NO. COA04-1634 FIFTH DISTRICT

NORTH CAROLINA COURT OF APPEALS

* *

WAYNE SHEPARD and	)	
ROSEMARY SANDERS SHEPARD,	)	
	)	
	)	
	)	
v.	)	From New Hanover County
	)	No. 02 CVS 1780
	)	
OCWEN FEDERAL BANK, FSB;	)	
WELLS FARGO BANK MINNESOTA,	)	
N.A.; and DONALD T. RITTER,	)	
in his capacity as Trustee	)	

****

BRIEF OF *AMICUS CURIAE* CENTER FOR RESPONSIBLE LENDING IN SUPPORT OF PLAINTIFF-APPELLANTS AND ARGUING FOR REVERSAL OF THE DISTRICT COURT

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THE INTEREST OF AMICUS CURIAE

The Center for Responsible Lending is a nonprofit, nonpartisan research and policy organization that promotes responsible lending practices and access to fair terms of credit for low-wealth families. CRL is dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices.

CRL is respected as a leading authority on lending issues. In the past year alone, CRL has testified before Congress on issues related to subprime lending three times. Moreover, CRL has been asked to provide expert technical assistance to more than thirty states when considering lending regulation and legislation. CRL frequently participates in consumer and industry trainings and panel discussions related to mortgage lending.

CRL is an affiliate of the Center for Community Self-Help ("Self-Help"), which also includes a credit union and a loan fund. Self-Help has provided more than $3.8 billion in financing to help low-wealth borrowers in forty-eight states buy homes, build businesses, and strengthen community resources. CRL's affiliation with Self-Help provides CRL with important insight into lenders' needs and responsibilities to communities.

CRL is particularly concerned about the effect that high up-front fees, such as the ones paid by Plaintiff-Appellants, have on the ability of low-wealth families

to build wealth through homeownership. Owning a home is the primary way that Americans build wealth and create financial stability to educate children, start new businesses, and weather emergencies.

In the United States today, one-half of all homeowners hold at least 50 percent of their net worth in their home equity. In an effort to strip away this equity and to reap profits on the front-end of a mortgage transaction, an increasing number of loans are structured in a way that requires borrowers to finance high up-front fees into their loan. As such fees are rolled into the balance of the loan and not paid out-of-pocket, borrowers may not be aware of the existence or magnitude of up-front fees. The adverse effect such up-front fees have upon low-wealth families is immediate, by stripping away the equity which these families have attempted to build over the course of years and, in some cases, generations.

As a task force from the U.S. Department of Treasury and the U.S. Department of Housing and Urban Development noted in its 2000 Joint Report, mortgage related fees in the subprime market often "far exceed[] what would be expected or justified based on economic grounds" and are "'packed' into the loan amount without the borrower's understanding." U.S. Dep't of Treasury & U.S. Dep't of Hous. & Urban Dev't, Joint Report on Recommendations to Curb Predatory Home Mortgage Lending (2000), at 2. The task force found that "[b]orrowers often did not realize how expensive their loans were, as the fees were

added into the amount financed rather than paid up-front, and may not have been adequately disclosed to the borrower." Id. at 21. Like the task force, CRL is very concerned about lenders who disguise the true cost of credit to borrowers by tacking large up-front fees onto the principal of their loan. See id. at 9.

At present, North Carolina's usury laws protect the homeowners of our state by providing meaningful remedies for the excessive, illegal, and usurious collection of interest. CRL believes that, in the present case, the trial court erred in its interpretation of our state's longstanding usury laws. CRL is concerned that if this decision is not overturned, such a ruling will encourage illegal and predatory lending practices by unscrupulous lenders which will in turn undermine the financial stability of the North Carolina communities that the Center for Community Self-Help has worked to build.

INTRODUCTION

North Carolina law provides borrowers three separate and distinct remedies for actions arising out of the imposition and collection of usurious interest. Two remedies are set forth in G.S. § 24-2, which provides for (i) the forfeiture of the entire amount of interest due under the note and (ii) the recovery of twice the amount of interest paid. The third remedy, established in Merritt v. Knox, 94 N.C. App. 340, 342, 380 S.E.2d 160, 162 (1989), allows a court to use its equitable

powers to reform the usurious loan and retroactively lower the applicable interest rate to the legal or judgment rate.

In the present case, an illegal and usurious nine-percent (9.0%) origination fee was financed into the principal balance of the Plaintiff-Appellants' mortgage. As a result, Plaintiff-Appellants have been forced to pay excessive and usurious interest *each* and *every* month as part of their mortgage payments. Had Plaintiff-Appellants not filed suit, they would have been required to pay $2,840.78 of additional usurious interest over the life of their illegal loan.

The trial court erroneously conflated the three available usury remedies, misapplying the stringent statute of limitations of one remedy to all three, and erroneously dismissing the Plaintiff-Appellants' claims as a result. We shall demonstrate that, because the Plaintiff-Appellants filed their claims within the relevant limitations period for the double-recovery and equitable reformation remedies, Plaintiff-Appellants' claims were timely and their case should be remanded for trial.

ARGUMENT

I. Of the three remedies provided for usurious lending practices, only the forfeiture remedy is subject to a limitations period that runs from the date of the agreement.

The most restrictive statute of limitations applies to claims brought under G.S. §24-2 for forfeiture of all interest owed, a remedy never sought by the Plaintiff-Appellants. In relevant part, Chapter 24-2 provides:

> The taking, receiving, reserving or charging a greater rate of interest than permitted by this chapter or applicable law, either before or after the interest may accrue, when knowingly done, shall be a forfeiture of the entire interest which the note or other evidence of debt caries with it, or which has been agree to be paid thereon.

Pursuant to such a remedy, the lender forfeits *any* and *all* interest to which it might have been entitled, effectively reducing the applicable interest rate on the extension of credit to 0.00% for the term of the loan.

Recognizing the severity of this remedy, G.S. § 1-53(3) places a short, two-year statute of limitations upon actions seeking forfeiture of usurious interest. Moreover, North Carolina courts interpreting the triggering event from which such a limitations period runs have taken an equally conservative stance. Our courts have forced borrowers to be vigilant to preserve forfeiture as a remedy by electing to start the clock on the limitations period at the earliest possible moment: the moment at which the agreement to extend credit is reached. See Merrit v. Knox,

94 N.C.App. 342, 380 S.E.2d 160, 162 (1989) ("The statute runs from… the date of the agreement for the forfeiture remedy"); Northwestern Bank v. Barber, 79 N.C.App. 425, 429, 339 S.E.2d 452, 455 (1986) (holding that the statute of limitations begins to run for the forfeiture remedy on the date of "the contract, promise, or agreement to a usurious rate as opposed to the collection or payment of that interest"); Haanebrink v. Meyer, 47 N.C.App. 646, 649, 267 S.E.2d 598, 600 (1980) ("the two year statute of limitations [for the forfeiture remedy] begins to run from the time an agreement or charge for usurious interest is first made").

Thus our courts have tempered the extreme remedy of forfeiture with a rigid statute of limitations. This statute of limitations, however, applies *only* to the *forfeiture* remedy for usury, and is thus wholly inapplicable to the present action where the Appellants have not sought this remedy. As set forth in Section II and III below, the relevant case law clearly supports the Appellants' argument that their claims for both the double-recovery of usurious interest and equitable relief are timely.

II. The Appellants' claim for the double-recovery of usurious interest paid during the two years preceding the filing of their civil action was timely.

The trial court erred in dismissing the Plaintiff-Appellants' usury claims as untimely, as they did bring such claims within two years of having paid usurious interest. In Section A, we discuss how the statute of limitations for the double-

recovery remedy differs from that of the forfeiture remedy, running from the payment of usurious interest, instead of the date of origination. In Sections B and C, we document that the nine percent (9.0%) origination fee illegally imposed under the Plaintiff-Appellants' loan constituted usurious interest which was not paid at closing, but rather was amortized across the life of their loan, forcing the Plaintiff-Appellants to pay a portion of this usurious interest every month. Finally, in Section D, we discuss analogous areas of law, which like North Carolina usury law, reflect the economic reality that capitalized fees are not paid at closing.

A. The right of action to recover the limited penalty for usurious interest paid expires two years after any such payment is made.

In addition to the forfeiture remedy, G.S. § 24-2 provides a second, more moderate statutory penalty: the recovery of twice any excessive and usurious interest paid by the borrower in the two years preceding the filing of a civil action. See Merritt, 94 N.C.App. at 342, 380 S.E.2d at 162 ("The statute runs from the date of payment for the double-recovery remedy, and from the date of the agreement for the forfeiture remedy"). Unlike the forfeiture remedy, which runs from the date of the agreement, "the statute of limitations on the recovery of twice the amount of interest paid begins to run upon payment of the usurious interest." Haanebrink v. Meyer, 47 N.C.App. 646, 648, 267 S.E.2d 598, 599 (1980).

While the forfeiture penalty established a fixed and discrete moment in time

by which a borrower must prosecute his or her rights in order to prevail, the double-recovery penalty creates a moving window in which to bring suit, albeit with a more limited recovery. As the Supreme Court of North Carolina has ruled:

> The right of action to recover the penalty for usury paid accrues upon *each payment* of usurious interest when *that payment* is made, *each* payment giving rise to a separate cause of action to recover the penalty therefore, which action is barred by the statute of limitations two years from *such* payment.

Henderson v. Security Mortgage & Fin. Co., Inc., 273 N.C. 253, 264, 160 S.E.2d 39, 47 (1968) (emphasis added).

Pursuant to the court's ruling in Henderson, borrowers need only show "evidence of usury paid within two years prior to the institution of [the] action," to avail themselves of the double-recovery penalty for usury. Henderson, 273 N.C. at 265, 160 S.E.2d at 48 (holding that a suit brought by borrowers more than two years after origination was timely, but barring the plaintiffs from collecting the double-recovery remedy on the portion of interest which had been paid more than two years prior to the filing of the action).[1] Plaintiff-Appellants allege that they paid usurious interest within two years prior to filing their suit, and as such, are entitled to the limited double-recovery penalty which they sought and which is

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[1] In order to take advantage of the double-recovery remedy, a plaintiff must have actually paid usurious interest within two years of filing suit. See Adams v. Beard Development Corp., 116 N.C.App. 105, 109, 446 S.E.2d 862, 865 (1994) (indicating that, although the statute of limitations would have allowed a borrower to bring a claim more than two years after origination, the plaintiff could not avail himself of the double-recovery penalty, because during this period he had not made *any* payments).

provided at law.

B. The portion of the Shepards' origination fee in excess of the rate permitted by law constitutes interest under North Carolina law.

Pursuant to North Carolina usury law, lenders are prohibited from including in the principal balance of any second mortgage fees or discounts which exceed two percent of the principal amount of the loan. See G.S. § 24-14(f). The origination fee of nine percent (9.00%), that Plaintiff-Appellants were charged was clearly in excess of the lawful rate under North Carolina law.

As the Supreme Court of North Carolina held more than a century ago, "*any* charges made against [a borrower] in excess of the lawful rate… whether called 'fines,' 'charges,' 'dues,' or 'interest,' are in fact interest, and are usurious." Hollowell v. Southern Building & Loan Ass'n. 120 N.C. 286, 286, 26 S.E. 781, 781 (1897) (emphasis added). Thus, according to long accepted legal precedent, the fee in question constitutes usurious interest.

C. Because the illegal and usurious origination fee was rolled into the principal balance of the Shepards' loan, the payment of the fee was spread out over the course of the loan.

Defendant-Appellees may wish to argue that because the fee was "fully earned" when the loan is made, the borrower's causes of action accrue from the

moment the loan is made. To conflate the moment when interest is "earned" with the moment when accrued interest is paid is simply untenable.

As discussed above, the statute of limitations for the double-recovery remedy runs from the date upon which usurious interest is *paid*, and not the date the agreement to pay is reached or the date the fee is "fully earned." See Merrit, 94 N.C.App. at 342, 380 S.E.2d at 162; Henderson, 272 N.C. at 264, 160 S.E.2d at 47; Haanebrink, 47 N.C.App. at 648, 267 S.E.2d at 599. If the borrower had *paid* this fee out-of-pocket at closing, then the statute of limitations would run from the moment of payment. In the present case, however, no such payment was made at or before closing; instead, the illegal and usurious fee was capitalized as part of the loan principal, to be paid in installments over the life of the loan.

To illustrate more clearly, let us examine Plaintiff-Appellants' loan. Plaintiff-Appellants borrowed $15,015.00, exclusive of the nine percent (9.0%) origination fee.[2] Had they been charged a legal, non-usurious origination fee of two percent (2.00%), the original principal balance of their loan would have been $15,315.30, nearly $1,200.00 less than the Plaintiff-Appellants were charged.[3]

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[2] The Appellants' base loan amount is $15,015. This sum is reached by subtracting the 9% origination fee ($1,485) from the starting principal amount of the loan ($16,500).

[3] The original principal balance is obtained by multiplying the Appellants' base loan amount ($15,015) by 102% (1.02). This method produces an original principal balance of $15,315.30, inclusive of a legal, non-usurious two percent (2.0%) origination fee ($300.30).

Plaintiff-Appellants contracted to repay their mortgage over fifteen years (180 payments) at an annual interest rate of 13.99%. If this 13.99% interest rate had been applied to a loan containing the maximum (2.0%) origination fee permitted by law, it becomes apparent that the Plaintiff-Appellants' monthly mortgage payments would have been reduced. By amortizing these payments over fifteen years,[4] the Plaintiff-Appellants' monthly mortgage payments would have been $203.86. See Appendix A, App. 2. In fact, Plaintiff-Appellants were required to paid $219.63 per month under the terms of their loan. See Appendix B, App. 9.

The additional fifteen dollars and seventy-seven cents ($15.77) which Plaintiff-Appellants *paid* each month is attributable entirely and exclusively to the illegally inflated and usurious, nine percent (9.0%) origination fee. Each month, Plaintiff-Appellants were required to *pay* a portion of this usurious interest back as part of their loan. Moreover, because this illegal and usurious fee was rolled into the principal balance of Plaintiff-Appellants' loan, the usurious interest was compounded (i.e. illegal and usurious interest accrued upon the financed illegal and usurious fee).[5]

[4] There is no simple formula for calculating actuarial interest for installment loans. To generate an amortization schedule one may: (a) rely upon complicated formulas, See, e.g., 12 C.F.R. 226, Reg. Z, App. J. (1993); (b) make use of amortization tables, See, e.g., Fed. Reserve Board Annual Percentage Rate Tables; or (c) rely upon financial calculators and computer programs. The amortization schedules attached at Appendices A, B and C, were generated upon a 32-bit Paraben Financial Calculator software, Version 5.00e, developed by Pine Grove Software (c) 2000.

[5] This compounding raises the true or effective note rate to 15.5% (not 13.99%, as was contracted for and disclosed in the note). The effective rate may be obtained by amortizing the maximum principal balance ($15,315.00) inclusive of a legal two percent (2.0%) origination fee over 180 payments of $219.63. See Appendix C, App. 16.

As a result, each and every month Plaintiff-Appellants *paid* usurious interest, and each and every month, they were harmed by being both overcharged and by having a smaller portion of their payments applied to principal. For comparison, let us examine the first three payments made under Plaintiff-Appellants' loan as it should have been made without the illegal and usurious fee, and then examine the same period under their loan as it was actually made and enforced:

Table 1
Plaintiff-Appellants' Loan *Without* Usurious Origination Fee
-Months 1 through 3-

Payment Date	**Starting Balance**	**Payment Amount**	**Applied To Interest**	**Ending Balance**
9/1/1997	$15,315.30	$203.86	$178.55	$15,289.99
10/1/1997	$15,289.99	$203.86	$178.26	$15,264.39
11/1/1997	$15,264.39	$203.86	$177.96	$15,238.49
Total Interest Paid:			*$533.77*	

Table 2
Plaintiff-Appellants' Loan *Including* Usurious Origination Fee
-Months 1 through 3-

Payment Date	**Starting Balance**	**Payment Amount**	**Applied To Interest**	**Ending Balance**
9/1/1997	$16,500.00	$219.63	$192.36	$16,472.73
10/1/1997	$16,472.73	$219.63	$192.04	$16,445.14
11/1/1997	$16,445.14	$219.63	$191.72	$16,417.23
Total Interest Paid:			*$576.12*	

As is demonstrated by the above excerpts from the applicable amortization tables, Plaintiff-Appellants paid excessive and usurious interest in each month. Moreover, the excessive imposition of interest was not limited to the first three months of the loan; Plaintiff-Appellants continued to be charged additional interest each and every month for the life of their loan in order to pay for the illegal and usurious nine-percent (9.0%) origination fee.[6]

For the calendar year immediately preceding the filing of the Plaintiff-Appellants' civil action, they were required to make monthly payments totaling $2,635.56, of which $2,080.64 was applied to interest. See Appendix B, App. 11 (Annual Totals 2001). Had the illegal and usurious origination fee not been imposed, Plaintiff-Appellants would have been required to make monthly payments totaling $2,446.32, of which $1,931.27 would have been properly applied to interest. See Appendix A, App. 4 (Annual Totals 2001).

The Plaintiff-Appellants' were required to pay a portion of the illegal and usurious fee each and every month *for the life of the loan*. As discussed above, the right of action to recover the double-recovery penalty for usury accrues upon *each* payment of usurious interest. Plaintiff-Appellants paid usurious interest within two

[6] Over the life of their loan, Plaintiff-Appellants were scheduled to pay an additional **$2,840.78** in illegal and usurious interest. That calculation is based on an assumption of the same loan term (180 months) and monthly payment amounts ($219.63). When we allocate these monthly payments to the legally correct principal balance ($15,315.30), the earned interest would have been $24,218.89 (See Appendix C, App. 21). When this amount is compared to the $21,378.11 of earned interest for a loan exclusive of the illegal origination fee (See Appendix A, App. 7), we obtain an interest differential of $2,840.78.

years of filing their complaint. Accordingly, the trial court erred in dismissing Plaintiff-Appellants' suit for failure to bring suit within the relevant limitations period.

D. The trial court's conclusion that these fees were "paid" at closing is inconsistent with how such fees are treated for tax purposes.

The trial court's ruling is also inconsistent with how such fees are treated in other areas of the law which recognize the economic reality that capitalized fees are not paid at closing. For example, the Internal Revenue Service ("IRS") and courts interpreting tax liability have examined the issue of when points that are financed into a loan are actually "paid" for purposes of tax deduction.[7] Where points are withheld from the proceeds of a loan, as occurred in the present case, courts have repeatedly held that the borrower *cannot* deduct the entire amount of the points in the year of the loan transaction. See, e.g., Schubel v. Comm'r, 77 T.C. 701, 704-07 (1981); Brown v. Comm'r, 37 T.C.M. (CCH) 571, 1978 WL 2829 (Apr. 3, 1978) ("As and when the loan is repaid, the 'points' become deductible as interest."); Cathcart v. Comm'r, 36 T.C.M. (CCH) 1321, 1977 WL 3054 (Sep. 22, 1977). The rationale for these decisions is simple: The points are

[7] As used in this section, "points" refers to origination fees and other similar fees, except to the extent that such fees include amounts that are usually separately stated on the settlement sheet, such as appraisal fees, property taxes, and attorney fees.

not paid at the time the loan is made, but are instead paid over the life of the loan as the borrower makes payments. See, e.g., Cathcart, 36 T.C.M. (CCH) 1321.

Consistent with these decisions, the IRS would not permit a taxpayer who finances points rather than paying them directly to deduct the points fully in the year the loan is made,[8] but would instead require any deduction to be distributed ratably over the life of the loan. See IRS Publication 936: Home Mortgage Interest Deduction (2004), available at http://www.irs.gov/publications/p936/. As one commentator has explained, "The IRS and the courts agree that points paid in connection with discounted loans are not deductible in the year of the loan transaction because the taxpayer is not considered to have 'paid' the points up front." Diane K. Klopsch, Note, What Are the Real Requirements for Interest Deductibility? An Analysis of Revenue Procedure 94-27, 21 U. Dayton L. Rev. 145, 165 (1995).

As the IRS analysis recognizes, the economic reality is that financed points meld inextricably into the amortization over the life of the loan. Given that fact, Plaintiff-Appellants paid a portion of the usurious origination fee (and the illegal interest accrued thereon) each time they made a mortgage payment under the terms

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[8] According to the IRS, a taxpayer cannot deduct the full amount of points in the year of the loan transaction unless the taxpayer has provided at or before closing an amount at least equal to the points charged (not counting seller-paid points) from funds that were not borrowed from the lender or broker. See 26 U.S.C. § 461(g); Rev. Proc. 94-27, 1994-1 C.B. 613, 1994-15 I.R.B. 17, 1994 WL 96886 (Mar. 28, 1994).

of their loan. Therefore, Plaintiff-Appellants' claims for the double-recovery usury remedy were timely.

III. Regardless of the two-year statute of limitations provided in G.S. §1-53, North Carolina courts will not enforce contracts which provide for interest in excess of the legal rate.

In addition to the statutory penalties provided under G.S. § 24-2, North Carolina borrowers are entitled to a third remedy: equitable reformation of the usurious loan to reflect the legal or judgment rate of interest. This third remedy arises out of the court's equitable powers and may be applied without regard to the statute of limitations provided under G.S. § 1-53.

In Merrit v. Knox, 94 N.C.App. 340, 342, 380 S.E.2d 160, 162 (1989), the Court of Appeals was confronted with a usurious loan which had evaded both the strict two-year statute of limitations for the forfeiture remedy (i.e. the borrower had not brought the claim within two years of origination) and the moving statute of limitations for the double-recovery remedy (i.e. the borrower had failed to make a payment within two years of filing suit). Despite the fact that the borrower's claim was outside the applicable statutes of limitations, the Court of Appeals concluded that, for reasons of public policy, it could not enforce a contract which in violation of North Carolina law.

The Court of Appeals concluded that, "[c]ontracts prohibited by statute are void" and that "contract provisions in violation of a statute… will not be enforced." As a remedy, the Court of Appeals used its equitable powers to retroactively reform the loan. Merritt, 94 N.C.App. at 342, 380 S.E.2d at 162. Although, both the borrowers and the lenders were willing to consent to a mutually agreed upon rate, the court concluded that because,

> [t]he provision for interest in the note was illegal and void… the note will be treated as if the parties had not specified any interest rate. Under such circumstances, the law will not apply the highest rate allowed by statute, but interest shall be at the legal or judgment rate.

Id. Regardless of the passage of time, and despite the borrowers' failure to prosecute their claim in a timely fashion, the Court of Appeals would not allow a lender to continue to reap profits from an illegal contract written in violation of North Carolina law.

Given the precedent set by Merrit v. Knox, and given the plaintiff-appellants' specific prayer for such equitable reformation in ¶ 14 of the Plaintiffs' Amended Complaint, the district court erred in dismissing the Appellants' case for failure to state a claim upon which relief could be granted. Even if the Appellants had made no payments whatsoever under the loan, they had standing to bring suit, and all claims were not barred by the relevant statute of limitations. Accordingly, the district court erred by dismissing this claim on statute of limitations grounds.

CONCLUSION

For the above stated reasons, the Court of Appeals should reverse the trial court's order dismissing Plaintiff-Appellants' claims as untimely and should remand the case for a trial upon the merits.

Respectfully submitted, this the 11th day of February, 2005.

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CERTIFICATE OF COMPLIANCE

Pursuant to Rule 28 of the Rules of Appellate Procedure, the undersigned hereby certifies that the foregoing brief, which is prepared using a proportional font, is less than 3,750 words (excluding cover, indexes, tables of authorities, certificates of service, this certificate of compliance and appendixes) as reported by the word-processing software.

This the 11th day of February, 2005.

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CERTIFICATE OF SERVICE

I, the undersigned, hereby certify that on this day I served the foregoing Amicus Brief on upon the parties to this cause by depositing a copy thereof in a postpaid, properly addressed wrapper in a Post Office or official depository under the exclusive care and custody of the United States Post Office Department, addressed to the attorneys of record as follows:

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This the 11th day of February, 2005.

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Seth P. Rosebrock
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