contingent on the fees actually being passed on to the third party.[45]

Once the courts have determined that a charge is interest, a judicial alteration of the terms of the parties' contract becomes necessary in order to determine whether the contract is usurious.[46] Because lenders frequently include front-end fees in the stated principal and then retain these fees when advancing the remainder of the stated principal to the borrower, the courts must determine the "true principal," which is the amount from which the borrower derived benefit. In order to arrive at this true principal, the amount of the fee is added to the stipulated interest and subtracted from the stipulated principal.[47] This judicial computation is necessary when either the lender retains a fee from the amount of the loan or the borrower "took it in one hand and with the other gave back to"[48] the lender the extra compensation. Once the true principal is determined, the court will add (1) the maximum legal amount of interest on the reduced principal and (2) the amount of this reduced principal. The resulting sum is the maximum legal amount the borrower could pay to the lender. Next, the court will compute the total amount the lender would receive under the terms of the contract. If the former total exceeds the latter total, the contract is not usurious.[49] The leading case of *Nevels v. Harris*[50] explicitly sets forth the true principal computation. In *Nevels* the lender retained $320.00 from the $6,400.00 principal of a five-year note. This $320.00 was a fee "for making or securing said loan," and the court judicially determined that the fee was interest.[51] Thus, the court reduced the principal amount to $6,080.00 in testing for usury. Although the *Nevels* contract was not usurious when tested against the reduced

45. *Id.* at 711-12; Nevels v. Harris, 129 Tex. 190, 102 S.W.2d 1046, 1049 (1937). *Greever v. Persky* apparently extended the *Nevels* holding to exclude from judicially determined interest not only fees passed on to third parties, but also fees charged by the lender for a consideration separate and distinct from the lending of money. Greever v. Persky, 140 Tex. 64, 165 S.W.2d 709 (1942).

46. *See* Adleson v. B.F. Dittmar Co., 124 Tex. 564, 80 S.W.2d 939, 940. (Tex. Comm'n App. 1935, opinion adopted).

47. Nevels v. Harris, 129 Tex. 190, 102 S.W.2d 1046, 1049 (1937).

48. Adleson v. B.F. Dittmar Co., 124 Tex. 564, 80 S.W.2d 939, 940 (Tex. Comm'n App. 1935, opinion adopted).

49. Nevels v. Harris, 129 Tex. 190, 102 S.W.2d 1046, 1049 (1937).

50. 102 S.W.2d 1046, 1049 (1937).

51. 102 S.W.2d at 1047.

principal,[52] judicial tampering can often result in a rate of interest that exceeds ten percent. For example, in *Adleson v. B.F. Dittmar Co.*[53] the commission of appeals determined that a contract calling for interest of 9.48 percent per annum effectively required interest at 11.268 percent after the stated principal had been reduced by a $240.00 brokerage fee.[54]

Although judicial reduction of stated principal by front-end fees is well established in case law, no cases decided prior to *Tanner Development Co. v. Ferguson*[55] have been found in which the courts reduced the principal by advance interest paid at the inception of the loan.[56]

Once a court has determined the full amount of compensation and the true principal, it must necessarily interpret the legislative meaning of another troublesome term, *per annum*. If a contract is for a period exceeding one year, the question arises whether *per annum* refers to the amount that can be legally charged within any given twelve-month period[57] or to the aggregate amount that can be charged over the term of the loan.[58] If *per annum* refers to any single

52. *Id.* at 1049. The court followed the following computations in testing the contract:
1. Determination of maximum legal amount.
   a. $6,080.00 x 10% = $608.00 (one year's maximum legal interest)
   b. $608.00 x 5 years = $3,040.00 (five years' maximum legal interest)
   c. $3,040.00 + $6,080.00 = $9,120.00 (maximum legal amount that could be paid under the contract)
2. Determination of contract charges.
   a. $6,400.00 x 8% = $512.00 (interest per year)
   b. $512.00 x 5 years = $2,560.00 (interest charged under the contract)
   c. $2,560.00 + $6,400.00 = $8,960.00 (amount paid under the contract)
3. Determination of usury.
   $9,120.00 - $8,960.00 = $160.00 (Borrower paid $160.00 less than maximum permissible amount.)

53. 124 Tex. 564, 80 S.W.2d 939 (1935).

54. 80 S.W.2d at 940.

55. Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777 (1977).

56. In Bothwell v. Farmers' & Merchants' State Bank and Trust Co., 120 Tex. 1, 30 S.W.2d 289 (1930), the Texas Supreme Court discussed the long established practice of not considering interest paid one year in advance to be usurious. The court called the rule illogical because the interest was unearned when paid; however, the court yielded to precedent and approved this practice. Nevertheless, the court refused to extend the rule to a contract calling for interest on unpaid advance interest. The court did not reach the question of judicially reducing the principal by advance interest payments. However, March 1, 1978 the supreme court, in First State Bank v. Miller, 563 S.W.2d 572 (Tex. 1978), reduced the stated principal of a loan by the amount frozen in the borrower's non-interest bearing account. This amount was equivalent to two years' interest and the borrower had no access to it. As a result of the judicial reduction of the loan the contract was found to be usurious. *Id.*

57. *See* Commerce Trust Co. v. Ramp, 135 Tex. 84, 138 S.W.2d 531 (1940).

58. *See* Adleson v. B.F. Dittmar Co., 124 Tex. 564, 80 S.W.2d 939, 941 (Tex. Comm'n

year, a contract is usurious if all interest payments made during any twelve-month period exceed ten percent of the true principal. If, however, *per annum* refers to a means of measuring the total interest allowed under the contract, the interest charged by the lender may be spread over the entire term of the loan. This latter interpretation of *per annum* allows interest rates in excess of ten percent during the early years of the note if counterbalanced by lesser rates during the later years.[59]

The 1940 case of *Commerce Trust Co. v. Ramp*[60] illustrates the twelve month interpretation of *per annum*. In that case a credit company loaned $50,000.00 for ten years at the rate of six and one-half percent per annum. The borrower then executed a second note to secure further the $50,000.00 loan. This second note was for four years and, in essence, agreed to pay an additional amount equalling two and one-half percent per annum over the ten year period of the first note.[61] The courts do not consider such contracts as separate agreements but view them as parts of a single transaction.[62] Thus, when the terms of the two notes in *Ramp* were considered together, the interest charged was nine percent of the principal of the first note. However, because the payments on the four-year note were squeezed into the early years of the loan, the rate charged during each of these first four years was in excess of ten percent, the legal maximum.[63] The Amarillo Court of Civil Appeals held that the contract was usurious,[64] and, in affirming that holding, the Commission of Appeals of Texas stated that "this holding is so obviously correct that it becomes unnecessary to discuss the question."[65] The Texas Supreme Court adopted this judgment.[66] Other cases in which the courts have applied the twelve-month interpretation have involved stipulated interest paid before it has accrued.[67]

App. 1935, opinion adopted).

59. *See generally* Monnig, *supra* note 13, at 756.

60. 135 Tex. 84, 138 S.W.2d 531 (Tex. Comm'n App. 1940, opinion adopted).

61. 138 S.W.2d at 533.

62. *Id.*

63. *Id.* at 532-33.

64. Commerce Farm Credit Co. v. Ramp, 116 S.W.2d 1145 (Tex. Civ. App.—Amarillo), aff'd sub nom. Commerce Trust Co. v. Ramp, 138 S.W.2d 531 (Tex. Comm'n App. 1940, opinion adopted).

65. Commerce Trust Co. v. Ramp, 135 Tex. 84, 138 S.W.2d 531, 533 (Tex. Comm'n App. 1940, opinion adopted).

66. 138 S.W.2d at 537.

67. *See* Dallas Trust & Sav. Bank v. Brashear, 65 S.W.2d 288 (Tex. Comm'n App. 1933, jdgmt adopted); Southwestern Inv. Co. v. Hockley County Seed & Delinting, Inc., 511 S.W.2d 724 (Tex. Civ. App.—Amarillo, writ ref'd n.r.e.), *aff'd per curiam*, 516 S.W.2d 136 (Tex.

The Texas Supreme Court applied the concept of spreading interest charges over the entire term of the indebtness in the 1937 case of *Nevels v. Harris.*[68] The computations followed by the court effectively spread a $320.00 fee over the five-year term of the loan, and the court expressly adopted this spreading concept as the appropriate test for front-end fees.[69] The court reasoned that "[i]f the contract for the use and detention of the principal debt is not a sum greater than such debt would produce at 10 per cent, per annum from the time the borrower had the use of the money until it is repaid, it is not usurious."[70] The cases applying this doctrine have generally dealt with front-end fees.[71] Thus, a distinction based on the nature of the early payments—stipulated advance interest versus front-end fees—in fact existed between the cases following *Ramp* and those following *Nevels*. However, Texas courts have never expressly adopted this distinction,[72] and consequently the two case lines appear inconsistent.

In *Tanner Development Co. v. Ferguson*[73] the supreme court resolved this lingering disparity by expressly overruling *Ramp* and establishing the applicability of *Nevels'* spreading doctrine to both advance interest and to front-end fees.[74] In accepting spreading as the appropriate test for advance interest, the court rejected the twelve-month theory when it stated: "[i]n our opinion, it would be beyond the obvious intent of the Legislature in the enactment of Article 5069-1.06 to impose its severe penalties solely upon proof

---

1974). The *Tanner* court noted that the contract involved in *Southwestern Inv. Co.* would have been usurious under either the twelve month interpretation or the spreading concept and that in the supreme court's per curiam opinion, the court reserved judgment on this issue. Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 785 (Tex. 1977).

68. 129 Tex. 190, 102 S.W.2d 1046 (1937). See notes 49-51 and accompanying text.

69. 102 S.W.2d at 1049. If the court had applied *Ramp*, the contract would have been usurious because the borrower paid $832.00 during the first year of the loan.

70. *Id., citing* Eubanks v. Simpson, 90 S.W.2d 291, 292 (Tex. Civ. App.—Amarillo 1936, writ ref'd).

71. *See* Imperial Corp. of America v. Frenchman's Creek Corp., 453 F.2d 1338 (5th Cir. 1972); Adleson v. B.F. Dittmar Co., 124 Tex. 564, 80 S.W.2d 939 (Tex. Comm'n App. 1935, opinion adopted); Commerce Sav. Ass'n. v. GGE Management Co., 539 S.W.2d 71, 81 (Tex. Civ. App.—Houston [1st Dist.]), *modified on other grounds*, 543 S.W.2d 862 (Tex. 1976); Southern States Mortgage Co. v. Lykes, 85 S.W.2d 780 (Tex. Civ. App.—Amarillo 1935, writ ref'd).

72. In 1975 the legislature expressly provided for spreading interest charges as well as front-end fees in real estate transactions. TEX. REV. CIV. STAT. ANN. art. 5069-1.07(1) (Supp. 1978).

73. 561 S.W.2d 777 (Tex. 1977).

74. *Id.* at 786.

that one year's interest payments exceeded statutory limits. . . ."[75] As evidence of the legislature's intent, the court noted that a 1975 amendment to the usury laws specifically adopted the spreading concept for loans secured by real estate.[76]

This determination of legislative intent automatically foreclosed any arguments as to the technical and economic differences between advance interest and front-end fees.[77] These differences are relevant only if the legislature intended the phrase "ten percent per annum" to be interpreted as the amount payable in a twelve month period. The distinction between prepaid stipulated interest and front-end fees rests on the time at which the charge is paid. The borrower actually pays the lender the advance interest before the elapse of the time for which the interest is charged. On the other hand, the lender charges the borrower the front-end fees at the inception of the loan, but because the fees are included in the stated principal, they are paid as the principal is repaid. Thus, if ten percent per annum means the amount payable in a twelve month period, advance interest should be added in in the year it is actually paid, and front-end fees should be spread over the full time the borrower has use of the principal amount.[78] This distinction is immaterial if ten percent per annum measures the total amount chargeable during the entire term of the loan because the contract is looked at in its entirety, not as an annual obligation. Concerned with the confusion that would result from treating the two types of

75. *Id.* at 787. In 1967 the legislature codified the interest and usury laws, and at that time amended former article 5073, which related to penalties for usury. Under the former law the borrower could recover double the usurious interest he had actually paid. Various other remedies were scattered throughout the law pertaining to specific types of contracts and lenders. *See generally* Pearce & Williams, *supra* note 34. The 1967 amendment simplified this array of penalties and provided that "[a]ny person who contracts for, charges or receives interest which is greater than the amount authorized by this Subtitle, shall forfeit to the obligor twice the amount of interest contracted for, charged or received, and reasonable attorney fees fixed by the court." TEX. REV. CIV. STAT. ANN. art. 5069-1.06. (1971)

76. TEX. REV. CIV. STAT. ANN. art. 5069-1.07 (Supp. 1978). The *Tanner* court noted this statute; however, the statute did not apply to the Ferguson contract because the parties executed it in 1973, two years before the adoption of the statute.

77. The court noted that this distinction had been discussed in several law review articles. After footnoting the articles, the court commented that its citation of these writings was not to be construed as approval of the conclusions therein. Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 785. See Monnig, *supra* note 13, Loiseaux, *supra* note 13; Pearce & Williams, *supra* note 34; Comment, *Usury in Texas: Spreading Interest over the Entire Period of the Loan*, 12 HOUS. L. REV. 159 (1974). *See also* Note, PROBLEMS OF INTEREST: TEXAS MUNICIPAL BONDS AND THE USURY LAWS, 54 TEXAS L. REV. 1130, 1137-41 (1976).

78. *See* Monnig, *supra* note 13, at 750, 752.

compensation differently, the court avoided the argument that the two types of early charges should be treated differently because of their technical distinctions and adopted the spreading concept for both types of payments.

The spreading of interest charges effectively allows a higher yield on the principal amount by allowing the lender the use of the prepaid interest from an earlier time. For example, if the lender collects $100.00 interest one year before it has accrued and deposits it in a savings account earning five percent interest, at the end of the year, when the interest is earned, he has derived $105.00 rather than $100.00 from the transaction. Such judicial approval of an effectively higher yield for lenders reflects a recognition of the modern money market.[79] This market establishes the availability of financial credit on a national scale, and strict interpretation of local usury laws can be damaging to the state's economy.[80] When lenders cannot achieve an adequate return on their money because of state regulation, they invest the funds in more profitable ventures, and the local borrower is denied access to necessary credit. The resulting restrictions on both commercial and consumer credit limit the state's economic activity.[81] Thus, not only has the court cleared up the apparent inconsistency of *Nevels* and *Ramp* and avoided the confusion of separate treatment for front-end fees and advance interest, but it has also provided a flexibility necessary to the continuing economic progress of the state.

In contrast to the stabilizing effect of the *Tanner* holding on the spreading issue, the court's holding that the stated principal of a vendor's lien note is not to be reduced by advance interest payments[82] creates a new dichotomy. It is not clear whether the court's distinction between money loans and the Ferguson contract is based on the nature of the early payment - a front-end fee as opposed to prepaid stipulated interest - or on the nature of the agreement - a money loan as opposed to a sale. Ferguson's advance payment was part of the nine and one-half percent interest stated in the agreement, and when computed under the spreading concept, the total charge for the loan was nine and one-half percent of the stated principal. Thus, this payment is distinguishable from those other fees which might be paid in addition to the stated interest. The

79. *See generally* Loiseaux, *supra* note 13, at 442-44.
80. *Id.*
81. *Id.*
82. Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777 (Tex. 1977).

court, however, specifically approved the judicial reduction of a stated principal in a cash loan by any "*interest*, fees, commissions, or other front-end charges."(emphasis added).[83] This statement seems to preclude any distinction on the basis of the nature of the early payment.

On the other hand, the factors the court listed as distinguishing the Ferguson contract from money loans are inherent in a non-recourse real estate sales agreement.[84] Assuming that such a sale is the key to the court's distinction and that the court intended to exempt sales agreements from judicial reduction of the principal sum, the question remains as to what public policy is served by this exemption. In a "declaration of intent" prefacing Article 5069, the legislature stated that it was "the intent of the Legislature . . . to protect the citizens of Texas from abusive and deceptive practices . . . perpetrated by unscrupulous operators, lendors, and vendors in both cash and credit consumer transactions."[85] This presumably sets forth the purpose of the state's restrictions on the use, forebearance, or detention of money. In distinguishing between a sales contract and a loan for money, the court noted that Ferguson exchanged his promissory note in consideration for ten acres of land from which Tanner did not retain anything. This essentially distinguishes between the land itself and the value of it. Although Ferguson had full use of the land, he did not have full use of its value. After making the initial interest payment of $21,506.93, Ferguson only derived the benefit of the lender's forebearance on $204,881.84.[86] It is difficult to see how this situation differs from the reduced cash amount advanced to a borrower after deduction of a broker's fee in a money loan.

---

83. *Id.* at 287 (emphasis added); First State Bank v. Miller, 563 S.W.2d 572 (Tex. 1978).

84. Although the court apparently limits the distinction to real estate transactions, personal property secured by a purchase money security agreement might fall into the same category as real estate secured by a vendor's lien. These security agreements cover a conveyance; the debtor has full use of the consideration during the indebtness; and the secured party looks only to the collateral or its proceeds for satisfaction. The significance of the limiting of the debtor's liability is not clear unless the court considers the lender's voluntary relinquishment of the legal right to sue on the debt as entitling him to greater flexibility in fashioning the terms of the loan. *See* TEX. BUS & COMM. CODE ANN. § 9.107 (Tex. UCC 1968).

85. TEX. REV. CIV. STAT. ANN. art. 5069 (1971).

86. The note in the amount of $226,388.77 was dated November 8, 1973. On November 12, Ferguson paid $21,506.93, a full year's interest, in advance. Thus, the court of appeals held that Ferguson, from November 12, 1973 until default on July 20, 1975, had full use of only $204,881.84. Ferguson v. Tanner Dev. Co., 541 S.W.2d 483 (Tex. Civ. App.—Houston [1st Dist.] 1976), *rev'd*, 561 S.W.2d 777 (Tex. 1977).

It is possible that the facts of the particular transaction in *Tanner* influenced the court. The arrangement to prepay interest was at the borrower's request in order to gain tax advantages. Although the court stated that this voluntary nature of the payment was irrelevant to the issue of usury,[87] the fact that the prepayment was not a result of a devious or abusive practice by the lender would affect the equities of the situation. To allow Ferguson to collect the high penalties awarded by the court of civil appeals would be to allow the plaintiff a windfall because the parties bargained from equal positions of strength and were fully aware of the legal implications of their contract. The supreme court alluded to this result when, in discussing the adoption of spreading, it stated, "to do otherwise would be manifestly unfair and unjust under the law as it existed when the Ferguson-Tanner contract was executed."[88]

Regardless of the reason for the court's refusal to reduce the stated principal of the Ferguson contract, the distinction between real estate sales agreements and cash loans creates new opportunites for creative lenders to avoid the usury law.[89] For example, the promissory notes negotiated by the sellers of real property can subsequently be sold to commercial lenders, who will be delighted with the high effective yields produced by the notes. Thus, the *Tanner* holding encourages lenders and sellers to cooperate in exacting higher rates from consumers. In addition, such cooperation could involve the lender as an even more active participant. In order to extract a greater sum from the borrower, the lender can acquire the land himself and reconvey the land to the borrower in exchange for a promissory note and vendor's lien. Because the *Tanner* holding exempts the sales transaction from judicial reduction of the principal, the lender can include in the stated principal whatever fees or commissions he chooses. It is probable, however, that the courts will avoid such results. Under the established policy of considering, in a test for usury, all documents relating to the transaction, the court can conclude that the value of the property as established by the

87. Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777 (Tex. 1977).

88. *Id.* at 787.

89. If a banker made a cash loan enabling the borrower to purchase the property, the lender could legally charge only 10% of the true principal of the note times the number of years over which the payment is extended. However, if he exchanged the property and forebore on the payment of the value of the land in consideration for the stipulated interest, he could conceivably require the entire interest in advance. The conveyance distinction would seem to set this transaction apart from the established application of the usury law.

sale to the lender is the true principal and then judicially determine that any excess in the borrower's cost is interest.[90]

Nevertheless, the distinction between a cash loan and a sale creates two arbitrary classifications of loans, one that involves the use of money and one that involves the forebearance of the lender. The first type of loan will be subjected to the judicial determination of true principal, and the lender must be careful to keep his total charges within the legally permissible rate as applied against a reduced principal. The second type of loan will not be subject to judicial tampering and consequently the lender can receive a higher effective rate of return on the transaction. In *Tanner Development Co. v. Ferguson*[91] the court has wisely resolved the lingering ambiguity in case law concerning the spreading of early interest over the entire term of the loan; however, the court, by creating a vague distinction between sales agreements and cash loans, has created an even greater dilemma that serves no public policy.

Elizabeth Creson Sisco

90. See note 62 and accompanying text.
91. 561 S.W.2d 777 (Tex. 1977).