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Home Equity Lending in Texas: Are Loan Origination Fees Interest?

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HOME EQUITY LENDING IN TEXAS: ARE LOAN ORIGINATION FEES INTEREST?

I. INTRODUCTION

In 1997, the Texas Constitution was amended to allow Texas homeowners to obtain loans using the equity in their homesteads as collateral.[1] However, this constitutional amendment contains numerous

1. *See, e.g.*, TEX. CONST. art. XVI, § 50(a)(6) (amended 2003).

provisions that restrict the availability of these loans by placing limitations on both borrowers and lenders.[2] One such limitation is a restriction that limits fees, exclusive of interest, that can be charged to the borrower in a home equity transaction to three percent of the loan's original principal amount.[3]

The constitutional amendment did not define what constituted a fee for purposes of a home equity loan,[4] and this ambiguity has created much concern among lenders.[5] This Comment argues that a loan origination fee[6] charged by a lender in a home equity transaction should be considered interest and not a fee for purposes of the three percent fee limitation.[7] Part II of this Comment will discuss homestead protection in Texas and the 1997 constitutional amendment authorizing home equity lending. Specifically, Part II will discuss the three percent fee limitation, the forfeiture and cure provisions contained in the constitutional amendment, and the problems inherent in interpreting what constitutes a fee for purposes of the cap on fees. Part III will discuss the potential charges to a borrower in a hypothetical home equity transaction by defining and describing the varying lender and non-lender charges. Part IV will discuss how interest and fees have historically been defined under Texas law. Part V will discuss whether the legislature intended a different definition of interest and fees for

2. *See id.* §§ 50(a)(6)(A)–(Q) (amended 2003).

3. *Id.* § 50(a)(6)(E).

4. *See id.* § 50(a)(6) (amended 2003); *see also* Julia Patterson Forrester, *Home Equity Loans in Texas: Maintaining the Texas Tradition of Homestead Protection*, 55 SMU L. REV. 157, 171 (2002) (recognizing that the amendment does not identify which fees are included in the fee cap); Patton L. Zarate, Comment, *An Ailing System: Possible Solutions for Curing the Texas Home Equity Loan Amendment*, 31 ST. MARY'S L.J. 461, 487 (2000) (acknowledging that the constitutional amendment gives no direct guidance with regard to which fees are included in the fee cap).

5. The topic for this Comment was suggested by Karen M. Neeley, General Counsel for the Independent Bankers Association of Texas, and of counsel for the law firm of Long, Burner, Parks & DeLargy. Ms. Neeley indicated that there is much concern in the lending industry regarding what constitutes a fee for purposes of the cap on fees and specifically whether an origination fee charged by a lender falls within the three percent fee cap. *See* Zarate, *supra* note 4, at 511 (stating that "[t]he many risks associated with the [a]mendment is cause for great worry among Texas lenders"); Jack Hams, *Forging Ahead in the Brave New World of Home Equity Lending*, TEX. BANKING, Sept. 1998, at 32, 32–33 (indicating that "many lenders [were] taking, at best, a cautious approach to home equity lending," in part, because of the "lack of clarity in the law about exactly what is included in the definition of 'fees'").

6. A loan origination fee is a fee charged by the lender at the origination of the loan and is intended to compensate the lender up front for the expense associated with originating the loan. *See* J. Alton Alsup, *Pitfalls (And Pratfalls) of Texas Home Equity Lending*, 52 CONSUMER FIN. L.Q. REP. 437, 442 (1998) (indicating that "[l]enders typically attempt to recover their overhead and direct costs of loan origination through the charging of a so-called 'origination fee' at loan settlement"); Zarate, *supra* note 4, at 490 (indicating that an origination fee is "charged to cover expenses associated with making a loan").

7. *See* TEX. CONST. art. XVI, § 50(a)(6)(E) (setting forth the fee limitation without defining what constitutes a fee or providing a definitional reference).

purposes of the three percent cap on fees. Part V will also examine the language of the pertinent section of the constitutional amendment, applying the rules of statutory construction in Texas, and will discuss how Texas regulatory agencies interpret the amendment.

Part VI will discuss four recent judicial interpretations of the constitutional amendment relative to the classification of points and/or origination fees in Texas home equity transactions. Part VI will also discuss a recent decision by the Texas Supreme Court interpreting the cure provision contained in the constitutional amendment and its application to a violation of section 50(a)(6)(E). In addition, Part VI will provide a summary of recent home equity cases.

Part VII will discuss the relevant policy considerations in classifying interest and fees for purposes of home equity lending in Texas and lender options for dealing with the problem created by the uncertainty of whether a loan origination fee constitutes interest or a fee. Part VII will also discuss the 2003 amendment to the Texas Constitution on home equity lending, to the extent that the amendment addresses the problem of interpretation and the process by which a lender or note holder may cure a violation of the home equity law. Finally, Part VIII will summarize why loan origination fees should be considered interest and not fees for purposes of home equity lending in Texas.

II. THE ARRIVAL OF HOME EQUITY LOANS IN TEXAS

In 1997, Texas lawmakers proposed a constitutional amendment that, subject to voter approval, authorized home equity loans in Texas.[8] In November of that year, Texas voters approved the constitutional amendment,[9] effectively making Texas the final state in the union to authorize home equity lending.[10]

A. *Constitutional Protection of the Texas Homestead*

For over 150 years, the Texas Constitution has provided for the protection of Texas homeowners from the judgment liens of creditors.[11] In fact, prior to 1995 the only valid liens against a Texas homestead were those securing "debts for purchase money, improvements, or taxes."[12] In 1995, minor revisions were made to the Texas Constitution, including the allowance of a valid lien pursuant to a court order or written agreement in a divorce proceeding, but the constitution still did not allow Texas homeowners to obtain loans secured by the equity

8. *See* Tex. H.R.J. Res. 31, 75th Leg., R.S. (1997).

9. *See* TEX. CONST. art. XVI, § 50(a)(6) (amended 2003); Alsup, *supra* note 6, at 437 (indicating that the constitutional amendment was carried by nearly sixty percent of the popular vote).

10. *See* Forrester, *supra* note 4, at 158.

11. See, e.g., Alsup, *supra* note 6, at 437.

12. Forrester, *supra* note 4, at 159. *See* TEX. CONST. art XVI, § 50(a) (amended 1995).

in their homesteads.[13] Thus, with the passage of the 1997 constitutional amendment, home equity loans became available to Texas homeowners for the first time in Texas history.[14]

B. *The 1997 Constitutional Amendment*

The 1997 constitutional amendment authorizes certain voluntary liens on a Texas homestead.[15] These voluntary liens must be created by an agreement in writing with consent from the owner and the owner's spouse.[16] They may be foreclosed only by court order,[17] and the loan agreement cannot create personal liability for the borrower, absent fraud by the borrower in obtaining the credit.[18] Thus, the lender's only recourse in the event of default, absent fraud by the borrower, is to foreclose on the property.[19]

There are a number of lender restrictions and consumer protection provisions contained in the constitutional amendment.[20] Of these provisions and or restrictions, this Comment will focus on the three percent cap on fees and the forfeiture and cure provisions.[21] In addition, this Comment will discuss the problems inherent in interpreting the constitutional amendment.[22]

1. The Three Percent Cap on Fees

In accordance with the constitutional amendment, lenders cannot require the borrower "to pay, in addition to any interest, fees to any person that are necessary to originate, evaluate, maintain, record, insure, or service the extension of credit that exceed, in the aggregate, three percent of the original principal amount of the extension of credit."[23] Therefore, it becomes important to determine what constitutes a fee and what constitutes interest for purposes of home equity lending in Texas.[24] Should Texas lenders rely on the existing statutory definitions or regulatory interpretations for purposes of home equity lending?[25] Should they rely on the distinction between interest and

13. *See* TEX. CONST. art XVI, § 50(a) (amended 1995); Forrester, *supra* note 4, at 159 & n.13.
14. *See* Forrester, *supra* note 4, at 159.
15. TEX. CONST. art. XVI, § 50(a)(6)(A).
16. *Id.*
17. *Id.* § 50(a)(6)(D).
18. *Id.* § 50(a)(6)(C).
19. *See id.* §§ 50(a)(6)(C)–(D).
20. *See id.* §§ 50(a)(6)(A)–(Q) (amended 2003); Forrester, *supra* note 4, at 165 (noting that the amendment's requirements are mainly "measures designed to protect homeowners from unscrupulous lenders or from the consequences of a bad decision").
21. *See infra* Parts II.B.1–2.
22. *See infra* Parts II.B.3.
23. TEX. CONST. art. XVI, § 50(a)(6)(E).
24. *See* discussion *infra* Parts IV–VI.
25. *See* discussion *infra* Parts IV.A, V.B.

fees established by Texas case law in usury cases?[26] Did the legislature intend to treat the classification of interest and/or fees differently for purposes of home equity loans?[27]

2. The Forfeiture and Cure Provisions

The 1997 constitutional amendment called for the note's lender or holder to forfeit the loan's principal and interest if the lender or holder did not comply with its obligations in a home equity transaction and further failed to correct said violation within a reasonable period of time after notification by the borrower.[28] Assuming a lender can only obtain a valid lien on the homestead by strict compliance with the constitutional amendment,[29] may a lender who violated the fee cap still validate its lien by correcting the violation within a reasonable period of time after notification?[30]

3. The Problem of Interpretation

The constitutional amendment authorizing home equity loans leaves Texas lenders and borrowers with many questions.[31] Unfortunately, the constitutional amendment did not contain a section providing definitions of the terms used in the amendment.[32] Further, the amendment did not delegate interpretative authority to any legislative

26. *See* discussion *infra* Part IV.B.

27. *See* discussion *infra* Part V.A.

28. TEX. CONST. art. XVI, § 50(a)(6)(Q)(x) (amended 2003). Section 50(a)(6)(Q)(x) was amended in 2003 to provide a process under which certain violations of the Texas home equity law may be cured; the reasonable time requirement was stricken and replaced with a requirement that the lender or note holder correct the violation within sixty days after notification by the borrower. *See infra* Part VII.C.

29. *See id.* § 50(c).

30. *See* discussion *infra* Part VI.B; TEX. CONST. art XVI, § 50(a)(6)(Q)(x) (amended 2003) (indicating that a lender can cure a violation by correcting said violation within a reasonable time after notification by the borrower without providing whether said cure will validate the lien).

31. There are a number of legal articles or comments which discuss the issues raised by the constitutional amendment authorizing home equity lending including the following: Alsup, *supra* note 6, at 441–70; Charles C. Boettcher, Comment, *Taking Texas Home Equity for a Walk, but Keeping it on a Short Leash!*, 30 TEX. TECH L. REV. 197, 233–58 (1999); Forrester, *supra* note 4, at 169–73; Mark D. Morris, *Implementing a Texas Home Equity Lending Program—Documentation and Operational Issues*, 52 CONSUMER FIN. L.Q. REP. 471, 471–82 (1998); Michael K. O'Neal, *Update on Texas Home Equity Lending*, 56 CONSUMER FIN. L.Q. REP. 117, 117–25 (2002); Zarate, *supra* note 4, at 484–507; Hams, *supra* note 5, at 32–33.

32. *See* TEX. CONST. art. XVI, § 50(a)(6) (amended 2003).

or regulatory body.[33] Thus, barring legislative action to amend the constitution, the issue of interpretation was left to the courts.[34]

Acknowledging the problem of interpretation created by "[t]he fact that most of the provisions regarding implementation of home equity lending reside in the constitution," the Office of Consumer Credit Commissioner, in conjunction with the Department of Banking, the Savings and Loan Department, and the Credit Union Department, issued the Regulatory Commentary on Equity Lending Procedures.[35] The Commentary represents the opinions of the four state agencies that regulate the entities making home equity loans in Texas.[36] The stated purpose of the Commentary is to "provide guidance to lenders and consumers concerning the regulatory views of the meaning and effect" of the constitutional amendment authorizing home equity lending.[37] Although the Commentary specifically states that the views expressed in the Commentary will be used to assess compliance with the requirements of the amendment in both examination and enforcement situations, the issuing agencies acknowledge that the courts may choose not to defer to the Commentary's interpretations in resolving disputes between borrowers and lenders.[38] Even so, the Commentary is presently "the most significant statement"[39] of how state regulators are interpreting the new home equity law.[40] Further, because the Texas Supreme Court cited the Commentary in its evaluation of the issues raised in *Stringer v. Cendant Mortgage Corp.*,[41] it is likely "entitled to some weight as persuasive authority."[42]

III. Potential Charges in a Home Equity Transaction[43]

In a typical home equity transaction, the borrower may be required to pay certain fees, in addition to interest, that are associated with the

33. *See id.*; *see also* Boettcher, *supra* note 31, at 222 (indicating that one problem with the amendment is that the legislature did not pass enabling legislation which would have allowed for a regulatory agency to interpret the amendment's provisions); Zarate, *supra* note 4, at 501 (indicating that the legislature granted no regulatory authority to any state agency over home equity lending).

34. *See* Zarate, *supra* note 4, at 504. In 2003, Texas lawmakers addressed the issue of interpretation during the regular session of the 78th legislature. *See infra* Part VII.C.

35. Office of Consumer Credit Comm'r, Regulatory Commentary on Equity Lending Procedures 1 (1998) [hereinafter Commentary].

36. *See id.*

37. *Id.*

38. *See id.*

39. O'Neal, *supra* note 31, at 119.

40. *Id.*

41. 23 S.W.3d 353 (Tex. 2000).

42. O'Neal, *supra* note 31, at 120; *see also Stringer*, 23 S.W.3d at 357 (citing to the Commentary).

43. The author has over twenty-three years experience in the banking business and is familiar with the varying lender and non-lender charges associated with residential real estate transactions.

origination of the loan.[44] Because the constitutional amendment authorizing home equity loans limits the fees, exclusive of interest, "necessary to originate, evaluate, maintain, record, insure, or service the extension of credit,"[45] to three percent of the loan's original principal amount,[46] an understanding of the basis for each charge[47] is necessary in order to determine what constitutes a fee versus what may be properly classified as interest.[48] To assist in that determination, this section will distinguish between those charges retained by the lender[49] and those paid to third parties.[50]

A. *Lender Charges*

Lender charges are the fees and interest amounts retained by the lender in connection with the transaction.[51] They can take varying forms, but common lender charges include discount points, origination fees, commitment fees, underwriting fees, credit report fees, and interest.[52]

1. Discount Points

Discount points are a percentage of the loan paid up front by the borrower and are typically associated with a buy-down of the interest rate.[53] For example, a lender might offer its customers varying interest rate options depending upon the amount of discount points the borrower is willing to pay upon closing of the loan.[54] The following chart represents a hypothetical example of how discount points can be used to buy-down the contract interest rate on a $50,000 home equity loan with a term of fifteen years:

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44. *See, e.g.*, COMMENTARY, *supra* note 35, at 3–4.
45. TEX. CONST. art. XVI, § 50(a)(6)(E).
46. *Id.*
47. *See* discussion *infra* Part III.A–B.
48. *See* discussion *infra* Parts IV–VI.
49. *See* discussion *infra* Part III.A.
50. *See* discussion *infra* Part III.B.
51. *See* Alsup, *supra* note 6, at 442 (discussing several charges retained by the lender).
52. *See* COMMENTARY, *supra* note 35, at 3–5 (describing several charges incidental to a real estate transaction); Alsup, *supra* note 6, at 442 (discussing several types of lender charges used to recoup the cost of originating the loan, including itemized charges for specific services rendered).
53. *See* Alsup, *supra* note 6, at 445; Morris, *supra* note 31, at 474; Zarate, *supra* note 4, at 488.
54. *See* Zarate *supra* note 4, at 488 (indicating that "many borrowers elect to lower the interest rate over the life of their loan" by the payment of points at closing).

	Option "A"	Option "B"	Option "C"
1. Contract Rate on Loan[55]	8.50%	8.00%	7.50%
2. Discount Points Paid Up-Front	0	1	2
3. Monthly Payment Amount[56]	$492.37	$477.83	$463.51
4. Corresponding APR[57]	8.50%	8.17%	7.83%

In this hypothetical, the borrower can obtain a fifteen-year loan at eight and one-half percent or he can choose to pay one percent of the loan amount up front and receive an eight percent rate on the loan. This means that the borrower pays $500 up front to obtain the lower rate for the life of the loan.[58] For Federal Truth in Lending purposes, a discount point is considered a prepaid finance charge,[59] and the amount of the fee is subtracted from the principal amount of the loan and added to the finance charge to determine the annual percentage rate paid by the borrower.[60] If the borrower wishes to have an even lower rate on the home equity loan, choosing Option "C" would require payment of discount points totaling two percent of the loan amount. In this case, the borrower would pay $1,000 to buy a seven and one-half percent rate for fifteen years.[61]

2. Origination Fees

A loan origination fee is calculated the same way as a discount point.[62] An origination fee is a percentage of the original principal amount of the loan charged to the borrower at the origination of the loan.[63] Most lenders charge origination fees to cover their up-front cost associated with making a loan.[64] For Federal Truth in Lending purposes, an origination fee is treated exactly like a discount point

55. *See* Alsup, *supra* note 6, at 444. The nominal contract or note rate of interest does not take into account "all other charges by the lender in connection with the loan that constitute interest" under Texas law. *Id.*

56. Notice that there is a corresponding reduction in the monthly payment amount as the rate is reduced. Thus, in Option "C" the borrower would pay $1,000 up front in discount points and have monthly payments $28.86 lower than if the borrower had paid no discount points. The actual payment amount could vary slightly from those used in this hypothetical depending on the method of calculation.

57. The Annual Percentage Rate or APR is defined as "a measure of the cost of credit, expressed as a yearly rate." 12 C.F.R. § 226.22(a)(1) (2003). This hypothetical assumes one month to the first payment and that there are no other charges affecting the APR.

58. $50,000*1%=$500.

59. *See* 12 C.F.R. §§ 226.2(a)(23), .4(a), .4(b)(3) (2003).

60. *See* 12 C.F.R. §§ 226.18(b), .22(a) (2003).

61. $50,000*2%=$1,000.

62. *See* Morris, *supra* note 31, at 474 (indicating that points refer to both origination fees and discount points); Alsup, *supra* note 6, at 445 (discussing an origination fee in terms of a percentage of the loan amount); Zarate, *supra* note 4, at 490 (describing an origination fee in terms of a percentage of the loan amount).

63. *See* Morris, *supra* note 31, at 474.

64. *See* Alsup, *supra* note 6, at 442; Zarate, *supra* note 4, at 490.

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because the amount of the fee is subtracted from the loan amount and added to the interest charge to determine the annual percentage rate paid by the borrower.[65] Thus, under our hypothetical, a one percent loan origination fee would equate to $500 paid by the borrower at the origination of the loan.[66] In the hypothetical above, if the lender customarily charged a one percent loan origination fee in addition to the contract interest rate on all its home equity loans, then the borrower would pay this charge regardless of the loan rate structure chosen.[67] Likewise, the lender might offer home equity loans without a loan origination fee. In this scenario, the lenders would likely factor the cost of originating these loans into the interest rates they charge on their loans so as to recover their up-front cost over the life of the loan.

3. Other Potential Lender Charges

In addition, there are other charges that may be assessed by lenders in residential real estate transactions which may or may not be charged to home equity borrowers.[68] For example, a lender might charge a commitment fee, an underwriting fee, or a credit report fee in conjunction with the origination of the loan.[69] Commitment fees are generally paid to the lender for a commitment to make a loan at a future date.[70] Underwriting fees are fees charged by some lenders to analyze the borrower's credit and capacity to repay the loan.[71] Underwriting fees are typically paid up-front at the time of application or upon the closing of the loan.[72] The credit report fee is generally charged by the lender to offset the lender's cost in obtaining the borrower's credit report.[73]

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65. *See* 12 C.F.R. §§ 226.4(a), .4(b)(3), .18(b), .22(a) (2003).

66. $50,000*1%=$500.

67. *See* Alsup, *supra* note 6, at 445 (suggesting that the payment of an origination fee does not reduce the interest rate).

68. *See* COMMENTARY, *supra* note 35, at 3–5 (describing some of the possible fees in addition to interest and indicating that there is no prohibition against the lender absorbing some of the fees). There are also statutory limitations on the types of fees that can be charged in connection with a secondary mortgage loan where the interest rate on the loan exceeds ten percent. *See* TEX. FIN. CODE ANN. §§ 342.002, .004–.005, .307–.308, .502 (Vernon Supp. 2003); COMMENTARY, *supra* note 35, at 4–5 (indicating that in addition to the limitation on fees contained in the constitutional amendment, "secondary mortgage loans" are also subject to a limitation on the "types of fees that may be charged").

69. *See* Alsup, *supra* note 6, at 442 (indicating that the lender may charge itemized fees for specific services rendered); *supra* note 68.

70. A commitment fee is defined as "[a]n amount paid to a lender by a potential borrower for the lender's promise to lend money at a stipulated rate and within a specified time." BLACK'S LAW DICTIONARY 266 (7th ed. 1999).

71. *See Home Equity Loan Information: A Consumer Guide to Home Equity Loans, at* http://www.home-equity-loan-information.com/home-equity-costs.html (last visited July 2, 2003) (on file with the Texas Wesleyan Law Review).

72. *See id.*

73. *See* COMMENTARY, *supra* note 35, at 3.

B. *Non-Lender Charges*

In addition to the charges imposed by the lender, there are expenses incidental to the origination of a home equity loan that are paid to third parties.[74] Examples include: 1) appraisal fees to third-party appraisal companies for determining the value of the property; 2) title insurance to protect the lender in the event there is a title defect; 3) attorney's fees for preparing the loan documentation; 4) filing fees; 5) escrow fees to the title company for acting as the escrow agent in the transaction; 6) courier fees; 7) survey fees; 8) broker's fees; and 9) flood zone fees for evaluating and monitoring whether the property lies in a flood zone.[75] These fees may or may not be incurred in any given transaction and may or may not be charged to the borrower depending on the circumstances.[76]

IV. Defining Interest and Fees Under Texas Law

A. *Texas Statutes and Regulations*

Interest is defined in the Texas Finance Code as "compensation for the use, forbearance, or detention of money."[77] The Texas Administrative Code defines prepaid interest as "[i]nterest paid separately in cash or by check before or at consummation in a transaction, or withheld from the proceeds of the credit at any time."[78] The code further indicates that terms including points, discounts, and origination fees are often used to identify prepaid interest.[79] For purposes of charges on secondary mortgage loans, the Texas Administrative Code provides that a lender may charge "[p]repaid interest in the form of points, such as origination or discount points . . . so long as the total amount of interest contracted for, charged, or received, when spread over the full term of the loan . . . does not exceed the applicable interest limit" provided for by Texas law.[80] Thus, it would appear that Texas, by statute and by regulation, classifies points and loan origination fees as interest rather than fees.[81]

B. *Texas Case Law in Usury Cases*

In determining what constitutes "compensation for the use, forbearance, or detention of money,"[82] Texas courts have historically treated fees retained by the lender as interest for purposes of the state's usury

74. *See, e.g., id.* at 3–4.
75. *See id.*
76. *See supra* note 35.
77. Tex. Fin. Code Ann. § 301.002(a)(4) (Vernon Supp. 2003).
78. 7 Tex. Admin. Code § 1.102(20) (West 2003) (Fin. Comm'n of Tex., Consumer Credit Regulation).
79. *Id.*
80. 7 Tex. Admin. Code § 1.701(b).
81. *See supra* text accompanying notes 77–80.
82. Tex. Fin. Code Ann. § 301.002(a)(4) (defining "interest").

laws, except where the charge "entitle[s] the borrower to a distinctly separate and additional consideration apart from the lending of money."[83]

In *Texas Commerce Bank-Arlington v. Goldring*,[84] the Texas Supreme Court considered a case where a borrower sued a bank for usury because the bank required him to pay, in addition to interest, attorney's fees incurred by the bank in the collection of the note and incurred in defending the borrowers' title in the property pledged as collateral.[85] The court stated that a charge which "entitle[s] the borrower to a distinctly separate and additional consideration apart from the lending of money" was not interest and could not form the basis of usury.[86] The court held that the services performed by the attorneys did not constitute interest as it was "consideration in addition to the simple lending of money."[87]

In *Stedman v. Georgetown Savings & Loan Ass'n*,[88] the Texas Supreme Court considered a case where the plaintiff paid the lender a commitment fee for an option to obtain a permanent loan.[89] After obtaining the permanent loan, the plaintiff sued the lender claiming the commitment fee when combined with interest on the note constituted usury.[90] The court stated that to constitute usury "'there must be an overcharge by [the] lender for the use and detention of the lender's money.'"[91] Holding that the commitment fee charged did not constitute interest, the court stated that a bona fide commitment fee does not constitute interest because the fee purchases an option which binds the lender to make a loan in the future, and thus "'entitles the borrower to a distinctly separate and additional consideration apart from the lending of money.'"[92]

83. Tex. Commerce Bank-Arlington v. Goldring, 665 S.W.2d 103, 104 (Tex. 1984); *see also* Stedman v. Georgetown Sav. & Loan Ass'n, 595 S.W.2d 486, 488 (Tex. 1979); Gonzales County Sav. & Loan Ass'n v. Freeman, 534 S.W.2d 903, 906 (Tex. 1976) (citing Greever v. Persky, 140 Tex. 64, 165 S.W.2d 709, 712); *Greever*, 140 Tex. 64, 165 S.W.2d at 712 (originating the test to determine whether a charge constitutes a fee or interest in usury cases: whether the charge gives the borrower separate consideration apart from the loan itself); Walker v. Ross, 548 S.W.2d 447, 450 (Tex. Civ. App.—Fort Worth 1977) (per curiam), *writ ref'd n.r.e.*, 554 S.W.2d 189 (Tex. 1977) (indicating that a fee charged by a lender is interest unless it is a valid charge other than "for the use, forbearance or detention of money"); Terry v. Teachworth, 431 S.W.2d 918, 925 (Tex. Civ. App.—Houston [14th Dist.] 1968, writ ref'd n.r.e.(quoting *Greever*, 140 Tex. 64, 165 S.W.2d at 712).

84. 665 S.W.2d 103.

85. *Id.* at 104.

86. *Id.*

87. *Id.*

88. 595 S.W.2d 486 (Tex. 1979).

89. *Id.* at 487.

90. *See id.*

91. *Id.* at 488 (quoting Crow v. Home Sav. Ass'n of Dallas County, 522 S.W.2d 457 (Tex. 1975)).

92. *Id.* (quoting Gonzales County Sav. & Loan Ass'n v. Freeman, 534 S.W.2d 903, 906 (Tex. 1976)).

In *Gonzales County Savings & Loan Ass'n v. Freeman*,[93] the Texas Supreme Court considered a case where the lenders charged a two percent loan fee to the borrowers in conjunction with the closing of a $38,400 loan to construct two homes for resale.[94] The borrowers sued the lender claiming that the loan fee constituted interest and rendered their loan usurious.[95] The lender claimed that the fee was consideration for making available a permanent loan to the Freemans in the future.[96] However, the lender also testified that the loan fee was intended to compensate the lending company for expenses associated with negotiating the loan.[97] The trial court granted summary judgment in favor of the lender, but the appeals court reversed.[98] While affirming the appellate court's judgment,[99] the supreme court addressed the issue of what constitutes interest under Texas law.[100] The court stated that "[a] charge which is in fact compensation for the use, forbearance or detention of money is, by definition, interest regardless of the label placed upon it by the lender."[101] However, the court further stated that "a fee which commits the lender to make a loan at some future date does not fall within this definition"[102] because the fee "entitles the borrower to a distinctly separate and additional consideration apart from the lending of money."[103] The court noted that the loan fees at issue were listed on the settlement statement as an expense associated with the $38,400 loan.[104] Finding that the lender failed to establish the fee's true nature, the court affirmed the court of civil appeal's judgment.[105]

In *Terry v. Teachworth*,[106] the Houston Court of Civil Appeals considered a case where the lender charged the borrower an origination fee of $7,125 and a fee for other extraordinary services of $15,000, in addition to interest on the loan.[107] The borrower brought suit against the lender claiming that the loan was usurious.[108] The lender argued that the extraordinary services fee was for "distinct services rendered in the nature of cost and disbursement control and construction supervision."[109] The appellate court upheld the trial court's ruling that such

93. 534 S.W.2d 903 (Tex. 1976).
94. *Id.* at 905.
95. *Id.*
96. *Id.* at 905–06.
97. *Id.* at 908.
98. *Id.* at 905.
99. *Id.* at 909.
100. *See id.*
101. *Id.* at 906.
102. *Id.*
103. *Id.*
104. *Id.* at 909.
105. *Id.* at 908–09.
106. 431 S.W.2d 918 (Tex. Civ. App.—Houston [14th Dist.] 1968, writ ref'd n.r.e.).
107. *See id.* at 924.
108. *Id.* at 919–20.
109. *Id.* at 923.

amounts constituted interest and rendered the loan usurious.[110] In its analysis, the court relied on precedent stating, "[A] lender may, without violating the usury law, make an extra charge for any distinctly separate and additional consideration."[111] Further, the court stated that whether a charge was in fact "'distinctly separate and additional consideration'" was a fact question for a jury[112] and finding no reversible error in the case, the court upheld the lower court's holding that the loan was usurious.[113]

In *Walker v. Ross*,[114] the Fort Worth Court of Civil Appeals considered a case where the borrower executed a note to the lender for $55,000 and only received $50,000 in loan proceeds.[115] The borrower claimed that under the terms of the loan, the lender would borrow the money from a bank and the borrower would pay an additional $5,000 plus the interest that the bank charged the lender.[116] The lender claimed he charged the additional $5,000 for promotional work he did for the borrower, for the loss he took in a real estate venture in which the parties were involved, and for his services in obtaining a loan from the bank.[117] The trial court entered judgment for the lender finding the charge was not interest.[118] The appellate court reversed and remanded the case,[119] holding that the fee charged by the lender was interest because it was "for the use and detention of money."[120] The court stated, "that where the face amount of the loan is greater than the amount actually advanced, the principal upon which the lender may charge interest is the amount advanced, and the difference (where there are no valid charges) is considered prepayment of interest."[121] In deciding the case, the court further distinguished between a fee charged by a broker, who arranges a loan by bringing the parties together, and a fee charged by a lender.[122] While the fee charged by the broker for obtaining a loan is not interest, the fee charged by the lender is interest, because it "is compensation for the use, forbearance, or detention of money."[123]

Thus, the current test for determining whether a charge constitutes a fee or interest in usury cases is whether the charge "entitle[s] the

110. *Id.* at 924.
111. *Id.* at 925 (quoting Greever v. Persky, 140 Tex. 64, 165 S.W.2d 709, 712 (1942).
112. *Id.* (quoting *Greever*, 165 S.W.2d at 712).
113. *Id.* at 927.
114. 548 S.W.2d 447 (Tex. Civ. App.—Fort Worth 1977, writ ref'd n.r.e.) (per curiam).
115. *See id.*
116. *Id.* at 449.
117. *Id.*
118. *See id.* at 448.
119. *Id.*
120. *Id.* at 452.
121. *Id.* at 450.
122. *See id.*
123. *Id.*

borrower to a distinctly separate and additional consideration apart from the lending of money."[124] If the borrower receives consideration separate and apart from the lending of the money, then it is a fee.[125] If not separate and apart, then it is interest.[126] If this rule is applied to home equity loans, loan origination fees would likely be considered interest under Texas law[127] because they represent compensation to the lender in connection with the lending of money, and the borrower receives no additional consideration.[128]

V. Interpreting the Constitutional Amendment—Did the Texas Legislature Intend a Different Definition of Interest and Fees for Purposes of the Three Percent Cap on Fees?

A. *The Rules of Statutory Construction or the Plain Meaning Doctrine*

In interpreting the constitution, Texas courts "rely heavily on its literal text and must give effect to its plain language."[129] They "strive to give constitutional provisions the effect their makers and adopters intended"[130] and to "avoid a[ny] construction that renders any provision meaningless or inoperative."[131] Further, "[i]n construing a constitutional amendment, [the courts] may also consider its legislative history."[132]

The issue is whether a loan origination fee, charged by a lender in a home equity transaction, is properly classified as interest or as a fee for purposes of the three percent cap on fees.[133] The relevant part of the Texas Constitution states,

> The homestead of a family, or of a single adult person, shall be, and is hereby protected from forced sale, for the payment of all debts except for: . . . an extension of credit that: . . . does not require the owner or the owner's spouse to pay, in addition to interest, fees to any person that are necessary to originate, evaluate, maintain, record, insure, or service the extension of credit that exceed, in the

124. *See supra* note 83.
125. *Id.*
126. *Id.*
127. *See supra* notes 82–123 and accompanying text.
128. *See* Alsup, *supra* note 6, at 442 (indicating that "[l]enders typically attempt to recover their overhead and direct costs of loan origination through the charging of a so-called 'origination fee' at loan settlement"); Zarate, *supra* note 4, at 490 (indicating that an origination fee is "charged to cover expenses associated with making a loan").
129. Stringer v. Cendant Mortgage Corp., 23 S.W.3d 353, 355 (Tex. 2000).
130. *Id.*
131. *Id.*
132. *Id.*
133. *See* Tex. Const. art. XVI, § 50(a)(6)(E) (providing for a three percent cap on fees, exclusive of interest, without defining what constitutes interest or a fee).

aggregate, three percent of the original principal amount of the extension of credit . . . .[134]

To determine the proper classification of a loan origination fee, one must first determine what constitutes interest and what constitutes a fee required to originate a loan.[135] Using the dictionary to define interest[136] and fee,[137] these definitions support the argument that a loan origination fee[138] should be considered a fee and not interest for purposes of a home equity loan, because a loan origination fee is a charge to originate a loan.[139]

Yet, as previously discussed, Texas defines interest by statute as "compensation [allowed by law] for the use, forbearance, or detention of money."[140] Further, the Texas courts have historically considered fees retained by the lender as interest for purposes of the state's usury laws, except where the fee "entitle[s] the borrower to a distinctly separate and additional consideration apart from the lending of money."[141] So, what was the Texas legislature's intent when it adopted the three percent fee limitation contained in the constitutional amendment?[142]

The legislative history reveals that there were three competing constitutional amendments authorizing home equity loans presented to the House Committee on Financial Institutions during the 75th legislative session.[143] The three amendments presented were H.J.R. 70 by Representative Danburg,[144] H.J.R. 31 by Representative Patterson,[145]

134. *Id.*

135. *Id.* (providing for a three percent cap on fees, without defining interest or fee).

136. The dictionary defines interest as "[t]he compensation fixed by agreement or allowed by law for the use or detention of money." BLACK'S LAW DICTIONARY 816 (7th ed. 1999).

137. The dictionary defines a fee as "[a] charge for labor or services." BLACK'S LAW DICTIONARY 629 (7th ed. 1999).

138. The dictionary defines a loan origination fee as "[a] fee charged by a lender for preparing and processing a loan." BLACK'S LAW DICTIONARY 629 (7th ed. 1999).

139. Zarate, *supra* note 4, at 490 (indicating that an origination fee is "charged to cover expenses associated with making a loan").

140. TEX. FIN. CODE ANN. § 301.002(a)(4) (Vernon Supp. 2003).

141. *See supra* note 83.

142. *See infra* text accompanying notes 143–67.

143. *See* Audio tape: *Proposing a Constitutional Amendment Authorizing a Voluntary, Consensual Encumbrance on Homestead Property for the Purpose of an Equity Loan: Hearings on Tex. H.R.J. Res. 70 Before the House Comm. on Fin. Inst.*, 75th Leg., R.S., Tape 1, Side A, B (March 24, 1997) (on file with the Texas Wesleyan Law Review); Audio tape: *Proposing a Constitutional Amendment Permitting an Encumbrance Against Homestead Property for Certain Extensions of Equity Credit: Hearings on Tex. H.R.J. Res. 31 Before the House Comm. on Fin. Inst.*, 75th Leg., R.S., Tape 1, Side A, B (March 24, 1997) (on file with the Texas Wesleyan Law Review); Audio tape: *Proposing a Constitutional Amendment Authorizing a Voluntary Consensual Encumbrance on Homestead Property for the Purpose of an Equity Loan: Hearings on Tex. H.R.J. Res. 44 Before the House Comm. on Fin. Inst.*, 75th Leg., R.S. Tape 1, Side A, B (March 24, 1997) (on file with the Texas Wesleyan Law Review).

144. *Hearings on Tex. H.R.J. Res. 70*, *supra* note 143.

145. *Hearings on Tex. H.R.J. Res. 31*, *supra* note 143.

and H.J.R. 44 by Representative Wolens.[146] Of the three amendments presented, only Representative Wolens's amendment initially contained a limitation on the fees that could be charged by lenders making home equity loans.[147] In presenting H.J.R. 44, Representative Wolens discussed the fee limitation included in his amendment, explaining that a lender could not charge a fee of more than three percent on a first lien note or five percent on a second lien note.[148] In explaining what constituted a fee for purposes of the cap, Representative Wolens specifically included origination fees in the list of fees subject to the cap.[149] H.J.R. 44 was left pending in committee,[150] but Representative Wolens's inclusion of origination fees in his description of those charges subject to a cap on fees[151] suggests that at least Representative Wolens considered a loan origination fee to be a fee and not interest.[152]

This is especially important because Representative Wolens would later include a three percent cap on fees as part of an amendment to Representative Patterson's Bill, H.J.R. 31, when it was debated on the house floor.[153] Representative Wolens offered what he described as the ten commandments as an amendment to Representative Patterson's constitutional amendment.[154] Included in the ten commandments was the three percent cap on fees, although the record is devoid of any debate or discussion at that time as to what constituted a fee for purposes of the cap.[155] Ultimately, Representative Wolens three percent cap on fees was adopted as an amendment to H.J.R. 31.[156]

Likewise, it appears that at least one member of the Senate thought that it was possible for some fees to be interest.[157] This inference may be drawn from the response of Senator Jerry Patterson to a list of concerns contained in a letter from the "AARP" read by Senator Moncrief.[158] When asked if H.J.R. 31 provided for "reasonable limits on interest rates and fees" on home equity loans, Senator Patterson

146. *Hearings on Tex. H.R.J. Res. 44*, *supra* note 143.

147. *Compare* Tex. H.R.J. Res. 70, 75th Leg., R.S. (1997), *and* Tex. H.R.J. Res. 31, 75th Leg., R.S. (1997), *with* Tex. H.R.J. Res. 44, 75th Leg., R.S. (1997).

148. *Hearings on Tex. H.R.J. Res. 44*, *supra* note 143.

149. *Id.*

150. Tex. H.R.J. Res. 44, 75th Leg., R.S. (1997).

151. *Hearings on Tex. H.R.J. Res. 44*, *supra* note 143.

152. *See id.*

153. Audio tape: *Proposing a Constitutional Amendment Permitting an Encumbrance Against Homestead Property for Certain Extensions of Equity Credit: Hearings on Tex. H.R.J. Res. 31 Before the House Comm. on Fin. Inst.*, 75th Leg., R.S., Tape 4, Side B (May 9, 1997) (on file with the Texas Wesleyan Law Review).

154. *Id.*

155. *Id.*

156. *See* Tex. H.R.J. Res. 31, 75th Leg., R.S. (1997); *Hearings on Tex. H.R.J. Res. 31*, *supra* note 143.

157. *See infra* notes 158–63 and accompanying text.

158. Audio tape: *Proposing a Constitutional Amendment Permitting an Encumbrance Against Homestead Property for Certain Extensions of Equity Credit: Hearings*

replied that they were "limited by the current banking statutes in Texas" and that he believed that limit was "currently about eighteen-percent by law."[159] This would suggest that Representative Patterson believed that at least some fees are subject to the state's interest rate ceilings and thus considered interest.[160] Next, when asked if H.J.R. 31 provided for "fair terms for home equity loans, prohibiting unfair fees and loan provisions," Senator Patterson replied that there was a three percent cap.[161] This would suggest that he believed that some fees were subject to the three percent cap on fees.[162] Taken together, these two statements suggest that Senator Patterson realized that some fees might be considered interest under Texas law and thus subject to the usury ceiling while other fees would fall within the three percent cap on fees.[163]

Was the legislature aware of the statutory definition of interest under Texas law, as well as the courts treatment of fees retained by lenders in Texas usury cases?[164] If the legislature intended a different treatment in the classification of fees for purposes of home equity lending, it could have explicitly stated so in the constitutional amendment either by defining interest and fees, or by excluding lender charged fees from the provision which excludes interest from the cap on fees.[165] The legislature's failure to do so suggests that the legislature did not intend a different interpretation of interest and fees for purposes of the three percent cap on fees.[166]

Finally, absent a clear showing of legislative intent to the contrary, "statutes are presumed to be enacted by the legislature with full knowledge of the existing condition of the law."[167] Is there any reason why this rule would not apply to the legislature's passage of a proposed constitutional amendment? If, in passing a constitutional amendment, the legislature is also presumed to have knowledge of the current status of the law, does the legislature's silence on this issue suggest that the legislature intended for current law to control?[168]

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on Tex. H.R.J. Res. 31 Before the House Comm. on Fin. Inst., 75th Leg., R.S., Tape 4, Side B (May 24, 1997) (on file with the Texas Wesleyan Law Review).

159. *Id.*

160. *See id.*

161. *Id.*

162. *See id.*

163. *See id.*

164. *See* discussion *supra* Part IV.

165. *See* TEX. CONST. art. XVI, § 50(a)(6) (amended 2003) (setting forth a fee limitation, exclusive of interest, without defining what constitutes interest or a fee anywhere in the constitutional amendment).

166. *See supra* notes 129–64.

167. *E.g.*, Allen Sales & Servicenter, Inc. v. Ryan, 525 S.W.2d 863, 866 (Tex. 1975).

168. *See supra* notes 129–65.

B. *The Regulatory Commentary on Equity Lending Procedures*[169]

Shortly after the voters approved the constitutional amendment authorizing home equity lending in Texas, the Office of Consumer Credit Commissioner, in conjunction with the Department of Banking, the Savings and Loan Department, and the Credit Union Department, issued the *Regulatory Commentary on Equity Lending Procedures*.[170] The Commentary specifically addresses the three percent fee limitation issue and classifies fees and interest into eight categories[171] including: (1) interest and fees; (2) voluntary optional fees; (3) fees to originate; (4) fees to evaluate; (5) fees to maintain; (6) fees to record; (7) fees to insure; and (8) fees to service.[172]

The Commentary notes that interest is excluded from the three percent cap on fees and states "'interest' means interest as defined in the *Texas Credit Title* and as interpreted by the courts of the state of Texas."[173] The Commentary further states "charges that constitute interest under the law, including, for example, points, are not fees subject to the three percent limit."[174]

In discussing fees to originate an equity loan, the Commentary states that "[f]ees to originate an equity loan that are not interest fall within the three percent limitation."[175] Thus, it creates the presumption that there could be origination fees that fall outside the three percent cap on fees.[176] It describes the fees subject to the cap as those paid "to third parties for separate and additional consideration for activities relating to originating a loan."[177] The Commentary suggests that attorney's fees for document preparation are fees that fall within the limitation.[178] Read together, these two sections of the Commentary suggest that certain loan origination fees charged by a lender, and historically considered interest under Texas law, would fall outside the definition of a fee for purposes of the three percent cap on fees.[179]

169. COMMENTARY, *supra* note 35.
170. *Id.* at 1–2.
171. *Id.* at 3–4.
172. *See id.*
173. *Id.* at 3.
174. *Id.*
175. *Id.*
176. *See id.*
177. *Id.*
178. *Id.*
179. *See id.*

VI. THE HOME EQUITY CASES

A. *Judicial Application of the Three Percent Cap on Fees to Lender Charges*

In *Tarver v. Sebring Capital Credit Corp.*,[180] the Waco Court of Appeals considered a case where the lender charged the borrower $3,384 in points and $1,692 in the form of an origination fee paid to Mortgage Plus (as compensation for work it did on the loan), while all other costs of closing the loan were paid by the lender.[181] These two charges totaled four and one-half percent of the principal amount of the loan.[182] The Tarvers filed suit, claiming, in part, that the lender's points violated the three percent cap on fees contained in section 50(a)(6)(E) and that as a result of the overcharge the loan should be discharged and the lien invalidated.[183] The plaintiffs argued that the lender's points were an additional charge[184] paid in "consideration of lowering the interest rate, not in exchange for making the loan."[185] They argued that this separate additional charge constituted a fee under the current rule of law in Texas.[186] The court responded that "points are calculated as a percentage of the principal," just like interest, the difference being that points are collected up front and interest is collected over the life of the loan.[187] The court considered the statutory definition of interest in Texas, the Texas Administrative Code, and the Regulatory Commentary on Equity Lending Procedures before concluding that points constitute interest under Texas law.[188] The court further held that "'points' as defined herein are 'interest,' not 'fees,' under section 50(a)(6)(E) of the Texas Constitution."[189] Not at issue and thus not addressed by the court in *Tarver* was whether the lender's origination fee constituted interest or a fee for purposes of the three percent cap on fees.[190]

What is important to note is that this court, in interpreting the plain meaning of the constitutional amendment, chose to look to Texas law in interpreting the amendment's plain meaning.[191] The court stated that: "[b]y the plain language of the [constitutional] provision, as interpreted by reference to Texas statutes and administrative regulations, we conclude that points are not 'fees' under subsection 'E,'

180. 69 S.W.3d 708 (Tex. App.—Waco 2002, no pet.).
181. *Id.* at 709–10.
182. *Id.* at 710.
183. *Id.*
184. *Id.* at 711 (quoting First Bank v. Tony's Tortilla Factory, 877 S.W.2d 285, 287 (Tex. 1994)).
185. *Id.*
186. *See id.*
187. *Id.* at 711.
188. *Id.* at 712.
189. *Id.* at 713.
190. *See id.* at 710.
191. *See id.* at 712.

because they are not charged to 'originate, evaluate, maintain, record, insure, or service the extension of credit.'"[192]

In *Pelt v. U.S. Bank Trust National Ass'n*,[193] the Dallas Division of the United States District Court for the Northern District of Texas ruled that points are not fees for purposes of the three percent cap on fees in a home equity transaction.[194] In this case, the Pelts claimed that the lender's lien was invalid[195] and sought to have the lender "forfeit all principal and interest on the loan secured by the property."[196] The Pelts claimed the lender violated the three percent cap on fees by charging them $12,000 in points[197] and by failing to cure the default within a reasonable time after notification.[198] The lender contended that discount points were not fees, but interest, and thus were not subject to the limitations on fees.[199] Further, the lender claimed that if the points were fees, they were voluntarily paid and therefore not subject to the cap on fees.[200] The court granted the lender's motion for summary judgment on this issue, finding "as a matter of law, that section 50(a)(6)(E) was not violated, because under Texas law discount points are interest on a loan, [and] not fees related to origination of the loan."[201]

In *Thomison v. Long Beach Mortgage Co.*,[202] the Austin Division of the United States District Court for the Western District of Texas considered a case where a borrower brought suit against a lender, alleging that the lender violated the three percent cap on fees contained in section 50(a)(6)(E) of the constitutional amendment authorizing home equity loans in Texas.[203] The specific issue in the case was whether the lender's origination fee and discount points fell within the three percent cap on fees.[204] If either charge was determined by the court to be a fee for purposes of the three percent cap on fees, then the loan would be in violation of the constitutional amendment,[205] and therefore subject to the forfeiture provision contained in section 50(a)(6)(Q)(x).[206]

192. *Id.* at 712 (quoting TEX. CONST. art. XVI, § 50(a)(6)(E)).
193. No. CIV.A.3:00-CV-1093-L, 2002 WL 31006139 (N.D. Tex. Sept. 5, 2002).
194. *Id.* at *3.
195. *Id.* at *1.
196. *Id.* at *2.
197. *Id.* at *1.
198. *Id.* at *2.
199. *Id.* at *2.
200. *See id.* at *2.
201. *Id.* at *3.
202. 176 F. Supp. 2d 714 (W.D. Tex. 2001), *vacated*, No. CIV.A.A:00CA783JN, 2002 WL 32138252 (W.D. Tex. Aug. 9, 2002).
203. *Id.* at 715.
204. *Id.* at 716.
205. *Id.*
206. *See id.* at 718.

The court held that the lender's origination fee constituted a fee and not interest for purposes of the three percent cap on fees,[207] without deciding whether a discount point fell within the limitation on fees.[208] It ordered the lender to "'forfeit all principal and interest of the extension of credit.'"[209] The court, in applying the amendment's plain meaning, relied heavily on a literal interpretation of the constitutional amendment.[210] Stating that "[w]hen interpreting our state constitution, we rely heavily on its literal text and must give effect to its plain language,"[211] the court found that the origination fee was a fee for purposes of the constitutional fee cap.[212] The court rejected the lender's argument that the charges were interest under the law because the charge was for the borrower's use of the money, indicating that the lender's argument was simply not helpful in providing the court with a method for classification of the charges.[213] Further, the court dismissed the lender's argument that both charges constituted interest because the state's administrative code and case law treats both charges as interest for purposes of usury.[214] The court did not dispute the lender's assertion but stated that the classification of these fees for purposes of usury was not dispositive.[215] Instead, the court held that the constitution's plain language controlled and that interpretations in the administrative code and case law for purposes of usury were not controlling.[216] Dispositive to the court was the fact that the lender had described the charge as a "loan origination fee"[217] and that the constitutional amendment prohibited fees in excess of three percent that were necessary to originate home equity loans.[218] The court stated "that in instances such as this one, the stated name of the charge is dispositive, while the purported reason for the charge is irrelevant."[219] Acknowledging that the court's interpretation could result in lenders playing "semantic and numerical games"[220] by simply changing the name of the charge to reallocate the charge to interest or vice versa, the court stated that the only limits on such games were "[section] 50(a)(6)(E)'s cap on fees and the Texas usury laws."[221]

207. *See id.* at 716.
208. *See id.* at 718.
209. *Id.* at 718 (quoting TEX. CONST. art. XVI, § 50(a)(6)(Q)(x) (amended 2003)).
210. *Id.* at 716–17.
211. *Id.* at 716 (quoting Doody v. Ameriquest Mortgage Co., 49 S.W.3d 342, 344 (Tex. 2001)).
212. *See id.*
213. *See id.* at 717.
214. *Id.*
215. *Id.*
216. *Id.*
217. *Id.* at 717–18.
218. *Id.* at 718.
219. *Id.* at 717 n.6.
220. *Id.*
221. *Id.*

In *Breaux v. United Companies Lending Corp.*,[222] the Houston Division of the United States District Court for the Southern District of Texas considered among other things, whether a loan origination fee charged by a lender in a home equity transaction was a fee or interest for purposes of the three percent fee limitation under the Texas Constitution.[223] The Breauxs received a $200,000 home equity loan from Arkansas Fidelity Mortgage Corporation.[224] They claimed that the lender overcharged them in connection with the loan by charging fees, in addition to interest, greater than three percent of the principal loan amount.[225] The fee limitation for this loan was $6,000 and the Breauxs contended that they were charged $7,636.04 in fees.[226] Included in these fees was a mortgage lender's fee in the amount of $2,917.31, payable to the lender.[227]

The court, in analyzing the claim, first noted that their claim was moot in that the Breauxs had sold the home and paid off the loan in question.[228] However, the court assumed *arguendo* that a present controversy existed for consideration of the claim.[229] The court then held, in part, that the lender had not violated the three percent fee limitation.[230] As part of its analysis, the court considered whether the mortgage lender's fee was a fee for purposes of the fee cap, or whether it was interest and therefore excluded from the cap on fees.[231] The court considered the statutory definition of interest in Texas, noting that the "[c]ourts and regulatory agencies have treated as 'interest' any lender-retained fees or charges that are not supported by separate and distinct consideration for the loan and the lender's ordinary overhead and expenses."[232] The court pointed out that the HUD-1 Settlement Statement reflected that the mortgage lender's fee was actually an origination fee to the lender.[233] The court found that this fee and three other fees paid to the lender were "overhead charges retained by the lender [and] that [they] were not supported by a separate and distinct consideration."[234] Accordingly, the court held that these charges were interest and not fees for purposes of the three percent cap on fees.[235]

222. No. H-99-3384 (S.D. Tex. Mar. 14, 2001) (unpublished opinion).
223. *Id.* at 9.
224. *See id.* at 1.
225. *Id.* at 4.
226. *Id.* at 6.
227. *Id.*
228. *Id.* at 4.
229. *Id.* at 5.
230. *See id.*
231. *Id.* at 9.
232. *Id.* at 8–9.
233. *Id.* at 9.
234. *Id.*
235. *Id.*

B. *Judicial Interpretation of the Cure Provision*

In *Doody v. Ameriquest Mortgage Co.*,[236] the issue of whether a lender could cure a violation of the three percent cap on fees and thus validate the lender's lien was decided by the Texas Supreme Court.[237] In this case, the borrower argued that the lender could not have created a valid lien under section 50(c) of the constitution because the lender did not comply with section 50(a)(6)(E) when the loan was made, notwithstanding that the lender subsequently cured the violation.[238] The lender argued that the cure provision in 50(a)(6)(Q)(x) not only serves to cure violations of the constitutional amendment's forfeiture provisions, but also serves to "validate the lien under section 50(c)."[239] The Texas Supreme Court agreed with the lender, holding that the cure provision contained in section 50(a)(6)(Q)(x) serves not only to cure the "particular lender obligation at issue under section 50(a)(6), but also to validate the lien."[240]

C. *Summary of the Home Equity Cases*

The issue of whether a loan origination fee charged by a lender in a home equity transaction constitutes interest or a fee for purposes of the constitutional three percent cap on fees has yet to be definitively decided under Texas law.[241] The two cases directly on point, *Thomison* and *Breaux*, both being federal district court cases, came to different conclusions.[242] The only thing one knows for sure is that a lender can cure a violation of the three percent cap on fees, and that such cure will operate to validate the lender's lien.[243]

VII. Dealing with the Problem

A. *Policy Considerations*

Texas law has historically treated origination fees as interest.[244] So, why treat origination fees any different for purposes of home equity?[245] To do so would unfairly subject lenders to huge risk without

236. 49 S.W.3d 342 (Tex. 2001).
237. *Id.* at 347.
238. *Id.* at 345.
239. *Id.*
240. *Id.* at 347.
241. *See supra* notes 180–235 and accompanying text.
242. *See* Thomison v. Long Beach Mortgage Co., 176 F. Supp. 2d 714, 718 (W.D. Tex. 2001), *vacated by*, No. CIV.A. A:00CA783JN, 2002 WL 32138252 (W.D. Tex. Aug. 9, 2002); Breaux v. United Cos. Lending Corp., No. H-99-3384 (S.D. Tex. Mar. 14, 2001) (unpublished opinion).
243. *Doody*, 49 S.W.3d at 347.
244. *See* discussion *supra* Part IV.
245. *See* Telephone Interview with C. Ed Harrell, Partner, Hughes, Watters & Askanase, L.L.P. (Oct. 17, 2002) (indicating that he did not see a reason to treat origination fees on home equity loans differently than we treated origination fees on loans before there was home equity lending); *see generally* Telephone Interview with Karen

notice under the law[246] and would contradict the principal of *stare decisis*.[247] Further, by dealing with this problem and providing lenders with certainty in the law, Texas consumers will benefit as will the State of Texas.[248]

By clarifying this issue, the risk to lenders will be reduced and consumers will likely benefit.[249] Consider the potential adverse consequences to a lender who could have an entire portfolio of home equity loans subject to threat of total loss, or at the very least significant refund expense, not to mention the potential litigation expense.[250] By removing this risk, it is likely that more lenders will be willing to enter the market.[251] And, with more lenders in the market and less risk associated with these loans, the cost of borrowing will likely decline.[252] Further, by reducing the risk in this area the secondary market for these loans will likely improve,[253] thereby reducing the cost and increasing the availability of home equity credit.[254]

In addition, by reducing the risk to lenders and increasing the number of market participants making home equity loans in Texas, there will be more money available to Texas consumers to consolidate their current obligations, to purchase products and services, or to invest in their businesses.[255] This may have the effect of spurring economic growth in Texas, because consumers will see an increase in their dis-

M. Neeley, General Counsel, Independent Bankers Association of Texas, and Of Counsel, Long, Burner, Parks & DeLargy (Oct. 15, 2002) (indicating that she believed origination fees should be classified as interest for purposes of home equity loans because they fall within the legal definition of interest in Texas).

246. *See* TEX. CONST. art. XVI, § 50(a)(6)(Q)(x) (providing for severe penalties for non-compliance).

247. Stare decisis is "[t]he doctrine of precedent, under which it is necessary for a court to follow earlier judicial decisions when the same points arise again in litigation." BLACK'S LAW DICTIONARY 1414 (7th ed. 1999).

248. *See infra* notes 249–56.

249. *See* Alsup, *supra* note 6, at 469 (indicating that lenders will pass the risk of loss and additional compliance cost on to consumers in the form of "underwriting standards and pricing models").

250. *See infra* notes 260, 262; TEX. CONST. art. XVI, § 50(a)(6)(Q)(x) (amended 2003) (providing for the lender to relinquish the entire principal and interest for violations not corrected within a reasonable time after notification by the borrower).

251. *See* Hams, *supra* note 5, at 32 (A survey of lenders reported that "almost half of respondents said they were offering home equity loans but were not actively promoting the product. Fewer than one-in-five were actively promoting the loans. The remainder either had no plans to enter the field or were waiting for more market and legal clarification.").

252. *See supra* notes 249, 251 and accompanying text.

253. *See* Alsup, *supra* note 6, at 469–70 (indicating that "secondary market investors in Texas equity loans will be wary of [the] risks").

254. *See supra* notes 249, 251.

255. *See supra* notes 249, 251; *infra* note 256.

posable incomes via bill consolidation or because home equity credit is available to them.[256]

B. *Lender Options*

Some lenders may take the position that an origination fee is interest under existing Texas law[257] and continue to charge origination fees, taking the risk where the origination fee, if determined to be a fee, would put the total fees charged over the three percent cap on fees.[258] The risk from doing so could be great.[259] It could result in significant forfeitures by lenders active in home equity lending.[260] Even if one assumes that the violation can be cured by refunding overcharges,[261] the cost to lenders could be significant, especially in a class action lawsuit.[262]

On the other hand, some lenders will likely take a conservative position and stop charging origination fees on home equity loans until the law is settled.[263] These lenders will likely increase their interest rates to cover the loss of income generated by origination fees. By doing so, these lenders would be forced to recover their cost of originating the loan over the life of the loan through increased interest earnings. However, this may not be an acceptable solution for all lenders, as the lender would bear the risk of not being able to fully recover their up-front cost in the event of an early payoff of the loan. Some lenders may not be willing to take the risk and consequently elect to stay out of the home equity market altogether.[264]

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256. *See* Boettcher, *supra* note 31, at 225 (indicating that the State of Texas would benefit from home equity lending because of the "increase in the amount of disposable income and purchasing power" of those accessing their home equity).

257. *See* discussion *supra* Part IV.

258. *See* TEX. CONST. art. XVI, §§ 50(a)(6)(E), 50(a)(6)(Q)(x) (amended 2003) (providing for the lender to relinquish all principal and interest for violations not corrected within a reasonable time after notification by the borrower).

259. TEX. CONST. art. XVI, § 50(a)(6)(Q)(x) (amended 2003).

260. *See generally* Telephone Interviews with C. Ed Harrell, Partner, Hughes, Watters & Askanase, L.L.P. (Oct. 17, 2002 & Feb. 21, 2003) (indicating that if origination fees were determined to be a fee subject to the three percent cap on fees it could have the effect, if not cured, of destroying entire portfolios of home equity loans).

261. *See* TEX. CONST. art. XVI, § 50(a)(6)(Q)(x) (amended 2003) (indicating that a lender can cure a violation by complying with its obligations under the loan agreement within a reasonable time after notification by the borrower).

262. *See* Telephone Interview with C. Ed Harrell, Partner, Hughes, Watters & Askanase, L.L.P. (Oct. 17, 2002) (indicating that even refunds could be costly, especially in a class action).

263. *See* Hams, *supra* note 5, at 32 (indicating that "many lenders were taking, at best, a cautious approach to home equity lending").

264. *See* Boettcher, *supra* note 31, at 263 (indicating that some lenders might stay out of the home equity market because of the "restrictive nature of the lending provisions" and the penalties for non-compliance); Hams, *supra* note 5, at 32 (reporting in a survey of lenders that "almost half of respondents said they were offering home equity loans but were not actively promoting the product. Fewer than one-in-five

C. *The 2003 Constitutional Amendment*

During the regular session of the 78th legislature, Texas lawmakers passed a proposed constitutional amendment providing, among other things, for regulatory interpretations of certain provisions of the Texas Constitution governing home equity lending.[265] In addition, the 2003 constitutional amendment amends the forfeiture and cure provision contained in section 50(a)(6)(Q)(x) of the Texas Constitution, setting forth specific criteria under which a lender or note holder can cure most violations of the Texas home equity law.[266] On September 13, 2003, Texas voters approved the proposed constitutional amendment[267] which will become effective after the election results are certified.[268]

The 2003 constitutional amendment provides that the "legislature may[,] by statute[,] delegate one or more state agencies the power to interpret" various provisions of the Texas Constitution on home equity lending.[269] Texas lawmakers did so during the 78th legislative session by passing enabling legislation, which in conjunction with the constitutional amendment, delegates interpretative authority to two state agencies, the State Finance Commission, and the Credit Union Commission.[270] The State Finance Commission was granted authority to issue interpretations applicable to all lenders authorized to make home equity loans, except those regulated by the Credit Union Commission for which the Credit Union Commission was granted that authority.[271] To the extent feasible, these two agencies are required by this legislation to adopt consistent interpretations.[272] Thus, the State Finance Commission and the Credit Union Commission, upon the effective date of the 2003 constitutional amendment, will possess the power and authority to interpret certain sections of the Texas Constitution governing home equity lending, including section 50(a)(6)(E), which sets forth the three percent cap on fees.[273]

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were actively promoting the loans. The remainder either had no plans to enter the field or were waiting for more market and legal clarification.").

265. *See* Tex. S.J. Res. 42, 78th Leg., R.S., (2003) (to be codified at TEX. CONST. art. XVI, § 50(u)).

266. *See* Tex. S.J. Res. 42, 78th Leg., R.S. (2003) (to be codified at TEX. CONST. art. XVI, § 50(a)(6)(Q)(x)).

267. Associated Press, *Results*, FORT WORTH STAR-TELEGRAM, Sept. 14, 2003, at 27A (citing *2003 Constitutional Amendment Election*, Tex. Sec'y of State, *at* http://204.65.104.19/elchist.exe (last visited Oct. 27, 2003) (on file with the Texas Wesleyan Law Review).

268. *The Texas Constitution: Frequently Asked Questions*, Tex. Sec'y of State, *at* http://www.capitol.state.tx.us/txconst/faq.html (last visited Oct. 27, 2003) (on file with the Texas Wesleyan Law Review).

269. *See* Tex. S.J. Res. 42, at sec. 50(u).

270. *See* Act of June 20, 2003, 78th Leg., R.S., ch. 1207, 2003 Tex. Sess. Law. Serv. 3427 (Vernon) (to be codified at TEX. FIN. CODE §§ 15.308, .413).

271. *Id.*

272. *Id.*

273. *See id.*

The 2003 constitutional amendment also provides protection for lenders, whose acts or omissions comply with the interpretations provided by the appointed state agencies, or whose actions are consistent with interpretations of a state or federal appeals court; by providing that such lender's acts or omissions shall not constitute a violation of the constitutional provisions governing home equity lending.[274]

As to the forfeiture and cure provision, the 2003 constitutional amendment provides that a lender or note holder shall have sixty days from notification by the borrower to correct most violations of the home equity law or to comply with the lender or note holder's obligations under the law.[275] To cure a violation of the three percent cap on fees, the 2003 constitutional amendment provides that a lender or note holder must pay to the borrower, within sixty days of the date the "lender or holder is notified by the borrower" of the violation, the amount of any overcharge paid by the borrower in connection with the loan.[276] Failure to correct the violation in accordance with this provision shall subject the lender or note holder to complete forfeiture of "all principal and interest."[277]

In summary, passage of the 2003 constitutional amendment and its enabling legislation represent a significant step toward resolving the issue of whether a loan origination fee constitutes interest or a fee for purposes of the three percent cap on fees.[278] One can only hope that these regulatory agencies will promptly deal with this issue and provide guidance to both borrowers and lenders.

VIII. CONCLUSION

Historically, loan origination fees have been classified by Texas statutes and regulations as interest and not as fees.[279] Further, Texas courts have treated fees retained by the lender as interest for purposes of the state usury laws, except where the fee "entitle[s] the borrower to distinctly separate and additional consideration apart from the lending of money."[280] Most lenders charge origination fees in an effort to collect, at the closing of the loan, their up-front cost of originating the loan.[281] Without origination fees, lenders would be forced to recover their up-front cost over the life of the loan, presumably by charging higher interest rates.[282]

274. *See* Tex. S.J. Res. 42, at sec. 50(u).
275. Tex. S.J. Res. 42, at sec. 50(a)(6)(Q)(x).
276. *Id.*
277. *Id.*
278. *See* discussion *supra* Part VII.C.
279. *See* discussion *supra* Part IV.A.
280. *See supra* note 83.
281. *See supra* note 6.
282. *See* discussion *supra* Part III.A.2.

Further, if the legislature had intended a different treatment in the classification of fees for purposes of home equity lending, it could have explicitly stated so in the 1997 constitutional amendment by defining interest or fees for purposes of the cap on fees, or by excluding lender charged fees from the provision excluding interest from the cap on fees.[283] Its failure to do so suggests that the legislature did not intend a different interpretation of interest and fees for purposes of the three percent cap on fees.[284] Finally, the constitutional amendment authorizing home equity loans provides for severe penalties for noncompliance.[285] It would be unjust to subject an innocent lender to such penalties without notice under the law.

It is for these reasons that a loan origination fee charged by a lender in a home equity transaction should be classified as interest and not as a fee for purposes of the three percent cap on fees contained in section 50(a)(6)(E) of the Texas Constitution.

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283. *See* discussion *supra* Part V.
284. *See* discussion *supra* Part V.
285. *See* TEX. CONST. art. XVI, § 50(a)(6)(Q)(x) (amended 2003).