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STATE CAPITOL
PHOENIX, ARIZONA

September 4, 1969

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DEPARTMENT OF LAW OPINION NO. 69-23 (R-83)

REQUESTED BY: THE HONORABLE DAVID B. KRET
Arizona State Senator

QUESTION: Is a loan agreement rendered usurious by charging the borrower the fee known as "points" if the sum of the "points" and the interest charged on the loan exceed the legal maximum interest rate permitted by A.R.S. §§ 44-1201 to 44-1204?

ANSWER: Yes.

A.R.S. §§ 44-1201 to 44-1204, relating to interest, provide:

"§ 44-1201 Rate of interest for legal indebtedness; limitation on rate of interest which may be contracted; interest on judgments

"A. Interest for any legal indebtedness shall be at the rate of six dollars upon one hundred dollars for a year, unless a different rate is contracted for in writing.

"B. A rate of interest, not to exceed ten per cent per annum, if agreed to in writing, signed by the debtor, shall be paid. A judgment given on such agreement shall bear the rate of interest provided in the agreement, and it shall be specified in the judgment.

"§ 44-1202. Usury prohibited; forfeiture of all interest upon obligation involving interest exceeding ten per cent

"No person shall directly or indirectly take or receive in money, goods, or things in action, or

in any other way, any greater sum or any greater value for the loan or forbearance of any money, goods, or things in action, than ten dollars on one hundred dollars for one year. Any person, contracting for, reserving or receiving, directly or indirectly, any greater sum or value, shall forfeit all interest.

"§ 44-1203. Application to principal of payments made upon interest contracted in excess of ten per cent; judgment in action to recover obligation involving usurious interest limited to amount due on principal

"Where a rate of interest greater than ten per cent per annum is contracted for, reserved or received, directly or indirectly, all payments of money or property made on account of such interest, or as inducements to contract for more than ten per cent per annum, whether made in advance or not, shall be deemed payments made on account of the principal. In an action brought to recover the amount of the obligation the court shall give judgment for no greater amount than the balance determined to be due upon the principal, without interest, after deducting such payments.

"§ 44-1204. Payments of interest on obligation involving more than ten per cent interest on counterclaim in action brought on obligation; action to recover payments of interest in excess of principal on usurious obligation

"In an action to recover on an obligation whereby there is contracted for, reserved or taken, a greater rate of interest than ten per cent per annum, all payments made in money or property may be pleaded as a counterclaim or set-off. If such payments exceed the amount of the principal, judgment may be given in favor of the defendant for the excess, with interest at the rate of six per

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cent per annum. If such payments exceed the amount of the principal of the debt or obligation an action may be maintained to recover the excess."

In construing the above usury statutes, the Arizona Courts have followed the rules generally followed by the courts in this country in allowing a lender to charge certain fees in connection with a loan and not treating the fees as interest, but denominating other fees as additional interest, with the distinction depending upon the purposes of the fees and the amounts in relation to the purposes.

The most difficult question to answer is when an additional charge or fee is deemed to be interest.

In Grady v. Price, 94 Ariz. 252, 383 P.2d 173 (1963), the Arizona Supreme Court, upon considering A.R.S. § 44-1202, said in 94 Ariz. at 256:

"A lender, in addition to the highest rate of interest, may charge the borrower reasonable fees for services rendered in connection with the loan, or require reimbursement of expenses incurred, such as the examination of title, recordation of papers, and perhaps traveling expenses and other similar expenses. [Citations omitted.] But such charges must be limited to specific services rendered and expenses incurred, and may not be made a device through which additional interest or profit on the loan may be exacted, [Citations omitted]. Nor may a lender charge to a borrower the ordinary overhead expenses of his business. [Citations omitted.]"

In finding usurious a loan agreement whereunder the borrower was required to pay to the lender a 3% brokerage fee in addition to the maximum rate of interest permitted by law, the Court in Grady v. Price, in 94 Ariz. at 257, said:

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"While it is possible that . . . Grady could have charged . . . for some of the expenses he incurred in connection with the loans if such charges had been specific and in reasonable amount, we cannot approve a provision by which the lender adds a set percentage of the amount loaned as a blanket fee to cover indefinite expenses, some of which are certainly part of the normal overhead of the lending business, where that fee plus the rate of interest exacted exceeds the maximum rate of return premitted by the statute. To do so would open an easy avenue for avoidance of the usury penalties." [Footnote omitted.]

The Arizona Supreme Court again considered the effect of requiring a borrower to pay a brokerage fee and various other charges in addition to the maximum rate of interest permitted by law in Modern Pioneers Insurance Company v. Nandin, 103 Ariz. 125, 437 P.2d 658 (1968). We think it appropriate to cite at some length from the opinion in Modern Pioneers Insurance Company v. Nandin, in 103 Ariz. at 131, as follows:

"In the instant case McNichols testified that the brokerage fee was set by him at eight per cent, and that that figure was based upon the availability of funds, the work involved, and the time it would take to get the loan ready and find a market for it. Most of the work appears to have been done, however, by the bookkeeper that Nandin was forced to hire and pay for, rather than by Acoma. It is obvious that a brokerage fee of nearly \$4,000 for what little was done by Acoma was unreasonable in the extreme, and since we have already held that part of it was indirectly received by MPI [Modern Pioneers Insurance Company], in addition to a note bearing the maximum legal interest, this whole transaction must fail as usurious.

* * *

"In 21 A.L.R. 871, cases are collected on the propriety of various types of expenses, including appraisals, title-clearing, preparing and recording documents, insurance expense, collection expenses, and miscellaneous expenses. The authorities therein cited show that certain expenses such as title-policy premiums, appraisal fees, etc., are generally permitted to be passed on to the borrower. The same is true with many other fees and costs which the lender actually pays out, such as the cost of credit reports, etc. If, however, we continually expand the list of permissible items, it will eventually be possible for the lender to contract out all of his overhead, add the contractual payout to the interest, and obtain the maximum interest as his net profit instead of his gross profit from which his expenses must be paid. A typical example of this is the frequent requirement that the borrower pay for a service which checks twice a year to see that the borrower has paid the taxes on the property mortgaged for security. Before the presence of such services, the lender had to check the taxes, or demand to see the tax receipts. If he had a large number of loans he might pay an employee to do this. This was as much a part of his overhead as his rent. It was not the intent of the usury statute that the lender should be allowed to collect the maximum rate plus his overhead."

The instant question was considered by the Arizona Supreme Court in Altherr v. Wilshire Mortgage Corporation, 104 Ariz. 59, 448 P.2d 859 (1968), in the form of a 5% discount that a borrower was required to pay by receiving only 95% of the amount loaned. The Court said, in 448 P.2d at 863:

"In the trade this means that if the permanent loan was for \$1,000 Wilshire would take \$50 of that amount, so Altherr would get only \$950. This is a common practice, similar to that of many lending institutions which refer to them as

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'points.' If a lender made an eight per cent loan, and, in addition to the interest, required the borrower to pay points, or a discount, usury would be clear immediately. But where the points or discount are required on a long-term loan, the amount involved must be spread over the entire term of the loan to determine whether the eight per cent maximum allowable interest is exceeded." (Original emphasis.)

The Court of Appeals of Maryland defined the term "point", in connection with a loan, in B. F. Saul Company v. West End Park North, Inc., 250 Md. 707, 246 A.2d 591 (1968), at page 595:

"Our search reveals that there is no mysterious connotation to the word 'point.' It simply denotes a fee or charge equal to one per cent (1%) of the principal amount of the loan which is collected by the lender at the time the loan is made. It may be used interchangeably with the term 'bonus,' 'premium,' 'loan origination fee' or 'service charge.' The basic tenet to remember is that it is a fee or charge which is collected only once, at the inception of the loan, and is in addition to the constant long term stated interest rate on the face of the loan."

The Court of Appeals of Maryland also announced the rule which is cited from Altherr v. Wilshire Mortgage Corporation, supra, that the charge of a fee called "points" made at the inception of the loan should not be considered interest paid in the initial year of the loan, but should be computed or spread over the term of the loan.

The Court of Appeals of Maryland in 246 A.2d at 596 - 597, illustrated the effect of charging "points" with the following example:

"Let us assume that the borrower has applied for a loan of \$10,000 bearing interest at the rate of six per cent (6%), with the interest and unpaid balance being paid in fixed monthly installments over a period of twenty (20) years, with a charge of five 'points' being deducted by the lender. This \$10,000 loan with five 'points' charged results in a five per cent (5%) discount applied to the principal sum and yields a \$9,500 net loan to the borrower.

"The borrower who thus receives a net of \$9,500 after deducting five 'points' and pays back \$10,000, plus interest, in monthly installments over twenty (20) years is not paying the \$500 deducted from the face amount of the loan in the first year but is paying a small portion of this each month over the entire twenty (20) years.

"The determinative factor as to whether or not the interest in such a case is usurious is the annual effective rate of interest (not to be confused with the term 'stated interest'). If the annual effective rate of interest does not exceed eight per cent (8%) then it is not usurious and this annual effective rate of interest is computed as follows,
. . . .:

"The dollar amount of interest payable during the life of the loan is ascertained by multiplying the amount of each monthly payment by the number of months and subtracting the net principal of the loan. Hence, in the case of a \$10,000 loan at six per cent (6%) with five points deducted payable over 20 years, with the fixed monthly payment of \$71.65:

\$71.65 X 240 (20 years X 12 mos.)= \$17,196.00
total paid by borrower

Less net loan after subtracting points
deducted 9,500.00

Total dollar amount of interest paid
for the use of \$9,500.00 during
life of loan 7,696.00

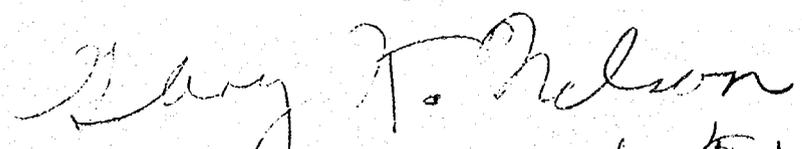
The stated rate of interest in
the note itself is 6%

The current yield to the lender,
who receives interest at
the rate of \$600.00 per year
for a \$9,500.00 loan, is
\$9,500.00 divided into
\$600.00= 6.31%

But because the lender not only
receives a current yield of
6.31% but during the life
of the loan also receives
back the \$500.00 deducted
from the face amount of the
loan, he has a yield to
maturity of 6.65%

(6.65% being the annual effective rate of interest)."
[Footnotes omitted.]

Respectfully submitted,


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The Attorney General *by F. d.*