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**USURY IN ARKANSAS:
A LENDER'S GUIDE**

This discussion focuses on common questions Arkansas commercial lenders face today in an era of unprecedented interest rate instability. It does not deal with (a) consumer loans and their 17% limit or with (b) first mortgage residential real estate loans, as to which the rules are well settled. It also sets forth results of federal preemptions and branching statutes, without detailed analysis of the underlying statutes.

1. ARKANSAS LENDERS – Because of federal legislation, state banks chartered in Arkansas and national banks organized here simply have no ceiling on loans whose original balance exceeds \$2,000, regardless of the purpose of the loan or the nature of the collateral. No affirmative recitation in the documents is necessary to take advantage of the preemption.

Does this mean that these Arkansas lenders can make loans in other states subject to the same lack of a meaningful ceiling? Until that issue is litigated, you have to assume not.

2. BRANCHING LENDERS – Out of state lenders who have branched into Arkansas may choose the law of their home state as governing the interest rate ceiling on a loan, if they meet certain qualifications. (This discussion assumes that virtually no lenders are going to prefer Arkansas's constitutional rate structure to their own.)

If a loan is (a) approved by an officer in Arkansas, (b) disbursed here and (c) that approval is communicated to the borrower here, such as by telephone call from the loan officer, the lender is bound by the Arkansas usury structure. If any one of these three elements is tied to the home state instead, the lender is free to choose its law. If the loan is subject to credit scoring and that system has been approved in the home state, without giving the Arkansas officer the authority to override that system, approval is treated as having occurred in the home state.

If the lender's documentation system will permit it, it is a good idea to include a recital in this regard in the note or loan agreement, such as "the borrower agrees that the interest rate on this loan is governed by laws of Home State, where it was approved and from which it was disbursed...." Disbursement occurs when the borrower gets the money, not a local title company or escrow agent---if they cut the check, the disbursement is local.

Out of state lenders who have not taken advantage of this election and are governed by Arkansas law will have to pay attention to Arkansas rules, especially in a time of dropping rates.

3. MODIFICATIONS AND EXTENSIONS - It is common knowledge that, absent preemptions and exportation exceptions, Arkansas loans have a ceiling of five points over the Federal Reserve's primary credit rate (formerly the discount rate) at the time the loan is entered into (which also applies to penalty interest on or after default). If such a loan bears a rate in excess of the current formulation and it is modified (as a competitive matter) to lower the interest rate, must the lender lower the interest rate to the current maximum, or may it keep the original ceiling?

Generally, if the loan has not matured or been accelerated, the original rate ceiling may be retained, which may provide room for a fee as well. With no other modifications---for instance, adding collateral, requiring an unscheduled principal reduction, converting a line of credit to a term loan, etc.---almost certainly the lender is not creating a "new" loan for purposes of determining the applicable interest rate ceiling.

With regard to the imposition of the fee, the lender may go back to the traditional "life of the loan" analysis. The better argument is that such fees are not interest. They are not charges for forbearance in repaying a loan. But, even if such a fee were considered to be interest and added to the reduced interest proposed to be charged, under the life of the loan analysis, the resulting effective rate would have to exceed the maximum rate at the time the loan was originally closed. In other words, the fee would have to exceed the interest saving resulting from the rate reduction, over the life of the loan, which no borrower would have any incentive to pay.

4. NON-PREEMPTED ARKANSAS LOANS REVISITED - As with the modification analysis, if a loan for any reason is not eligible for a preemption or is otherwise subject to Arkansas' usury laws, the lender needs to re-visit the rules:

A. Arkansas Constitution. Arkansas Constitution Article XIX §13 ("Section 13") establishes the maximum rate of interest that may be charged on loans subject to Arkansas law and sets the penalties if the usury ceiling is violated.

B. Usury Limits: General Loans. As noted previously, the maximum rate of interest that may be charged on any such loan is 5% above the Federal Reserve Discount Rate on 90-day commercial paper (now the primary credit rate) in the Federal Reserve District in which Arkansas is located in effect at the time of the contract.

C. Consumer Loans. In addition to the maximum lawful rate applicable to all loans, the interest rate charged on consumer loans cannot exceed 17% per annum. For example, if the primary credit rate is 13%, the usury limit on consumer loans remains 17%, notwithstanding that interest at the rate of 18% can be charged on non-consumer loans.

D. Penalties For Violations Of Usury Limits.

1. General Loans. The borrower may recover twice the amount of interest paid (not just the excess).

2. Consumer Loans. If the interest charged exceeds 17% per annum, the loan will be void as to both principal and interest (as in the days before Amendment 60).

5. WHAT CONSTITUTES INTEREST UNDER ARKANSAS LAW?

Under Arkansas law, in addition to interest at the highest lawful rate, a lender may charge the borrower for all services or fees that are not within normal business expenses or overhead of the lender if charges are for services that benefit the borrower, notwithstanding that the services partially benefit the lender. Charges for services benefiting only the lender or which parallel the lender's normal business expenses constitute interest and must be added to the contract rate of interest to determine the actual effective rate of interest. Specific fees require some attention:

- A. Commitment Fees. While there are no definitive Arkansas cases on point, the better argument is that a fee which is paid for the reservation of loan funds at a future date and at an agreed interest rate is not a charge for the loan of money, but an independent contract.
- B. Origination Fees. Origination fees paid at closing are almost certainly interest and labeling them "commitment fees" does not help.
- C. Compensating Balances. A lender cannot require the borrower to open accounts as an express identifiable condition to getting a loan when the interest on the loan and the value of the use of the deposits gives the lender a total return in excess of the legal maximum.
- D. Credit Insurance. Lenders may require that a borrower insure his loan or his credit purchase. As agents for third party insurance companies, they may sell insurance at standard rates and commissions. They may buy it for the borrower. They may not require that he buy insurance through them, and they may not charge for insurance which duplicates the borrower's own coverage, nor may they participate in kickbacks, as distinguished from bona fide agent's fees from insurers which add to their lending profits. If lenders collect premiums for credit or credit-related property insurance out of the money they lend to borrowers, they must pay those premiums to third parties and insure that the borrower actually benefits or is given the opportunity to benefit from the insurance coverage for which they withheld the premium. Collecting the premium with professed intent to pay it out at some future time will not satisfy the court that the collector is not using the collection and supposed intent to pay it out as a cloak for usury.
- E. Disbursement. A lender may charge interest from the day of closing at the full maximum legal rate, even if funds are actually disbursed after the day of closing, provided the discrepancy involves no bad faith and relates to legitimate commercial problems of borrower and lender.

6. WHAT IS NOT INTEREST?

The following may be collected from the borrower and, if paid to third parties, do not constitute interest:

- A.) Title Insurance and Closing Costs.
- B.) Attorney's Fees Paid To Outside Counsel.
- C.) Appraisal Fees.

- D.) Recording Fees.
- E.) Guaranty Fees.
- F.) Environmental Study Costs.

7. VARIABLE RATE LOANS AND TIME OF CONTRACT - Section 13 mandates reference to the primary credit rate “at the time of the contract.” The date the lender has a contractual obligation fixes the “time of the contract.” The date on the note will control in most instances. However, if a binding commitment letter is issued, as noted above, the usury limit may well be fixed on that date. The maximum rate in effect at the “time of the contract” remains the applicable maximum rate for the life of the loan. The applicable rate does not float with changes in the primary credit rate. If the primary credit rate increases or decreases during the life of a loan, the maximum rate applicable to the loan does not change. If a loan matures and is renewed without a pre-existing commitment to extend the maturity date or renew the loan on pre-arranged terms, a new contract may well be created by the renewal, resulting in a new usury ceiling.

SUMMARY: As a result of federal preemptions, Arkansas state and national banks and residential mortgage generators typically may sidestep Arkansas’s interest rate structure altogether and their ceiling will simply be set by the market. Out of state lenders branching into Arkansas may bring their home state interest ceilings with them, also due to preemptions, if they follow clearly defined rules.

However, lenders not coming within those preemptions, voluntarily or involuntarily, currently are bound to a ceiling that is painfully close to five per cent per annum, and have an arcane and complex set of rules and penalties to get used to.

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