STATE OF TEXAS

FFICE OF CONSUMER CREDIT COMMISSIONER

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September 26 1986 86-5

Mr. Bill Jackson, President
HJH Financial Services, Inc.
1606 Stemmons Fwy. Suite 110
Carrollton, Texas 75006

Dear Mr. Jackson:

You have advised this office by letter that your company intends to "purchase Second Mortgage Home Improvement Retail Installment Contracts from builders throughout the state." You state that "The procedure would be:

"A. Buyer/Seller enter into a Retail Installment Contract.

"B. Seller assigns Retail Installment Contract and Material Mechanics Lien and HJH purchases said Contract from Seller.

"C. HJH discounts and sells said Retail Installment Contract to a lending institution and assigns the Retail Installment Contract and Material Mechanics Lien to that institution.

"D. Terms would be up to 180 months.

"E. Interest - Add-on.

"F. Method of payoff - providing the above steps are followed and regardless of what month and year the loan pays in full, Holder of Retail Installment Contract would use the 'Sum of the Monthly Unpaid Balances' method (Rule of 78).

"G. Seller or lending institution will purchase PMI (Private Mortgage Insurance) on individual contracts as deemed necessary as long as Seller of the goods or services or the lending institution pays the premium for any PMI."

You then ask the question, ". . . if the procedures as outlined above are followed, and if both parties purchasing said Retail Installment Contract are licensed lenders, would all parties be in compliance with Chapter 6 of the Texas Consumer Credit Code?"

Since you mentioned that you are unaware of the statutory procedure involved in requesting an opinion from this office, I would like to preface my remarks with a few general observations regarding interpretations issued by this office. Pursuant to the authority of Art. 5069-2.02A(10), 1.04(p) and 8.01(f), Vernon's Texas Civil Statutes, this office, in compliance with a proper request, will from time to time advise a requesting party as to our interpretation of Art. 5069-1.01 et seq., the Texas Credit Code. Art. 1.04(p) provides that a person does not violate the Credit Code by ". . . any acts done or omitted, that conform to the provisions of this Article, or to the provisions determined by the consumer credit commissioner, or that conform to an interpretation of this Title by the consumer credit commissioner . . . ."

You have limited your request for an interpretation to the provisions of Chapter 6 relating to second mortgage liens in connection with a retail installment contract. Because of the close relationship between second mortgage loans under the authority of Chapter 5 and second liens granted under Chapter 6, I would like to discuss the relationship between the two chapters. Chapter 5 regulates the conditions concerning the taking of a secondary mortgage by a lender authorized to make loans under that chapter. Art. 5069-5.01, V.T.C.S. defines a "secondary mortgage loan" as, ". . . a loan made to any person not to be repaid in ninety days or less which is secured, in whole or in part, by any lien or security interest or any interest in real property improved by a dwelling designed for occupancy by four families or less, which property is subject to the lien of one or more liens or security interests, prior mortgages or deeds of trust . . . ." While Chapter 5 regulates secondary mortgage "loans", Chapter 6 regulates retail installment "sales." The definition of "goods" in Art. 5069-6.01 provides in part ". . . all tangible personal property when purchased primarily for personal, family or household use and not for commercial or business use, including such property which is furnished or used at the time of sale or subsequently, in the modernization, rehabilitation, repair, alteration, improvement or construction of real property so as to become a part thereof. . . ."

We therefore have two separate statutes under which home improvements may be financed under distinctly different provisions. Chapter 5 provides for financing via a loan granted by a lender. A loan transaction normally involves just a lender and a borrower, however, the existance of persons who negotiate, arrange or "broker" secondary mortgage loans was recognized by the 69th Legislature in amendments to Chapter 5 which require those who negotiate or arrange secondary mortgage loans to be licensed.

Chapter 6 provides for the retail installment sale of home improvements. The only parties recognized by the statute in conjunction with the origination of a retail installment transaction is a buyer and a seller who agrees to "finance" the sale or to collect the cash price plus time price differential (and any other authorized charges) in installments. A retail installment contract is completed when the goods purchased or the work contracted for is completed and the retail buyer has signed a certificate of completion

or satisfaction as provided in Chapter 6. As far as the buyer is concerned the financing is then complete. In order to receive immediate full value for the contract the seller may sell the retail installment contract to a third party, the assignee. When a retail installment contract is sold to a third party the transaction is often referred to as an "indirect loan." Although not statutorily defined, the term "indirect loan" is used extensively by creditors as well as by the courts in regard to, and synonymous with, financing via a retail installment contract. Any payment by a third party to purchase a retail installment contract should be payable only to the seller as he is the only party with a salable interest in the contract. Any payment including the buyer as a payee or co-payee tends to characterize the credit transaction as a loan.

You have indicated that HJH would purchase retail installment contracts from contractors that have made such contracts with retail buyers. You add that HJH would then sell the retail installment contract to a lending institution and reassign the retail installment contract and "Material Mechanics Lien" to that institution. This reassignment aspect of your plan, while not traditional in these "indirect loans", is not critical to our discussion and does not affect this interpretation. You indicate that the terms of the retail installment contract would be up to 180 months and that "interest"(sic) would be "Add-on." You further indicate that in the event the contract is prepaid prior to its maturity ". . .regardless of what month and year the 'loan' (sic) pays in full, Holder of Retail Installment Contract would use the 'Sum of the Monthly Unpaid Balances' method (Rule of 78)."

I believe that where the words interest, add-on and loan are used in the two preceding sentences time price differential, precomputed and contract should be substituted respectively to properly describe the situation. This suggestion is not merely a matter of semantics but is crucial to this interpretation. Art. 5069-6.02(10) provides for the refund of unearned time price differential in such a manner as you have described, whereas under the provisions of Art. 5069-5.02(6)(ii) a refund of unearned interest would not be allowed on a secondary mortgage loan pursuant to the Sum of the Monthly Unpaid Balances (Rule of 78) method. Art. 5069-5.02(6)(ii) provides:

> "When any loan contract which includes precomputed interest and is payable in more than sixty substantially equal successive monthly installments beginning within one month plus fifteen days after the date of the contract is prepaid in full by cash, a new loan, renewal, or otherwise, or if the lender demands payment in full of the unpaid balance before the final installment due date, the lender shall retain earned interest for the period from the date of the loan to the date of prepayment in full or demand for payment in full in an amount not to exceed that which would accrue at the simple annual interest rate which the loan contract would have produced over its full term if each

scheduled payment had been paid on the date due when applied to the unpaid principal amounts determined to be outstanding from time to time according to the schedule of payments having due regard for the amount of each scheduled installment and the time of each scheduled installment period. In the event prepayment in full or demand for payment in full occurs on a date during an installment period, the lender, in addition to interest earnings for the installment period or periods that have elapsed, may retain for each day elapsed from the immediately preceding installment due date to the date of prepayment in full or demand for payment in full an interest charge produced by applying the simple annual interest rate under the contract as heretofore described to the unpaid principal balance of the loan determined to be outstanding according to the schedule of payments as of the immediately preceding installment due date and dividing that product by three hundred sixty-five. All interest contracted for and precomputed in the amount of loan in excess of the interest authorized to be retained by this subsection shall be refunded or credited to the borrower.

"The lender may also retain earned interest on any additions to principal or other permissible charges added to the loan subsequent to the date of the loan contract, at the simple annual interest rate as described above, from the date such additions are made until paid or until demand for payment in full of the total unpaid balance under the loan contract is made by the lender.

"If the loan contract does not contain precomputed interest, then interest may be earned on the principal balance, including additions to principal subsequent to the loan contract, from time to time unpaid, at the rate contracted for, until the date of payment in full or demand for payment in full."

As can be seen, the proper definition of the transaction is critical in determining how the refund of unearned interest/time price differential will be allowed.

The court in Espinoza v. Victoria Bank & Trust Co. 572 S.W.2d 816 (Tex.Civ.App.-Corpus Christi 1978, writ ref'd n.r.e.) entered into a very lengthy discussion as to the difference between a retail installment sale and a loan. In this case the bank was the seller as it had repossessed the object of the sale subject to a prior security agreement between the bank and the prior owner. The case is hard to compare due to the abiguities but the court held the transaction to be a sale. In significant language the court stated what the court considered to be a ". . .satisfactory legal test for determining whether or not a transaction should be treated under the Credit Code as an installment loan where the purchaser does not arrange for his own credit. Comporting with the rule that a court should consider the substance of a transaction rather than its mere form, we hold that, regardless of the labels the parties place on a transaction, or the forms that

they use, where the dealer is substantively involved(emphasis added) in arranging for the buyer's credit through a lending institution the transaction is not an installment loan contract but rather a retail installment sales contract." I have quoted the above language from the court's opinion because it reflects the uncertainty evident in the courts as well as in the financing community. As I have previously indicated, the plan which you have presented to this office for our interpretation is in the nature of a retail installment contract because it is a two party transaction involving a buyer and a seller, with the seller assigning the retail installment contract to a third party. We are aware of transactions that do not clearly fit this mold and become extremely ambiguous as to whether the transaction is a retail installment sale or a loan. Applying the test used in Espinoza v. Victoria Bank & Trust Co. it may become obvious that the seller is not substantively involved in arranging for the buyer's credit through a financing institution when the seller takes no part in arranging such credit but allows a third party to make such credit arrangement, thereby securing what appears to be a "loan" to the buyer by a lender. As I have indicated, if the transaction is so clouded that it is subsequently found to be not a sale pursuant to a retail installment contract but rather a loan to a borrower by a lender, the refund method authorized by Chapter 6 would not be allowed on a loan under the provisions of Chapter 5 having a term in excess of 60 months. Requiring additional consideration is the provision found in Art. 5069-5.01(2) that ". . . no person, except a bank, savings and loan association or credit union doing business under the laws of this State or of the United States and any person licensed to do business under the provisions of Chapter 3 of this Subtitle, shall engage in the business of making, negotiating, or arranging secondary mortgage loans . . ."(Emphasis added) which are subject to Chapter 5. As can be seen any person "negotiating, or arranging" secondary mortgage loans must be licensed under the provisions of Chapter 3 if they do not otherwise qualify under Chapter 5.

I have entered into this prolonged discussion of the differences between a retail installment contract under the provisions of Chapter 6 and a secondary mortgage loan under the provisions of Chapter 5 because the subject is very confusing and the parties to such transaction must act in a very exacting manner in order to properly abide by the requirements of each chapter as well as to escape the penalty provisions of Art. 5069-8.01 et seq.

In summary, we have the court saying that a retail sale which is being financed is a legitimate "retail installment transaction" when the dealer is substantively involved in arranging the credit and, in contrast, we have specific statutory provisions providing for third parties arranging or negotiating loans under Chapter 5. I do not believe a seller is substantively involved in arranging credit if the seller relegates to a third party, either an intended assignee or any other person, the activities

normally associated with the origination of a credit contract such as the taking of a credit application, investigating credit worthiness and completion and execution of documents. Although not literally applicable to the question, the Art. 7.01(d) definition of retail installment transaction authorizes certain relationships between seller and financing institutions who purchase contracts. Although not enumerated in Chapter 6 I believe these relationships are permissable in connection with Chapter 6 transactions. Conspicuously absent is any suggestion that another party may be involved as an intermediary who negotiates or arranges the transaction or that the financing institution may be involved to any greater degree in the origination of a retail installment transaction. If a home improvement financing transaction is negotiated or arranged by a seller who is substantively involved and such transaction is written on a retail installment contract we find such a transaction to be subject to Chapter 6. If a home improvement financing transaction is arranged by someone other than the seller we find such a transaction to be subject to Chapter 5. You should be governed by the above in determining whether a particular home improvement transaction should be financed pursuant to Chapter 5 or Chapter 6.

Your final inquiry numbered "G" states that a "Seller or lending institution will purchase PMI (Private Mortgage Insurance) on individual contracts as deemed necessary as long as Seller of the goods or services or the lending institution pay the premium for any PMI." There is no authority under Chapter 6 to charge a retail buyer for PMI or Private Mortgage Insurance. You have indicated that the cost of such insurance would be paid by the seller or a lending institution. We find that such practice would be permissible so long as the buyer is in no way, either directly or indirectly, charged for the insurance.

Sincerely,

Al Endsley
Commissioner