STATE OF TEXAS

OFFICE OF CONSUMER CREDIT COMMISSIONER

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SAM KELLEY, Commissioner

November 19, 1981 No. 81-27

Mr. James H. Wallenstein
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Dear Mr. Wallenstein:

This is in response to your written submissions to this Office requesting that we set out our position with regard to several questions concerning Article 5069, V.T.C.S., as recently amended by H.B. 1228. Because of the length of your submissions, I am not going to set out here your questions verbatim but rather attempt to state our position on the various matters you have raised, which I hope will be sufficient for your purposes.

It is our position that the term "variable rate contracts" does not include contracts for repayment at more than one fixed rate of interest. For example, a loan requiring repayment in two years and specifying interest at 15% per annum for the first year (or prior to the occurrence of a specified event, such as a leasing requirement) and 16% per annum for the second year (or after the specified event) is in the opinion of this Office a fixed-rate contract and not a variable rate contract.

It is our position that a loan does not become a variable rate loan simply because it contains a provision that in the event of default in payment the loan will bear interest at "the highest lawful rate," or because of a provision that monies advanced by the lender to satisfy obligations of the borrower or otherwise to protect its collateral will bear interest "at the highest lawful rate." Since the contracts discussed here were fixed-rate at the outset, the default rate would be that rate agreed to by the parties. I might interject here that I personally have never liked the use of the phrase "highest lawful contract rate" in a contract when referring to interest, primarily because I have never been sure what it meant. It seems there is now more of a problem than before since the enactment of H.B. 1228. I realize the use of this phrase has been recognized by at least one appellate court [Bundrick v. First National Bank of Jacksonville, 570 S.W.2d 12 (Tyler Ct. of Civ. App., n.r.e., 1978)] but I still think it is better practice to be more specific in the agreement, particularly in view of language now in the Code such as is in Art. 1.04(f) (variable rates only), which provides that the interest rate may not exceed the ceiling applicable to the contract for so long as debt is outstanding under the contract (which would include after default). Some of our views on interest after default are more fully set out in our Letter Interpretation No. 81-19, dated September 3, 1981.

In our view, the term "open-end account" does not include typical interim construction loans. These are loans with a definite sum to be advanced agreed upon at the outset and which do not "revolve" but may be advanced in more than one funding. On the "open-end account" question, our views are expressed in more detail in Letter Interpretation No. 81-24. In our opinion, a closed-end credit agreement does not become converted into an "open-end account" as defined by Article 1.01(f) simply because it contains a provision that upon default in payment, the loan will bear interest "at the highest lawful rate," or because it contains a requirement that monies advanced by the lender to satisfy obligations of the borrower or otherwise to protect its collateral will bear interest "at the highest lawful rate."

You next pose several questions relating to the availability of the various ceilings authorized by Article 1.04 to particular types of loans or other extensions of credit (other Chapters of Article 5069, such as Chapter 7, still contain the "old" authorized charges). I will here attempt to set out our views on the various questions of this nature which you presented. Article 1.04(a) and its several subsections prescribe four types of interest rate or time price differential ceilings available for various contracts. However, other sections of Article 1.04 must be considered in determining whether a particular ceiling is applicable to a particular type of credit extension. On fixed-rate, closed-end contracts, either the indicated rate ceiling or the quarterly ceiling may be contracted for. Article 1.04(e) prohibits the use of the annualized ceiling in this type of contract, and Article 1.04(c) provides that the monthly ceiling may be contracted for only in variable rate transactions that are not made for personal, family or household use. We are of the opinion that three ceilings are available for applicability to a fixed-rate, open-end contract; i.e. the indicated rate ceiling, the quarterly ceiling and the annualized ceiling. It should be noted, however, that in our opinion the indicated rate ceiling on such a contract is subject to weekly adjustment and the indicated rate ceiling for one week may not be "locked in" forever (with the exception of a charge of 18% per annum) and made applicable to all loans or purchases made pursuant to the open-end account during its existence. The quarterly and annualized ceilings would be adjusted in accordance with the provisions of Article 1.04(h)(1). Our views on this point are more fully set out in our Letter Interpretation No. 81-22 dated September 30, 1981.

In closed-end, variable rate loans, the parties may contract for the indicated rate ceiling or the quarterly ceiling; and in closed-end, variable rate loans for other than personal, family or household use, the parties may contract for the monthly ceiling instead of one of the just mentioned ceilings. I would refer you to our Letter Interpretation No. 81-21 dated September 23, 1981, in which we express our views on "floating ceilings." It is our opinion that in closed-end variable rate loans the applicable ceiling, whether it be the indicated rate ceiling (weekly), quarterly or monthly ceiling, must "float."

In open-end, variable rate transactions, the indicated rate ceiling, the quarterly ceiling, and the annualized ceiling are all available; and the monthly ceiling is available on such contracts if made for other than personal, family or household use. The first three mentioned ceilings would be adjusted in accordance with Article 1.04(h)(2); the monthly ceiling as provided in Article 1.04(c).

I am in agreement with your view that the ceiling does not float on a fixed-rate, closed-end loan. In connection with this concept, you raise several questions concerning transactions which involve a commitment to make a long-term (usually), fixed-rate, closed-end loan which will be funded not on the date of the commitment but on some future date at which time the loan is closed. I will attempt to express our views as to the allowable interest charges on transactions of this type. If at the time the commitment contract is entered into in connection with a fixed-rate, closed-end loan the parties also agree to the interest rate to be charged on the contract when it is subsequently funded, if the agreed to rate is lawful at the time it is agreed to, it will be lawful at the time the loan is closed and funded. If the parties do not contract for a rate of interest at the time of the commitment but, rather, wait until the time of funding or some other subsequent date to agree on the applicable rate of interest, the applicable ceiling is that in effect at the time the rate of interest is agreed upon and not that in effect at the time of the commitment. If the parties agree at the time of the commitment to a particular rate but at some future date agree to change the applicable interest rate, the ceiling at the time of the subsequent agreement is applicable to that subsequent agreement. If at the time of commitment the parties have agreed on a lawful rate of interest applicable to the contract and that agreed upon rate is not changed by mutual agreement prior to the closing of the loan, it is still applicable to the contract when closed even though the ceiling may have changed either up or down prior to closing.

We are of the opinion that in variable rate, closed-end or open-end loans for other than personal, family or household use in which the parties have agreed that the monthly ceiling is applicable the ceiling "floats" and is subject to adjustment from month to month. Also, in all variable rate, open-end loans the applicable ceiling "floats" (Letter Interpretation No. 81-21, September 23, 1981).

You next pose several questions concerning the necessity, if any, that the contract between the lender and the borrower designate the ceiling applicable to the contract. First, the "easy" portion of these questions. It is our position that there is no requirement that a specific ceiling be designated in a closed-end, fixed-rate contract. Additionally, I can find no language in Article 1.04(h)(1) expressly stating that in an open-end, fixed-rate contract the applicable ceiling must be designated. The first sentence of 1.04(h)(1) provides, in part, as follows:

> "If the agreement of the parties so provides, or is amended pursuant to Section (i) of this Article or Article 1A.01 of this Title to so provide, a creditor of an open-end account may, as an alternative to the indicated rate ceiling, from time to time implement any rate permitted under the quarterly or annualized ceiling, ..."

Also, Article 1.04(i)(1)(C), when referring to the notice requirements applicable to open-end accounts, requires that the obligor be advised of the period for which the rate has been elected, or at which time the ceiling will be adjusted. It seems clear that if in an open-end, fixed-rate contract the creditor elects to implement a rate permitted by the annualized ceiling, for example, the creditor must give notice that the rate will be in effect for a year from the time of implementation and will be subject to adjustment at that time. I do not think it is required, however, for the creditor to have to additionally designate that the annualized ceiling is applicable to the contract, although there would be no objection to a creditor doing so, and in fact a number have already done so in their notices of amendments. But so far as this Office is concerned, if the obligors are advised of the rate implementation dates and periods for which the rates are implemented, or the time at which the ceiling will be adjusted, it is not further required that the agreement (or notice of amendment) specifically state that a particular ceiling is applicable to the contract.

Article 1.04(h)(2) requires that the applicable ceiling be disclosed to the obligor in a variable rate, open-end account. Therefore, it is our position that in a variable rate, open-end contract the ceiling applicable to the agreement must be specified and disclosed to the obligor.

The next of your questions dealing with the "designation of ceilings" problem is the one which has caused the most difficulty, and it has been raised by many others in addition to you. This question is: "Must a closed-end variable rate credit agreement specify in the contract the particular ceiling applicable to the contract?"

Again, the "easy" part first. Article 1.04(c) authorizes the parties to variable rate contracts that are not made for personal, family or household use to agree to a variable rate subject to adjustment on a monthly basis. That Article further provides that the "... parties may further agree that the rate from time to time in effect may not exceed the monthly ceiling from time to time in effect...." I believe, therefore, that this Article mandates that in either open-end or closed-end variable rate contracts for which the monthly variable rate provision is desired and available, the contract between the parties must designate and specify that the monthly ceiling is applicable to the contract.

The language of Article 1.04(c) is of course not applicable to closed-end, variable rate contracts other than those in which the parties have agreed will be adjusted monthly. There is no similar language found in the part of Article 1.04(e) dealing with closed-end, variable rate contracts subject to either the indicated rate ceiling or the quarterly ceiling. Neither is there language referring to the requirements of closed-end, variable rate contracts similar to that found in Article 1.04(h)(2) which requires disclosure of the applicable ceiling in an open-end, variable rate contract. So, as far as I can tell, there is no express language requiring the designation of the ceiling applicable to a closed-end, variable rate contract. However, in trying to arrive at a correct solution to this question, I have had to give consideration to the first sentence of Article 1.04(f) which provides that "The parties to any contract, including a contract for an open-end account, may agree to and stipulate for a rate or amount by contracting for any index, formula, or provision of law, by or under which the numerical rate or amount can from time to time be determined." (Emphasis added.) It seems to me that this underlined last portion of the sentence is saying that there must be a method by which the rate of interest can be determined. If it is not known which ceiling is applicable to the contract, there can be and probably will be during the term of every variable rate closed-end contract some times when the allowable rate cannot be determined from the terms of the contract. For example, assume that at the time such a contract is made both the indicated rate ceiling and the quarterly ceiling are 24% per annum, and the current quarterly ceiling is subject to adjustment on January 1, 1982. Assume that a closed-end, variable rate, one year loan is made at prime rate plus 3% but with no designation of whether the ceiling applicable to the contract is the indicated rate ceiling or the quarterly ceiling. Further assume that from now until December 31, 1981 the indicated rate ceiling remains at 24%, that the quarterly ceiling for the first quarter of 1982 is again 24%, but that for the first week in January, because of a decrease in the 26-week Treasury Bill rate, the indicated rate ceiling drops to 18% per annum but that prime plus 3% at that time is 20%. What rate may be charged on the loan at that time? The rate cannot be determined by looking only to the contractual terms. The lender could take the position that 20% could be charged since that figure would be below the quarterly average, while the borrower could well contend that 18% was the maximum since the indicated ceiling should be applicable to the contract.

It should also be mentioned that the parties to one of these types of contracts may never rely on both the indicated rate ceiling and the quarterly ceiling in any one contract (Article 1.04(e)). Additionally, Article 1.04(f) provides that the rate on the contract shall never exceed the ceiling applicable to the contract.

In formulating our position on this question, we have been confronted with what seemed, at least to us, something of a dilemma. On the one hand, we can point to no provision of the statute requiring designation of either the indicated rate ceiling or the quarterly ceiling in these types of contracts, while other sections require designation in other types of contracts. On the other hand, it is clear that only one of the ceilings can be applicable to any given closed-end variable rate contract and that neither party can rely on both. Additionally, as previously pointed out, Article 1.04(f) requires that the rate can be determined from time to time on the contract. There will be times when the rate could not be determined unless the applicable ceiling is known.

We have decided that the approach which will comport with the lack of designation requirement in the statute but still achieve the requirement of 1.04(f) to be able to determine the rate is to take the position that the indicated rate ceiling is applicable to the contract unless the parties designate otherwise; i.e. contract that the quarterly ceiling is the applicable ceiling. I realize that there is no express language in Article 1.04 stating that this is the appropriate position for this Office to take. However, it seems to me that the indicated rate ceiling is throughout the statute always the "basic rate"; every other ceiling is an alternative ceiling. As Article 1.04(a) provides, the parties may contract for a rate not exceeding the indicated rate ceiling but, as an alternative, may contract for a rate not exceeding some other ceiling. This approach is used throughout Article 1.04. It seems that this position conforms with the overall intent and purpose of the sections of the statute. It results in the indicated rate ceiling being applicable to closed-end, variable rate contracts unless the parties go further and contract otherwise. It ensures that only one ceiling is relied upon as is required by the statute, and it allows the requirements of Article 1.04(f) to be met in that the rate on the contract can always be determined. It is our position therefore that in absence of a contractual agreement otherwise, in a closed-end, variable rate contract the indicated rate ceiling is applicable to the contract.

It is our opinion that no section of H.B. 1228 was intended to change existing concepts of the "spreading" of interest although I should mention I have never been quite certain of what those concepts are. (There is an excellent discussion of the "spreading" problem by Mr. Frank A. St. Claire in St. Mary's Law Journal, Vol. 10, page 753). Insofar as loans are concerned, we follow the concept as set out by the Supreme Court in Nevels v. Harris, 102 S.W.2d 1046 (Sup. Ct. Tex., 1937), and what we perceive to be the "actuarial method" of computation. Apparently, the holding of the Supreme Court in Tanner Development Co. v. Ferguson, 561 S.W.2d 777 (Sup. Ct. Tex., 1977) will be the applicable "spreading" concept in transactions involving the credit sales of real estate. I would point out, however, that Article 1.04(f) provides that in variable rate contracts the rate or amount produced by the variable rate formula may not exceed the ceiling from time to time in effect and applicable to the contract.

If the parties agree pursuant to the provisions of Article 1.04(c) that in a variable rate contract the applicable ceiling is the monthly ceiling, they may also agree that the interest rate on that contract will be subject to adjustment monthly. In other words, in these types of contracts, the parties must look at the rate on the contract at the first of each calendar month to ensure that it does not exceed the monthly ceiling for that month.

The requirements of Article 1.04(i) do not become applicable when the rate of interest on an open-end, variable rate loan changes automatically in accordance with the index or formula specified in the loan documents provided that the rate increase does not exceed the maximum rate agreed to which could be charged on the contract. For example, if the contract provided that the rate on the contract would be the annualized ceiling and the parties so agreed, there would never be a necessity to later give the notice required by Article 1.04(i) because of rate (ceiling) fluctuations either up or down so long as the formula remains the same. However, the notice requirement of Article 1.04(h)(2), second paragraph, is applicable in the case of open-end accounts for personal, family or household use.

However, if the open-end, variable rate contract provides for an index or formula tied to one of the applicable ceilings but further provides that the rate charged will never exceed some percentage, such as 22%, if the formula produced a rate in excess of 22% and the creditor wished to charge a rate on the contract in excess of 22%, such higher charge could not be made unless there was compliance with Article 1.04(i).

Article 1.04(j) provides as follows:

> "If a creditor implements an annualized or quarterly ceiling as to a majority of its open-end accounts that are under a particular plan or arrangement and are for obligors in this state, that ceiling is also the ceiling for all open-end accounts that are opened or activated under that plan for obligors in this state during the period that the election is in effect."

Our interpretation of the words "plan or arrangement" as used in this section is that they refer to general credit programs such as a bank card program offered by a bank. Such a "plan or arrangement" would be uniform and standardized, and would generally be available to all qualified customers of the lender. The "plan or arrangement" would have general applicability to all borrowers or potential borrowers, and the contract terms and overall design of the plan would be the same for all participants in the program. We believe such programs as retail revolving charge agreements as well as bank credit card programs were intended to be such "plans and arrangements." It is our opinion that "plan or arrangement" as used in Article 1.04(j) was not intended to include all commercial loans, or all construction loans (which if typical would be closed-end transactions anyway), or all 90-day commercial loans (probably closed-end also) made by a lender. Such commercial loans (even if they were open-end lines of credit to commercial borrowers) are separate and individual transactions, separately negotiated and agreed upon and would not be subject to Article 1.04(j).

You next ask our position as to whether both a particular state rate ceiling and a federal rate ceiling may be applicable to one contract. Stated another way, can the ceiling applicable to a variable rate contract "flip flop" from a state ceiling to a federal ceiling?

Without quoting verbatim the section, the Depository Institutions Deregulation and Monetary Control Act of 1980, Title V, Part B, § 511(a) provides that the federal business and agricultural loan rate preemption provision is applicable if the rate thereby prescribed exceeds the rate authorized by state law or constitution to be charged on such loans. Any state statute or any constitutional provision limiting the rate to one lower than that authorized by the federal law is preempted. However, the federal law is not applicable as long as the authorized state ceiling is in excess of that of the Federal Act. Article 1.04(m) of the state statute provides as follows:

> "The ceilings provided by this Article for a contract, including a contract for an open-end account, are optional and any person may, notwithstanding any other law, contract for, charge, and receive the rates or amounts allowed by this Article for that contract, or the rates or amounts allowed by any other applicable provision of this Title <u>or any other law applicable to such a contract</u>, except as restricted under Section (q) of this Article."

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As can be seen from the underlined portion of Article 1.04(m), it seems clear that the state statute authorizes interest charges on credit extensions if such are authorized by federal statute. It also appears that if the applicable state rate ceiling on a contract drops below the ceiling authorized by the federal preemption, the federal law automatically becomes available and its ceiling becomes available to be applicable to the contract. Our position is, therefore, that if the contract authorizes such possible "dual ceilings," one state and one federal, then those ceilings may be interchangeably applicable to one contract.

Sincerely yours,

Sam Kelley

Sam Kelley
Consumer Credit Commissioner