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Texas Supreme Court Rules "Discount Points" Are Not Interest! Effective June 21, 2013, Discount Points Are Subject to the Three-Percent Fee Cap for Homestead-Secured Home Equity Loans and Lines of Credit

I. Introduction

On June 21, 2013, the Texas Supreme Court ("Court") issued its long-anticipated opinion in ***Finance Commission of Texas v. Norwood***.[1] As a threshold matter, originators of home equity loans under Section 50(a)(a)(6) of the Texas Constitution are prohibited from charging more than three percent in fees in connection with such bans, absent certain notable exclusions, such as "interest." Since the enactment of the Texas constitutional amendment in 1998, it has been a matter of debate whether "discount points" may be excluded from the three-percent cap. Under this seminal decision, lenders are prohibited from treating discount points as "interest" and therefore must include the points in the three-percent cap on fees on homestead-secured home equity loans and lines of credit.

II. The *Norwood* Decision

Section 50(a)(6)(E) of Article XVI of the Texas Constitution provides that a valid home equity loan is one 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 aggregate, three percent of the original principal amount of the extension of credit.

That provision limits the amount of fees and costs (other than interest) that the homeowner is required to pay to three percent of the principal amount of the loan.

In ***Tarver v. Sebring Capital Credit Corp***,[2] the Texas Court of Appeals opined that discount points are interest and are excluded from the three-percent cap. Based upon the ***Tarver*** decision, and the subsequently enacted regulation, lenders have excluded discount points from the calculation of fees subject to the three-percent cap.

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1 No. 10-0121, 2013 WL 3119481 (S.Ct. Tex. June 21, 2013).

2 69 S.W.3d 708 (2002).

In seeking to provide some clarity as to what is included in the term "interest" in that section, the Finance Commission in 2003 adopted a rule that defined "interest" as provided in the Texas Finance Code and as interpreted by the courts, and added this clarification: "Charges an owner or an owner's spouse is required to pay that constitute interest under the law, for example per diem interest and points, are not fees subject to the three percent limitation."[3] That rule was declared invalid by the 2005 district court decision, ***ACORN v. Finance Commission of Texas***.[4]

In 2010, the Texas Court of Appeals in Austin upheld the 2005 district court decision striking down the Finance Commission's interpretation of what constitutes "interest" for purposes of the three-percent fee cap. The Texas Court of Appeals reasoned that including lender-retained fees would render the three-percent cap meaningless.[5]

Note that the court of appeals did not say that per diem interest and discount points are not interest, and must be included in determining the amount of fees and charges limited by the three-percent cap. All it said is that the rule that specifically included per diem interest and discount points in the definition of what is "interest" and provided a safe harbor for the lender is not valid.[6]

In ***Norwood***, the Court affirmed the appellate decision regarding discount points. The Court reasoned that such an interpretation allowing the legislature to define interest would permit the legislature to periodically modify that definition, thereby defeating the purpose of the constitutional home equity lending fee cap, which could only be amended by popular vote. The Court also noted that the definition of interest was modified to include lender-retained fees after the regulations became effective. The Court found that interest for purposes of the home equity lending provisions should be the general meaning of "interest," or the amount calculated by multiplying the interest rate by the principal balance.[7]

The Court also invalidated regulations interpreting the constitutional requirement that a home equity loan be closed only at the office of the lender, an attorney at law, or a title company to mean that the borrower could consent to the creation of a lien on the homestead by mailing the lender the required consent or attend the closing through an attorney-in-fact.[8] The Court reasoned that the regulation defeated the purpose of the provision that was implemented to prohibit the coercive closing of an equity loan at the owner's home.

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3 *Id*. (effective January 1, 2004).

4 2006 WL 4959302 (Tex. Dist.). In *Norwood*, the Court noted that the constitutional amendment necessary for Texas to become the last state to allow home equity lending required "that the compromises finally struck … [to] withstand future political pressures on the Legislature [involved] lengthy, elaborate, detailed provisions, remarkable even for our State's Constitution…." *Norwood*, No. 10-0121, slip op. at n. 14 (citing J. Alton Alsup, *Pitfalls (and Pratfalls) of Texas Home Equity Lending*, 52 Consumer Fin. L. Q. Rep. 437 (1998)).

5 303 S.W.3d 404 (Tex. App. – Austin 2010).

6 *Id*.

7 *Norwood*, No. 10-0121, slip op. at 11 & 29-32 (Pts. I. & IV.B.).

8 *Id*. at 32 – 34 (Pt. IV.C).

Further, the Texas Supreme Court upheld a regulation establishing a rebuttable presumption that the notice prescribed in Texas Constitution Article XVI, Section 50(g), is received three days after it is mailed.[9]

This decision means that, effective June 21, 2013 (the date of the ***Norwood*** decision), Texas homestead-secured home equity lenders must immediately include all lender-retained charges, including origination and discount points, within the three-percent cap. Lenders also should not close a home equity loan unless the borrower can attend closing at the office of a lender, an attorney at law or a title company.

III. Analysis

A. Finance Commission of Texas v. Norwood, et al. (ACORN), No. 100121 (Tex. June 21, 2013)

In ***Norwood***, the Court overturned two of the Commissions' home equity rules and affirmed one of the home equity rules. After determining that it had jurisdiction to hear the case, the Court ruled on the following three issues: (1) the definition of "interest" in the three-percent fee cap under Section 50(a)(6)(E) of the Texas Constitution; (2) whether a borrower can use a power of attorney for a Texas home equity loan closing under Section 50(a)(6)(N) of the Texas Constitution; and (3) whether there is a rebuttable presumption under Section 50(g) of the Texas Constitution that the Notice Concerning Extensions of Credit is received, and therefore provided, three days after it is mailed.

The Court held that the Commissions' interpretative authority is the same as the Judiciary's interpretative authority and that the Commissions' interpretations are to be reviewed in the same manner as judicial decisions.[10] The Court further opined that the Commissions have no more interpretative authority than the courts have.

B. Definition of Interest for Three-Percent Fee Cap under 7 Section TAC 153.1(11)

Section 50(a)(6)(E) caps fees to any person that are necessary to originate, evaluate, maintain, record, insure or service the extension of credit at three percent of principal. The Court queried whether the Commissions correctly gave "interest" the same meaning as Section 301.002(a)(4) of the Texas Finance Code, which includes fees paid to the lender, thereby removing lender fees from the three-percent fee cap. The court of appeals had held the Commissions did not give the correct meaning to "interest," reasoning that the statutory definition of interest is purposely broad to protect borrowers from usury.[11]

The Court held that, according to the Commissions, the meaning of "interest" is as defined in Section 301.002(a)(4) of the Texas Finance Code and as interpreted by the courts. The Court stated that the fatal difficulty with the Commissions' interpretation is that it did not merely adopt the substance of the statute at the time the interpretation became effective, but also adopted whatever definition of "interest" the

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[9] *Id*. at 34 (Pt. IV.D).

[10] In the *Norwood* opinion, "Commissions" refers to four state regulatory agencies that jointly issued a Regulatory Commentary on Equity Lending Procedures. *See Norwood*, No. 10-0121, slip op. at 5, n. 19, citing: Office of Consumer Credit Comm'r et al., Regulatory Commentary on Equity Lending Procedures 1 (Oct. 7, 1998) [hereinafter *Regulatory Commentary*], *available at* http://www.fc.state.tx.us/homeinfo/homeq2.pdf and http://www.occc.state.tx.us/pages/Legal/commentary.htm (last visited June 17, 2013).

[11] 303 S.W.3d 404.

legislature may enact from time to time in amending Section 301.002(a)(4). The Court further stated that the Commissions acknowledged that the legislature could change the effect of its interpretation and the meaning of Section 50(a)(6)(E) simply by amending the statute, and that this actually happened.

With regard to the three-percent fee cap, the Court stated:

> The Commissions' interpretation of the fee cap, tying its meaning to a statute, utterly defeats the clear purpose of constitutionalizing it, which was to place the limitation beyond the Legislature's power to change without ratification by voters. For this reason alone, the Commissions' interpretation is invalid….
>
> The functions of "interest" in applying the constitutional fee cap for home equity loans and in prohibiting usury are inversely related. If the word is given the same meaning in both contexts, then including lender-charged fees in "interest" strengthens usury laws and weakens the fee cap, though both are designed to protect consumers. That this was the intent of the framers and ratifiers of Section 50(a)(6)(E) is simply implausible …
>
> The Commissions' position is that in capping "fees to any person that are necessary to originate, evaluate, maintain, record, insure, or service" a home equity loan, the framers and ratifiers intended to cap only fees to any person *other than the lender*. But had that been their intent, surely the simplest and clearest way to express it would have been to use those four words, rather than the oblique phase, "in addition to any interest." This is especially true because there is another, well understood meaning of "interest": the amount equal to the loan principal multiplied by the interest rate. Applied to Section 50(a)(6)(E), that definition allows "any person" to mean just that.[12]

In overturning the Commissions' regulations with regard to the fee cap, the Court held that consistent with the history, purpose and text of Section 50(a)(6)(E), "interest" means the amount determined by multiplying the loan principal by the interest rate. A footnote indirectly addresses discount points, noting that this narrower definition of interest does not limit the amount a lender can charge for a loan; rather, it limits only what part of the total charge can be paid in front-end fees rather than interest paid over time. It thereby incentivizes lenders to determine borrowers' creditworthiness more carefully and helps borrowers better access the costs of credit.[13]

Thus, effective with loans that close on or after June 21, 2013, lenders and vendors performing due diligence need to include discount points or other equivalent origination charges in their three-percent cap calculation.

C. Power of Attorney for Texas Home Equity Loan Closing under 7 Section TAC 153.15

Section 50(a)(6)(N) provides that a loan may be closed only at the office of a lender, attorney at law, or a title company. The Commissions' interpretations allow a borrower to mail the required consent for a home equity loan to a lender and to close through an attorney-in-fact. The Court stated that both of these interpretations permit coercion in obtaining the required consent and a power of attorney at the borrower's home, allowing the final closing to occur later at one of the prescribed locations, thereby defeating the purpose of the constitutional provision. The Court further provided that closing a loan is a process and that it would clearly be unreasonable to interpret Section 50(a)(6)(N) to allow all the loan papers to be signed at the borrower's

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[12] *Norwood*, No. 10-0121, slip op. at 30-31 (emphasis in original).

[13] *Id*. at 32, n. 104.

house and then taken to the lender's office, where funding was finally authorized. The Court held that the Commission's interpretation of Section 50(a)(6)(N) contradicts the purpose and text of the provision and are therefore invalid. Accordingly, a power of attorney cannot be used for closing a Texas home equity loan.

D. Notice Concerning Extensions of Credit under 7 Section TAC 153.51

Section 50(g) requires that the loan not be closed before the twelfth day after the lender provides the borrower the Notice Concerning Extensions of Credit. The Commissions' regulations provide for a rebuttable presumption that the Notice Concerning Extensions of Credit is received three days after it is mailed. The court of appeals held the Commissions' interpretation to be reasonable, and the Court affirmed. In so holding, the Court provided that the Commissions' interpretation does not impair the constitutional requirements; it merely relieves a lender of proving receipt unless receipt is challenged.

IV. Observations and Conclusions

At this writing, no clarification has been given as to the effective date of the ***Norwood*** decision. Absent such clarification from the Texas Supreme Court, a conservative approach is warranted that would require inclusion of discount points in the three percent maximum fee cap immediately (meaning for all loans that close on or after June 21, 2013). Such a reading, however, leaves a number of uncertainties as to how best to cure any loans that have already closed and would generally lead to refunds of any such fees that would be in excess of the three-percent cap, if in fact such a course of action is necessary.

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