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FEDERAL PRE-EMPTION OF STATE USURY LAWS AFFECTING REAL ESTATE FINANCING

LYNN M. EWING, JR.* AND KENDALL R. VICKERS**

I. INTRODUCTION

The federal and state legislatures have long attempted to protect consumers from high interest rates by limiting the interest rates that financial institutions and individuals can charge borrowers.[1] To prevent state usury laws from impeding the operation of federally created institutions and programs, Congress enacted statutes in the 1970s that pre-empted state usury laws in narrowly defined circumstances.[2] As interest rates increased in the late 1970s, however, state usury laws not pre-empted by Congress reduced the availability of funds for lending, discriminated against small borrowers, caused funds to flow to "nonceiling states," and unduly influenced legal forms of ownership.[3] The effect was particularly severe on the housing industry: state usury ceilings reduced the supply of mortgage funds, raised down payment requirements, and resulted in shorter term mortgages, as lenders sought to protect themselves against long-term, fixed-rate mortgages.[4]

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1. *See* Comment, *Usury Legislation—Its Effects on the Economy and a Proposal for Reform,* 33 VAND. L. REV. 199 (1980).

2. *See, e.g.,* 12 U.S.C. §§ 85, 1709-1 (Supp. IV 1980); *id.* § 1831a (repealed 1980); 15 U.S.C. §§ 636, 687 (1976 & Supp. IV 1980).

3. *See* Nosari & Lewis, *How Usury Laws Affect Real Estate Development,* 9 REAL EST. L.J. 30 (1980).

4. *See* Crafton, *An Empirical Test of the Effect of Usury Laws,* 23 J.L. & ECON. 135 (1980).

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In reaction to these adverse effects on lending in general and specifically on real estate financing, Congress passed temporary pre-emption statutes in late 1979,[5] followed by sweeping pre-emption statutes passed as part of the Depository Institutions Deregulation and Monetary Control Act of 1980[6] (the "Act"). The Act completely eliminated state usury ceilings with regard to first mortgage residential real estate financing and provided federal ceilings for the interest chargeable on business and agricultural loans and loans made by insured banks, savings and loan associations, credit unions, and small business investment companies. This Article will examine the operation of and problems raised by the Act's pre-emption provisions.

II. THE DEPOSITORY INSTITUTIONS DEREGULATION AND MONETARY CONTROL ACT OF 1980

A. *Residential Real Estate Financing*

The most extensive pre-emption provisions in the Act apply to residential real estate financing.[7] Section 501(a)(1)(A) simply pre-empts any state law that limits the interest rate charged on any first lien residential loan.[8] The regulations of the Federal Home Loan Bank Board (the "Board"), the agency authorized to publish interpretations governing the implementation of section 501,[9] state that "first lien" will be defined by state law.[10] The regulations also state that a first lien is any lien obtained in a manner that gives the lender a first priority in the real estate security under state law.[11] Nevertheless, several questions have arisen over what constitutes a first lien.

The Board at one time maintained that section 501 applies to wrap-around mortgages.[12] A regulation proposed by the Board defines a purchase

5. Act of Dec. 28, 1979, Pub. L. No. 96-161, 93 Stat. 1233 (1979).

6. Pub. L. No. 96-221, 94 Stat. 161 (1980).

7. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 501, 94 Stat. 132, 161 (1980).

8. *Id.* § 501(a)(1)(A).

9. *Id.* § 501(f), 94 Stat. at 163.

10. 12 C.F.R. § 590.2(c) (1981).

11. *Id.* This section of the regulations defines "loans which are secured by first liens on real estate" to include "loans on the security of any instrument (whether a mortgage, deed of trust, or land contract)."

12. *See* 45 Fed. Reg. 86,500-02 (1980). Letters from Jerome Plapinger, Associate General Counsel, Federal Home Loan Bank Board, to unidentified addressees (May 20, 1980 & Aug. 8, 1980). A wrap-around mortgage typically involves a loan made on property subject to a prior mortgage securing a loan made at a lower interest rate. The wrap-around mortgage is a second lien securing a promissory note, the face amount of which includes not only the new advance but also the unpaid balance on the prior loan, which the wrap-around mortgagee agrees to pay according to its terms. By requiring a new higher interest rate on the whole face amount of the note, the lender's yield on the new advance is magnified. For a discussion of other forms of wrap-around mortgages, see Arditto, *The Wrap Around Deed*

money wrap-around loan as a first lien loan if the wrap-around lender retains sufficient funds to satisfy the "prior indebtedness."[13] Although the proposed regulation has a certain surface logic, a wrap-around mortgage is not the equivalent of a first lien mortgage, and it is questionable whether the Board can so stretch its interpretive powers. The comment period on the proposed regulation expired on May 2, 1981,[14] but no final regulation has been issued as of this writing.

The second interpretive question arising out of the first lien requirement is whether section 501 applies to a loan made subject to a prior lien, but on the condition that the lender will not advance funds except in an amount sufficient to enable the borrower to obtain a release from the first lien. The Board has given its opinion that such a loan does meet the first lien requirement, as long as each disbursement "will at all times be secured by a first lien on property and improvements roughly equivalent in value to the disbursements."[15] This opinion is logically correct because no interest is charged until a disbursement is made; interest is charged only on that portion of the loan actually secured by a first lien.

The third question concerns loans secured by both a first lien and a second lien on real estate. Is such a loan a first lien loan for purposes of section 501? Section 501(a)(1)(A) only speaks of *a* first lien and does not exclude first lien loans with additional security.[16] The Board appears to maintain that section 501 covers such a "mixed lien" loan, as long as the first lien security is sufficient collateral for the entire debt.[17] This pragmatic interpretation recognizes that the lender should not be penalized for seeking additional security. On the other hand, the very existence of additional security may indicate that the first lien security is not adequate. Whether the courts will accept the Board's position on this issue is uncertain. Lenders who make mixed lien loans should be aware of the possibility that section 501 may not cover such loans, thus subjecting them to state usury law limitations.

A fourth question is whether the first lien may be attached to a property interest less than a fee title and still qualify under section 501. The applicable regulation states that section 501 applies to loans secured by interests in real estate "whether in fee, or in a leasehold or subleasehold, extending

of Trust; An Answer to the Allegation of Usury, 10 PAC. L.J. 923 (1979).

13. 45 Fed. Reg. 86,501-02 (1980).

14. *Id.*

15. Letter from Rebecca H. Laird, Senior Associate General Counsel, Federal Home Loan Bank Board, to unidentified addressee (May 27, 1981). This and other unpublished letter opinions addressing specific questions regarding usury are compiled as "Legal Opinions on Usury Pre-emption" and are available from the Information Services of the Office of General Counsel, Federal Home Loan Bank Board, 1700 G. Street N.W., Washington, D.C. 20552.

16. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 501(a)(1)(A), 94 Stat. 132, 161 (1980).

17. Letter, *supra* note 15.

or renewable, automatically or at the option of the holder or the lender, for a period of at least 5 years beyond maturity of the loan."[18] The Board has interpreted section 501 to apply also to "time share interests" in a resort.[19] This interpretation does differentiate between "right to use time sharing" and "fee-title time sharing."[20] Thus, it appears that the borrower must have an interest in the real estate, rather than a mere license to use it, to qualify under section 501.

Other problems of interpretation concern the limitation of the application of section 501 to loans secured by "residential real property" or "residential manufactured homes."[21] Section 501(a)(1)(C)(i) to (ii) does specify that residential real property includes "stock in a residential cooperative housing corporation" and multi-family housing.[22] In many other situations, however, the application of section 501 is not so clear.

A common example is the real estate development loan. The Board defines "residential real property" to mean "real estate improved *or to be improved* by a structure or structures designed *primarily* for a dwelling, as opposed to commercial, use."[23] It is unclear whether a loan on undeveloped real estate held for speculation, but with the intent of eventual development into residential real estate, qualifies. If the borrower intends to use the loan proceeds for development, the loan clearly falls within the intent of section 501 and should be protected. If the loan is merely for the purchase price of the property, however, and the eventual residential use of the property is not certain, a lender seeking protection of section 501 should document the residential nature of the property.

An additional problem exists when the real estate is used for both residential and commercial purposes. The Board has issued an opinion that a mixed-use structure is residential if its primary use is residential, *i.e.*, if over one-half of the value or over one-half of the area of the structure is attributable to residential use.[24] The same reasoning should apply to a mixed use development. If, however, there is a basis on which to separate the commercial securi-

18. 12 C.F.R. § 590.2(c) (1981).

19. Letter from Rebecca H. Laird, Senior Associate General Counsel, Federal Home Loan Bank Board, to unidentified addressee (Aug. 11, 1981).

20. *Id.*

21. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 501(a)(1)(A), 94 Stat. 132, 161 (1980).

22. *Id.* § 501(a)(1)(C)(i)-(ii).

23. 12 C.F.R. § 590.2(f) (1981) (emphasis added). *See also* Letter from Rebecca H. Laird, Senior Associate General Counsel, Federal Home Loan Bank Board, to unidentified addressee (Jan. 22, 1981); Letters from Jerome Plapinger, Special Counsel, Federal Home Loan Bank Board, to unidentified addressees (July 10, 1980 & Aug. 12, 1980).

24. Letter from Ira L. Tannenbaum, Acting General Counsel, Federal Home Loan Bank Board, to unidentified addressee (Mar. 13, 1981).

ty from the residential security, not all of the property should become residential for pre-emption purposes.

Not all lenders may take advantage of section 501. Initially, section 501 applied only to insured institutions, lenders regulated by a federal agency, federally insured loans, and certain other federally-related lenders.[25] The Act was amended later to apply to owner-financed sales of personal residences when the owner retained a first lien.[26] Except for the homeowner-lender, a lender must regularly make or originate $1,000,000 of residential real estate loans per year to qualify under section 501.[27] These mortgage loans need not be first liens to contribute to the $1,000,000 requirement.[28] A lender must meet the $1,000,000 requirement on its own; controlled groups cannot aggregate their loan volumes to meet the requirement.[29]

Section 501 pre-empts state law only with regard to interest, discount points, and finance charges.[30] Although its language is broad enough to include nearly all lender charges made on origination or during the term of a loan, section 501 does not pre-empt state consumer protection laws.[31] Thus, section 501 does not apply to state limitations on prepayment charges, rights to prepayment, attorneys fees, or late charges.[32]

Section 501 applies to all loans, mortgages, credit sales or advances that otherwise meet its requirements.[33] The origination of a new loan clearly qualifies. The statute is less than explicit with regard to extensions, assumptions, and other modifications of loans made before section 501 was enacted. The Board has interpreted the 1979 temporary pre-emption statute to apply to modifications of loans resulting in obligations materially different from

25. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 501(a)(1)(C), 94 Stat. 132, 161 (1980) (incorporating by reference 12 U.S.C. § 1735f-5(b) (1976)).

26. Housing and Community Development Act of 1980, Pub. L. No. 96-399, 94 Stat. 1614 (1980). The Federal Home Loan Bank Board's legal staff has interpreted this section to apply to a credit sale of an owner-occupied duplex. *See* Letter from Rebecca H. Laird, Senior Associate General Counsel, Federal Home Loan Bank Board, to unidentified addressee (July 28, 1981).

27. 12 C.F.R. § 590.2(b)(6)(ii) (1981).

28. *Id.*

29. Letter from Rebecca H. Laird, Senior Associate General Counsel, Federal Home Loan Bank Board, to unidentified addressee (July 21, 1981).

30. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 501(a)(1), 94 Stat. 132, 161 (1980).

31. 12 C.F.R. § 590.3(c) (1981).

32. *See also* F.H.L.B.B. Interp. No. 590-6, 45 Fed. Reg. 8,000 (1980). The Federal Home Loan Bank Board interpreted the 1979 temporary statute not to preempt a Wisconsin statute that required lenders to refund "unearned" interest on prepayment if the interest rate on the loan was more than 10% per annum.

33. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 501(a)(1), 94 Stat. 132, 161 (1980).

those of the predecessor loans.[34] This interpretation also included refinancing of existing first loans.[35] If the lender has the right to call the loan due or to require refinancing if the loan is modified, the modified loan should qualify for protection under section 501, notwithstanding the form of the modification.

Another limitation of section 501 is that it applies only to loans made after March 31, 1980.[36] Under the same provision of the 1979 temporary statute, loans committed to before that date, but not closed until after March 31, 1980, were governed by state law.[37]

The states may opt out of the coverage of section 501.[38] At least ten jurisdictions have done so in whole or in part.[39] To opt out, a state must, before April 1, 1983, explicitly overrule that portion of section 501 limiting the interest that lenders may charge on first mortgage residential real estate loans.[40] On the other hand, a state at any time may limit discount points and other charges, and there is no requirement of explicitness.[41]

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34. F.H.L.B.B. Interp. No. 590-2, 45 Fed. Reg. 6,166 (1980).

35. *Id.*

36. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 501(a)(1)(B), 94 Stat. 132, 161 (1980).

37. *See* F.H.L.B.B. Interp. No. 590-1, 45 Fed. Reg. 2,840 (1980).

38. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 501(b)(2), 94 Stat. 132, 161 (1980).

39. *See* COLO. REV. STAT. §§ 5-13-101 to -105 (Cum. Supp. 1981); HAWAII REV. STAT. § 478-12 (Supp. 1981); 1980 Iowa Acts 547, § 32; KAN. STAT. ANN. §16-207a (1981); 1981 Mass. Acts 261, § 2; MINN. STAT. ANN. § 47.203 (West Cum. Supp. 1981); 1981 Nev. Stat. 1596, § 11; P.R. Law No. 3 (Mar. 20, 1980) (implemented by P.R. Reg. No. 22-A (Nov. 23, 1981)); S.C. CODE ANN. § 34-31-31 (Law Co-op. Cum. Supp. 1981); S.D. CODIFIED LAWS ANN. § 54-3-15 (Supp. 1981).

40. An example of sufficient explicitness is KAN. STAT. ANN. § 16-207a (1981): "The provisions of section 501(a)(1) of title V of public law 96-221 shall not apply with respect to loans, mortgages, credit sales and advances made in this state on and after the effective date of this act." The Mississippi legislature apparently feared inadvertently overriding federal law in the revision of state usury laws. 1980 Miss. Laws, ch. 492, § 7, provides, "This act shall not be construed as stating explicitly and by its terms that the State of Mississippi does not want the provisions of Sections 501(a)(1), 511 and 521 through 523 of the Depository Institutions Deregulation and Monetary Control Act of 1980 to apply . . . ."

Some have argued around the explicitness requirement. "Others argue that H.B. 1228, taken as a whole, represents such a significant and comprehensive revision of Texas usury law that the bill itself is an explicit affirmation of the desire of the state to reserve interest rate regulation unto itself." Farabee & Dobbs, *Recent State and Federal Developments in Interest Rate Regulation*, 44 TEX. B.J. 879, 883 (1981).

41. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 501(b)(4), 94 Stat. 132, 162 (1980).

B. *Business and Agricultural Loans*

Section 511 of the Act originally pre-empted state usury laws with respect to business and agricultural loans, but did not define such loans.[42] A subsequent amendment to the Act extended pre-emption to secured or unsecured loans made for "business or agricultural purposes."[43] Thus, qualification for pre-emption under section 511 is determined by the purpose of the loan, rather than the nature of the collateral. Section 511 still lacks definitions of "business" and "agricultural," and neither term has been amplified by regulation or case law. A lender seeking protection under section 511 should document the purpose of the loan thoroughly and should rely on this section only if the loan clearly is made for a permitted purpose. There are no restrictions on the type of lender who may qualify under section 511,[44] but the loan in question must be for $1,000 or more.[45]

The maximum interest rate chargeable on a qualifying loan is five percentage points over the discount rate in the applicable federal reserve district.[46] "Interest," however, includes "any compensation, however denominated, for a loan."[47] Thus, origination fees, discount points, and any other service charges, even penalties, must be included in determining whether a loan is within this restriction.

Section 511 applies only to loans made prior to April 1, 1983;[48] to loans agreed to prior to April 1, 1980, but funded, renewed, extended, or modified after April 1, 1980;[49] and to loans made prior to April 1, 1980, but subject to variable or fluctuating rates.[50] A state may opt out of the coverage of section 511 by an explicit election.[51]

C. *Loans Made by Insured Institutions*

Section 521 of the Act provides an additional pre-emption provision for insured banks, savings and loan associations, credit unions, and small

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42. *Id.* § 511(a).
43. Housing and Community Development Act of 1980, Pub. L. No. 96-399, § 324(b), 94 Stat. 1614, 1648 (1980).
44. *Id.*
45. The original requirement was $25,000. Act of Dec. 28, 1979, Pub. L. No. 96-161, § 202, 93 Stat. 1233, 1235 (1979).
46. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 511(a), 94 Stat. 132, 164 (1980).
47. Housing and Community Development Act of 1980, Pub. L. No. 96-399, § 324(b), 94 Stat. 1614, 1648 (1980).
48. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 511(a), 94 Stat. 132, 164 (1980).
49. Housing and Community Development Act of 1980, Pub. L. No. 96-399, § 324(c)(2), 94 Stat. 1614, 1648 (1980).
50. *Id.*
51. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 522, 94 Stat. 132, 165 (1980).

business investment companies.[52] The maximum interest rate chargeable under section 521 is one percentage point over the discount rate on ninety-day commercial paper at the federal reserve bank in the applicable federal reserve district.[53] The Board interprets section 521 to incorporate the doctrine of the "most favored lender," which has long been applicable to national banks.[54] This doctrine may authorize a rate higher than the one percent limitation prescribed if state law permits a greater rate on a given class of loans.[55] A state may opt out of the coverage of section 521 by an explicit election.[56]

III. CONCLUSION

For real estate lenders otherwise constrained by state usury laws, the Depository Institutions Deregulation and Monetary Control Act of 1980 may, by the pre-emption of state usury laws, provide a means to make loans at economically realistic interest rates. The qualified lender must be sure to satisfy the various requirements of the Act with regard to the type or purpose of the loan, the interest rate charged, and the security taken for the loan. Furthermore, the lender must be alert to any changes in state law that once again might subject it to restrictive state limitations.

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52. *Id.* § 521, 94 Stat. at 164.
53. *Id.*
54. 46 Fed. Reg. 13,987 (1981).
55. *Id.*
56. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 521, 94 Stat. 132, 164 (1980).