

4-1-1976

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Recommended Citation

Respress, William W. Jr. (1976) "Equity Participating in Real Estate Finance," *North Carolina Central Law Review*: Vol. 7 : No. 2 , Article 12.

Available at: <https://archives.law.nccu.edu/ncclr/vol7/iss2/12>

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Equity Participation In Real Estate Finance

I. INTRODUCTION

Throughout history lenders have sought to maximize their profits from the sums loaned. This has become increasingly necessary in recent years as the inflationary spiral has rooted itself in the American economy. The problem could be easily solved by raising interest rates as the prices of goods and services rise, except that virtually every state in the union has enacted some form of usury statute limiting the maximum rate of interest that can be charged.¹ The result of this is that the prime rate has, of late, surpassed that rate allowed by many states.² One need not strain the imagination to conclude that lenders are reluctant to do business when the prime rate is at 11 or 12 percent, while the legal maximum is at 8 or 10 percent. Under these circumstances lenders have been compelled to seek out new ways of using their funds while avoiding the dire effects of usury.³ One such technique which has come into vogue is equity participation. Though the concept is not new,⁴ it has been only intermittently used until the last "credit crunch." It has manifested itself in a variety of devices, three of which will be discussed in this writing. They are: sale and leaseback; loan agreements for a share of the profits; and ownership participation. These are selected because of their wide-spread appeal, and their continued use even after interest rates have begun to recede.⁵

The purpose of this writing is to examine each of the devices listed above, and to synthesize the criteria and the rules the courts have employed, in determining whether a given transaction violates the usury statutes. The discussion proceeds in three parts as follows: (1) the elements of usury and the courts' approach; (2) sale and leaseback; and (3) profit participation.

II. THE ELEMENTS OF USURY AND THE COURT'S APPROACH

Whenever usury is at issue, the courts look for four distinguishing characteristics. The presence of these elements is conclusive of the

1. Hershman, *Usury and "New Look" in Real Estate Financing*, 4 A.B.A. REAL PROP., PROB. & TRUST J. 315 (1969) (hereinafter cited as Hershman).

2. Merriman & Hanks, *Revising State Usury Statutes in Light Tight Money Market*, 27 MD. L. REV. 1 (1967).

3. The penalties for usury are quite harsh, ranging from a money penalty (as much as triple the amount of interest) to providing that the lender cannot make any contract in the state. See, e.g., N.C. GEN. STAT. § 24-4 and § 24-8; ARK. STAT. 1947 Ann., §§ 1201, 1202 (1966 Rpl.); MICH. STAT. ANN. § 303.20 (1947).

4. Hall v. Daggett, 6 Cow. 653 (N.Y. 1827).

5. Hershman at 320.

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issue, while the absence of one or more is clearly an absolute defense to the charge.⁶ These elements are generally articulated as, (1) a loan of money or something of value or the forbearance of enforcing a loan of money or collecting a thing of value, (2) an agreement between the parties that the principal shall be repayable in any event, (3) the receipt of more profit than is authorized by law, and (4) intent to violate the usury law.⁷

In attempting to discern the presence or absence of these elements, the courts have declared that they will look beyond the form of the transaction to its substance.⁸ Thus, when the courts review a sale and lease-back under a claim that a loan was really intended, they look, not at the form of the transaction, but at all its provisions and the circumstances as they existed at the time the deal was consummated. For instance in such a transaction the court would certainly determine whether there was an obligation to repurchase,⁹ or whether the selling price and the term of the lease forced repurchase.¹⁰ If the answer is yes to either of these queries, then the second element is present.

Some mention must be made of the process by which interest is calculated. It is not computed each year, and measured against the statute. Rather, one must determine the total amount to be paid over the life of the transaction, and compare that sum to the rate allowed by statute. Thus, a particular transaction may call for an excessive amount of interest in the early years of its term so long as the total amount paid, averaged over the life of the loan, is within the ceiling.¹¹ This is often a difficult task when future profits are the measure.

The most important consideration that the courts have, however, is the intent of the parties. Reference is not made to the last element listed *supra*, namely, intent to violate the law, for if the other elements are found the court will presume the last.¹² Rather, reference is made to the parties' intent to enter into a lender-borrower relationship. The courts take great pains to determine the intent of the parties, including their actions before and after the transaction,¹³ the financial condition of

6. See, e.g., *Kessing v. National Mortgage Corp.*, 278 N.C. 523, 180 S.E.2d 823 (1971); *Korth v. Tumlinson*, 73 S.W.2d 1048 (Tex. Civ. App. 1934).

7. 55 AM. JUR. *Usury* § 12 (1946).

8. See, e.g., *Houghton v. Burden*, 228 U.S. 161 (1913); *Brown v. Robinson*, 224 N.Y. 301, 120 N.E. 694 (1918); *Kessing v. National Mortgage Corp.*, 278 N.C. 523, 180 S.E.2d 823 (1971); *Deming Invest. Co. v. Giddens*, 41 S.W.2d 260 (Tex. Civ. App. 1931).

9. *Golden State Lanes v. Fox*, 232 Cal. App. 2d 135, 42 Cal. Rptr. 568 (1965).

10. *Hershman* at 320.

11. *Hershman*.

12. *Annot.*, 16 A.L.R.3d 475 (1967).

13. See, e.g., *Atkinson v. Wileken*, 142 Cal. App. 2d 246, 298 P.2d 147 (1956).

the borrower,¹⁴ and the amount of consideration paid for the equity position taken.¹⁵ In sum, the courts scrutinize every relevant piece of evidence in determining whether the parties intended the transaction to be a loan.¹⁶ One would not be entirely candid, however, without further noting that courts have historically been reluctant to disregard the form of any transaction without substantial proof.¹⁷ The courts seem to proceed under the notion that where a transaction is susceptible of two interpretations, one that is legal and the other that is illegal, then they will presume that the parties intended to remain within the law.¹⁸

III. SALE AND LEASEBACK

The sale and leaseback involves the transfer of a fee interest in the property affected with the investor simultaneously leasing the land and/or buildings back to the former owner. There are a number of reasons why a land owner may desire such an arrangement, including tax advantages and leveraging in a small equity position.¹⁹ For instance, where there are improvements on the land to be sold that have been fully depreciated, the seller may receive substantial tax advantages by selling the land at its fair market value and taking a leaseback. The seller can deduct the rental payments while putting the capital received, from the sale, to work in the business or in some other venture. Additional tax savings are realized by taking the capital gain tax on the sale rather than paying taxes on the profits from operations, where the improvements are fully depreciated. The investor's position is also quite acceptable. He can virtually assure himself of the return on his investment from the negotiated rentals. Furthermore, the investor may wish to mortgage the purchased property at a rate less than the rental payments, thus gaining leverage through the "spread" in rents and debt service while reinvesting the proceeds of the loan. Finally, the investor has the very real possibility of ending up with a piece of valuable property.²⁰

The above inducements also apply when the property is unimproved, with the additional consideration for the seller-lessee that such a sale may produce 100 percent financing of proposed improvements. Of course, the purchaser-lessor is not averse to buying land and eventually getting a building as a bonus at the end of the lease.²¹

14. *See, e.g., Kawauchi v. Tabat*, 49 Haw. 160, 413 P.2d 221 (1966).

15. *See, Kessing v. National Mortgage Corp.*, 278 N.C. 523, 180 S.E.2d 823 (1971).

16. *Wood v. Angeles Mesa Land Co.*, 120 Cal. App. 313, 7 P.2d 748 (1932).

17. *Arch A. Edwards Post No. 252, Regular Veterans Assoc. v. Gould*, 144 Colo. 334, 56 P.2d 908 (1960).

18. *See, e.g., Riley v. Sears*, 154 N.C. 509, 70 S.E. 997 (1911).

19. Hershman.

20. Hershman.

21. Hershman.

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It would not seem that the transactions set forth above, would run afoul of usury laws. Admittedly the sale and leaseback provides a financing device, but rent is not considered as interest. Thus, it is irrelevant to inquire as to the relationship the rents bear to the selling price in determining whether more profit is being earned than is allowed by law. Surely, if what has been set forth above were the extent of sale and leaseback agreements, the usury inquiry could be laid to rest. Alas, this is not the case.

Oftentimes either the investor-lessor or the seller-lessee will insist on a repurchase provision. The question then arises as to whether what is ostensibly a sale and leaseback is not in reality a loan.²² A sale contemplates

. . . the transfer of the general or absolute interest in property as distinguished from a special property interest. A loan, on the other hand, is the delivery of a sum of money to another under a contract to return at some future time an equivalent amount with or without an additional sum agreed upon for its use. . . .²³

Therefore, if the lease contains a repurchase provision and that provision is obligatory, it may be found to be no more than a repayment and, therefore, a loan.²⁴

On the other hand if the repurchase provision is optional the question becomes decidedly more difficult. Whether such a provision will be deemed to provide the same metamorphosis as its obligatory cousin above, will depend upon the intent of the parties. "The factors employed in deriving the intent are:

- (a) Whether the sales price of the property is substantially disproportionate to the value at the time of the transaction;
- (b) Whether the economic realities would dictate exercise of the option to repurchase."²⁵

As to the first criteria, if the purchase price is substantially lower than the fair market value of the property, the transaction takes on the characteristics of a loan because failure to exercise the option will result in a significant loss. In *Kawauchi v. Tabata*²⁶ this point is dramatically illustrated. The plaintiff, Kawauchi, held property upon which there were mortgages totalling \$70,000 that were about to be foreclosed. Plaintiff had been unable to find refinancing and was desperate to retain the property which was later appraised at \$160,000. The evidence adduced showed plaintiff was willing to sell the property for \$90,000

22. *Id.* at 320.

23. *Milana v. Credit Disc. Co.*, 27 Cal.2d 335, 339-340, 163 P.2d 869, 871 (1945).

24. *Golden State Lanes v. Fox*, 232 Cal. App.2d 135, 42 Cal. Rptr. 468 (1965).

25. *Hershman* at 320.

26. 49 Haw. 160, 413 P.2d 221 (1966).

if a repurchase provision was included in the leaseback agreement, and that he offered to repurchase at a 30% premium, i.e., \$27,000, and pay 5½% interest on the sale price and the bonus amounting to \$117,000.²⁷ The upshot of the negotiations was an agreement embodying the offer set forth above with a lease for three years and a provision that repurchase could be made any time prior to the expiration of the lease.²⁸ After the lease had expired without plaintiff exercising the option, he brought suit to have the sale and leaseback adjudged a usurious loan. The court closely examined the sales price and compared it to the court-appraised value of the property noting that \$70,000 of the sales price was paid over to the court as satisfaction of the foreclosure proceeding, but that the remaining \$20,000 was later paid over a period of time. Inquiry was also made into the negotiations preceding the sale and the court referred to testimony given at trial to the effect that the property was a steal at \$90,000, and "that man must be crazy to want to sell it for \$90,000."²⁹ Weight was also given to the fact that plaintiff was in need of a specific sum of money which he had been unable to procure through refinancing channels, and that defendants advanced that amount plus the realtor's fee with a small additional sum which plaintiff needed for improvements during the interim. The court concluded that the substantially reduced sales price coupled with the immediate need for funds clearly indicated that a loan was intended and that the rentals and bonus on the repurchase price must be considered to be interest.

A word of caution should be voiced here in regard to the weight to be given the disparity between selling price and appraised value. Certainly, advantageous property transactions occur daily, and one must remain cognizant of this fact in asserting inadequacy of price as a basis for finding that a loan was the true intentment of the parties. Assuredly, the criterion is universally used but it is not conclusive.³⁰

Indeed, there is a whole line of cases which hold that a deed given is not a mortgage despite a disparity in fair market value and selling price. It was held in *Arch A. Edwards Post No. 252, Regular Veterans Assoc. v. Gould*,³¹ that the fact that the selling price was substantially less than the original offer did not sustain the burden of proving a loan was intended. Though the original offer was \$210,000 and the price paid

27. *Id.* at 163, 413, P.2d at 224.

28. *Id.* at 165, 413 P.2d at 226.

29. *Id.* at 165, 413 P.2d at 225.

30. Annot., 89 A.L.R.2d 1060 (1966) (The annotation deals with deed absolute as a mortgage, and the role inadequate consideration plays in such a transaction. A strong analogy can be drawn between the two transactions and the criteria employed in judging each).

31. 144 Colo. 334, 356 P.2d 908 (1960).

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was \$72,214, the court found that more evidence was needed. The standard of proof necessary to find that a mortgage was intended was that of clear and convincing evidence.³²

An even more dramatic example is found in *Hicks v. Hicks & Norris*³³ wherein plaintiff who had executed a deed to defendant in consideration for defendant's mortgage of \$1,244.32 and payment by defendant of a second mortgage of \$400, demanded the transaction was merely a mortgage. The property was valued at between \$2,000 and \$2,500. Furthermore, evidence at trial showed that the defendant-grantee had executed an agreement to reconvey the property at the end of two years. The court held that such proof standing alone was not sufficient to show an intent to mortgage.³⁴

The lesson to be learned is that the court in reviewing a claim of usury will scrutinize the total transaction, and though disproportionate sales price is a factor to be weighed it is certainly not conclusive of the issue.³⁵ The other major factor considered in determining the true intent of the parties is whether the seller-lessee is compelled to repurchase by the economic realities of the transaction. This factor often comes into play in conjunction with the presence of disproportionate sales price mentioned above. For instance, in a transaction where the property has been sold for less than its true value and a short term lease has been executed, the repurchase is virtually dictated in the absence of an option to renew the lease.³⁶ Any other decision would involve a loss equal to the difference in the fair market value and the deflated selling price. Similarly, if both parties understood that the seller-lessee intended to use a substantial portion of the funds from the sale to improve the property, a comparatively short term lease without option to renew would certainly make it incumbent upon the seller to repurchase, *i.e.*, the economic realities would dictate exercise of the repurchase provision. These situations present one with the rather obvious coercive choice of either repurchasing the property or losing substantial sums of money, *i.e.*, pay off the loan or forfeit the equity. In *Gaither v. Clark*,³⁷ the court found that due to the economic realities of the sale and leaseback the device was used to disguise a usurious loan. There plaintiffs sold 400 acres of property and simultaneously took a lease for 99 years. The selling price was \$5,000, though appraisals showed the value to be between \$18,000 and \$20,000. The rent was fixed at \$600 per annum, though it was later reduced to half that amount, and an option to

32. *Id.* at 336, 346 P.2d at 910.

33. 18 Md. 47 (1832).

34. *Id.* at 54.

35. Annot., *supra* note 30.

36. Hershman at 320.

37. 67 Md. 18, 8 A. 740 (1887).

repurchase was given for three years from the date of sale. After reviewing testimony which indicated that the plaintiff had been seeking a loan prior to the sale, the court concluded that it was immaterial that the transaction was given the form of a sale and lease.

The standard seems to be, though certainly not articulated in this form, what a reasonably prudent businessman would expect the nature of the transaction to be. Furthermore, the factors set forth here reflect the maxim that equity abhors a forfeiture, and the cases in this area certainly show a commitment by the courts to prevent a windfall to the buyer where the facts reasonably support a finding that the parties really intended a loan. Hard and fast principles cannot be laid down which will insure a finding that a loan was intended, or that the transaction represents a *bona fide* sale and leaseback. However, some general suggestions can be made which would tend to sway the court toward affirming the form of the transaction.

If an opportunity to repurchase is to be included, then certainly it should not be obligatory.³⁸ On the other hand, the optional repurchase provision should not be short term, though the exact length will be governed by the individual facts of the case. The lease need not be long term, *i.e.*, approaching the economic life of the property if improved, but if it is short term renewal options should be granted. There should not be a great disparity between the selling price and the appraised value. Finally, the investor should indicate some interest in the property as owner. He should pay the taxes, assume liability for assessments, or at least join with the lessee in payment, and in general hold himself out as the landlord.³⁹

This writing should not be read as forecasting the demise of sale and leaseback as a financing device. The cases which are cited to show a given sale and leaseback overturned and held to be a loan are clear examples of overreaching on behalf of the buyer-lessor. This is not to say that in a given transaction the result would not have been different had the buyer not insisted on such oppressive terms. It is certainly within reason that an investor could reap the necessary profits to make the venture feasible, even though those profits exceed the amount allowed for interest, if the transaction is not so easily viewed as a loan. Research does not yield a case in which a sale and leaseback has been held to be a subterfuge for a usurious loan merely because the rents exceeded the rate at which money could be loaned, where the other factors did not indicate a loan was intended. Of course, not all sellers will be willing or able to pay higher rents, and some medium must be

38. See, 232 Cal. App.2d 135, 42 Cal. Rptr. 468 (1965).

39. See, 49 Haw. 160, 413 P.2d 221 (1966).

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met by carefully adjusting each variable while maintaining a watchful eye for provisions which would support a claim of usury.

Sale and leaseback offer a viable alternative in these times of increasing money costs in the face of antiquated usury statutes.⁴⁰ It provides advantages for the seller, while returning a reasonable profit to the buyer on the funds invested.

IV. PROFIT PARTICIPATION BY THE LENDER

A. Loan Agreements

The profit participation agreement is a device that has been successfully employed to return more profit than that otherwise allowed by law.⁴¹ The basic element that must be maintained in each agreement is the lender's willingness to subject part of his return to a contingency. The lender's profit is made dependent upon the success or failure of the venture financed by tying his return to the profits of the business.⁴² These loan agreements are typically in four parts: (1) The lender allows the borrower use of the money for a specified business venture or transaction; (2) the borrower agrees to repay the principal of the loan; (3) the lender refrains from specifying any interest rate as such; (4) the borrower agrees to pay the lender a specified percentage of the profits from the venture that the borrowed funds are ticketed to finance.⁴³ Depending upon the relative strengths of the parties, the need for funds, and the desire to lend, these provisions produce an agreement ranging from a guaranteed return plus profits⁴⁴ to merely some designated percentage of income.⁴⁵

Participation by a mortgagee in the profits of the mortgaged property may assume many forms. Manifestly, there may be provisions for the lender to take a percentage of the gross income, participate after gross profits reach a named dollar amount, receive a percentage of profits before or after taxes and/or depreciation, or some other scheme combining these or other factors. Regardless of the form or particular formula used the test is the same—whether the interest (and or profits) is at risk

40. Shanks, *Practical Problems in the Application of Archaic Usury Statutes*, 53 VA. L. REV. 327 (1967).

41. See, e.g., *Whittlemore Homes, Inc. v. Fleishman*, 190 Cal. App.2d 554, 12 Cal. Rptr. 235 (1961); *Beavers v. Taylor*, 434 S.W.2d 230 (Tex. Civ. App. 1968). But, compare, *Maze v. Sycamore Homes, Inc.*, 230 Cal. App.2d 746, 41 Cal. Rptr. 338 (1964).

42. Annot., *supra* note 12.

43. Comment, *The Application of Texas Usury Laws to Equity Participation Agreements*, 48 TEX. L. REV. 925, 928 (1970).

44. See, e.g., *Beavers v. Taylor*, 434 S.W.2d 230 (Tex. Civ. App. 1968).

45. See, e.g., *Trask v. Hazazer*, 4 N.Y.S. 635 (Super. Ct. 1888).

of loss.⁴⁶ If interest is contingent, the loan is not usurious unless it raises the return substantially in excess of the statutory maximum, and the fixed interest is at or close to the ceiling.⁴⁷

The general rule just set forth is infinitely easier to state than it is to apply. It provides for two extremes where the decisions are perfunctorily made and an expansive middle ground where one treads lightly. On one extreme there is an advance of money without an unconditional promise to repay. This is not a loan, and consequently not subject to usury statutes.⁴⁸ In such a case, the agreement simply calls for a share of the profits without mention of obligation to repay the advance. This is an investment. The other extreme occurs where the lender has an unconditional promise to repay, a provision for interest at the maximum rate, and a contingent interest in the profits.⁴⁹ Almost without exception the courts will find the loan to be usurious.⁵⁰

The area of concern is the middle ground. That area in which the lender has a secured promise of repayment of principal but instead of interest the agreement provides for some share of expected income, or some rate of interest below the statutory maximum, plus a share of the profits. Though no cut-off points can be declared, it can be stated with certainty that as the guaranteed rate of interest approaches the maximum, the chances of a court finding a loan usurious increase.

One court has stated the rule as follows:⁵¹

It appears to be the general rule that a plaintiff has established his case, *as applied to a demonstration that the nature of the obligation contracted was usurious*, when his evidence entitles the fact finder to conclude that the parties contemplated that an amount exceeding legal interest was to be paid,—or, as to something other than money to be paid, that the value thereof was not contingent or speculative and was so palpably in excess of legal interest as to show an intent to evade the usury law.⁵²

Two Texas cases provide some insight as to the application of this rule. It should be noted that in neither of these cases was there a provision for fixed or guaranteed interest. Instead the lender's return was based solely on the profits of the business. In *Beavers v. Taylor*,⁵³

46. See, e.g., *Richardson v. Hughitt*, 75 N.Y. 55 (1879); *Riley v. Sears*, 154 N.C. 509, 70 S.E.2d 997 (1911); *Beavers v. Taylor*, 434 S.W.2d 230 (Tex. Civ. App. 1968).

47. *Brown v. Cardoza*, 153 P.2d 767 (Cal. 1944); *Jameson v. Warren*, 267 P.2d 372 (Cal. App. 1928); *Thompson v. Hague*, 430 S.W.2d 293 (Tex. Civ. App. 1968).

48. *Burton v. Stayner*, 182 S.W. 394 (Tex. Civ. App. 1916).

49. See, Cases cited at note 47.

50. See, e.g., *Edwards v. Johnson*, 219 Ky. 113, 292 S.W. 750 (1927).

51. *Thompson v. Hague*, 430 S.W.2d 293 (Tex. Civ. App. 1968).

52. *Id.* at 296 (emphasis in original).

53. See, 434 S.W.2d 230 (Tex. Civ. App. 1968).

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Beavers and his partner, Dyett, borrowed \$5,000 from Taylor for their business. A note was executed and secured by the accounts receivable, cash and inventory of the partnership. The note provided for "no interest", and the simultaneous written loan agreements provided the following: (1) Lender could demand repayment at any time upon a feeling of insecurity; (2) Borrowers could repay the loan at any time after one year upon giving 90 days notice; (3) In consideration of the loan and services rendered borrowers agreed to pay (a) 1% of first \$10,000 gross sales per month; (b) 0.75% of the next \$15,000 gross sales per month; (c) 0.5% of gross sales exceeding \$25,000.⁵⁴ The evidence showed that Mrs. Taylor never rendered any services, that Beavers and/or Dyett paid some \$12,495 to Taylor, and that this sum represented an annual rate of 20%.⁵⁵ The court found that none of the instruments provided for excessive interest on their faces, and therefore the transaction did not present a prima facie case of usury. "In such event the burden is on appellants to show that there existed a device or subterfuge to charge usury, and that both parties had that purpose in contemplation at the time of the execution of the contract."⁵⁶ The contract provided for payments of a percentage of gross sales of the partnership. Had there been no sales, there would have been no payments forthcoming. The court concluded that the amount of return on the loan was contingent and uncertain, and the fact that it ultimately resulted in the lender receiving value in excess of the amount prescribed by statute did not render the loan usurious even if this was the probable result.⁵⁷

The record does not indicate whether evidence of the partnership's past performance was offered, but it would certainly seem to be relevant in determining the degree of risk which the lender incurred. One would assume that Mrs. Taylor had suffered very little risk if the business had consistently sold in excess of \$75,000-\$100,000 per month. On the other hand, the risk would be substantial if the business were a fledgling and had no sales history. Apparently, the court was satisfied that payment was geared to gross sales.

The opposite conclusion was reached in *Thompson v. Hague*,⁵⁸ apparently because the income was ascertainable, and thus not as uncertain. A note was executed for \$40,000, free of interest, and payable in about five years from date of execution. As consideration Hague assigned an existent lease of business property to the Thompsons for the

54. *Id.* at 231.

55. The maximum rate of interest in Texas is 10%. TEX. CONST. Art. XVI, § 11.

56. 434 S.W.2d 230, 231 (Tex. Civ. App. 1968).

57. *Id.* (emphasis added).

58. 430 S.W.2d 293 (Tex. Civ. App. 1968).

duration of the loan. The revenues from the lease were not to be credited to the principal but were to be used wholly as consideration of the loan. Revenues from the lease amounted to \$666.67 or about \$8,000 per annum. This brought a return on the loan of 20% well above the legal maximum for Texas.⁵⁹ The evidence adduced at trial indicated that the lenders were aware of the income from the lease and thus it was within their contemplation to receive a usurious rate of interest.⁶⁰ The court found that with the knowledge of the value of the rental revenues, the contract to receive such rentals as consideration for a loan was usurious on its face.⁶¹

These cases clearly do not define the limits to which a lender may go before a loan is condemned as usurious. Probably no case ever will. Nevertheless, one may readily see what the court means when it says“. . . the parties contemplated that an amount exceeding legal interest was to be paid. . . .”⁶² In *Thompson* the parties clearly knew what the rentals were, and they were virtually assured of the rate of return. On the other hand, in *Beavers* the record gives no basis upon which the lender could have contemplated a return. Gross sales could have varied dramatically with the seasons, the state of the economy, or the state of the particular industry.

In summary, most profit participation agreements can be structured to escape a court's finding that a usurious loan is involved. The only transaction that the lender must avoid is the guaranteed return. The arrangement must not be such that a particular sum in excess of the rate allowed is a virtual certainty. Such an adjustment should not prove to be onerous for the lender if sound business judgment is exercised in determining the levels and percentages of profit participation.

B. Ownership Participation

In times of a tight mortgage market with corresponding high interest rates and scarce mortgage money, borrowers have been seeking way to induce mortgage lenders to part with their funds. One such technique which has been gaining in popularity is ownership participation. The borrower actually offers an ownership position for no consideration or consideration grossly inadequate for the share to be given.⁶³ The lender's "piece of the action" may take any of the usual business forms including corporate shareholder, general partner, limited partner, joint venturer, tenant in common, etc. Lenders find the position advanta-

59. See, note 55 *supra*.

60. 430 S.W.2d at 295.

61. 430 S.W.2d at 296.

62. *Id.*

63. *Kessing v. National Mtg. Co.*, 278 N.C. 523, 180 S.E.2d 823 (1971).

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geous in many instances. Since they are owners, the lenders will receive more than simply the profits of the project. If the property appreciates in value or the business generates goodwill, the lender will be the beneficiary to the extent of his share of ownership.⁶⁴ The problem is that all these techniques of ownership participation have usurious implications.⁶⁵

Because of these implications the courts have been zealous in their attempt to expose the myriad of devices as subterfuges to evade the usury statutes.⁶⁶ The central question in each case is whether the transaction was intended as a means of avoiding the usury statutes.⁶⁷ A North Carolina case provides an interesting example. In *Kessing v. National Mortgage Corp.*,⁶⁸ the plaintiff applied for and received \$250,000 payable in monthly installments of \$500 each with interest at the rate of 8% per annum, the maximum legal rate.⁶⁹ The loan was secured by a first deed of trust on a leasehold interest and a second deed of trust on an apartment complex. As an additional requirement and condition for the loan, Mortgage Corporation insisted that Kessing form a partnership of which Kessing was to be a general partner, and one of two limited partners with Mortgage Corporation. The partnership agreement gave Mortgage Corporation a 25% interest in the partnership for its contribution of \$25. It was further provided that Mortgage Corporation should share in 25% of the profits while its liability would be limited to its contribution of \$25. Kessing was also required to transfer to the partnership the properties used to secure the trust deeds.⁷⁰ At trial the president of Mortgage Corporation testified that the defendant would not have made the loan for 8% interest, but that the equity participation and the conveyances were considerations for making the loan. He added that with the partnership profits the defendant expected a return of between 16% and 20%—certainly over 8%. After finding that the transaction was a loan, the court determined that it was usurious.⁷¹ In view of the president's testimony, such a finding was clearly expected.⁷²

The agreement in *Kessing*, without the president's testimony, was too blatant an example of overreaching by the lender to avoid a finding of

64. Comment, *Lender Participation in Borrower's Venture: A Scheme to Receive Usurious Interest*, 8 Hous. L. Rev. 546 (1970-71).

65. Hershman at 317.

66. See, note 43 *supra*.

67. Hershman at 317.

68. See, 278 N.C. 523, 180 S.E.2d 823 (1971).

69. N.C. GEN. STAT. 24-8 (1961).

70. 278 N.C. 523, 526, 180 S.E.2d 823, 825.

71. *Id.* at 531, 180 S.E.2d at 828.

72. *American Insurers Life Ins. Co. v. Regenold*, 243 Ark. 906, 423 S.W.2d 551 (1968); *Curnette v. Houston*, 163 S.W.2d 675 (Tex. Civ. App. 1942).

usury. It was apparent from the face of the agreement that the purpose was to provide for excessive interest. Despite this fact, some fear has been expressed that *Kessing* spells the "beginning of the end" for equity participation, at least in North Carolina.⁷³ This fear should be dispelled. Although there have been no later cases in North Carolina prescribing the limitations of *Kessing*, it is clear that the well grounded exceptions to the usury statutes remain undisturbed.⁷⁴ In *Riley v. Sears*,⁷⁵ two avenues of escape are articulated, namely the Risk of Loss Doctrine and the contingency exception. Of the two, the latter appears to be the more acceptable—at least for institutional lenders.

Riley makes it clear that to come within the ambit of the Risk of Loss Doctrine the investor must shed all appearances of a lender. He must incur "... Responsibility for ... debts and tak[e] the full risks of the venture."⁷⁶ This would exclude a provision for repayment of the sum advanced and as such would probably be unacceptable for most institutional lenders.⁷⁷ Private parties may however find that assuming a role as partner, joint venturer, or stockholder attractive. It would appear that the investor would have some degree of leverage in bargaining for a greater share of the business since the investment is not repayable as such.⁷⁸ Moreover, as a partner of the venture one could exercise some control over the decision making process and thus protect the investment and possibly even enhance the prospects of success. Using *Kessing* as a model, Mortgage Corporation might have assumed such a position by deleting the note and deeds of trust, and by providing for transfer of the properties to the partnership while taking an interest commensurate with the value of the investment to the partnership. Under this arrangement, Mortgage Corporation would have put its advance "at risk of loss" and would have had no promise of its return. Mortgage Corporation would have been a partner.

The discussion above assumes the omission of a promise to repay the investment. Assuredly, this is the safest means of avoiding any charge of usury, but it also places the lender in a position he is usually unwilling to assume. There are cases, however, which hold that an agreement for

73. Note, *Kessings v. National Mortgage Corporation—Is Participation Dead?*, 8 WAKE FOR. L. REV. 304 (1971-72).

74. The court in *Kessing* cited *Riley v. Sears*, 154 N.C. 509, 70 S.E. 997 (1911), with approval, albeit for an element of usury instead of with reference to ownership agreements.

75. *Id.* at 518, 70 S.E. at 1000-1001.

76. *Id.*

77. See, note 64 *supra*.

78. There are cases which have held that a partnership existed despite a provision for repayment of the sum advanced. See e.g., *Atkinson v. Wileken*, 142 Cal. App.2d 246, 298 P.2d 147 (1956); *Salter v. Havivi*, 30 Misc.2d 251, 251 N.Y.S.2d 913 (1961).

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repayment is not fatal to a claim of joint venture or partnership. In *Atkinson v. Wileken*,⁷⁹ negotiations resulted in the advance of \$4,000 to the plaintiff, and the execution of a promissory note for \$6,000 including 6% interest. The note was secured by a third deed of trust on plaintiff's rental property, and payment was set at \$80 per month. The court found the following facts to exist: plaintiff was in financial difficulties and had approached the defendant with an offer to sell the property; defendant, who had some real estate experience, refused the offer but told plaintiff we would help him save the property and together they would try to sell it; at the time of the transaction there were two deeds of trust on the property securing debts amounting to \$9,000 of which the second had a balloon payment of \$4,000 which was past due; defendant advertised the property, showed it to prospective buyers on several occasions, and performed some repair work; defendant procured a buyer who offered \$17,500 for the property; plaintiff later sold the property for \$23,500 and on defendant's demand, based his one half profit on the \$17,500 offer; and defendant was paid \$4,600, whereupon he released the third deed of trust.⁸⁰ The court found that the transaction constituted a partnership and was outside the proscriptions of the usury statute. In responding to the claim that the monthly payments were evidence of a loan, the court noted that the \$80 per month amounted to about one half of the total rentals or the share to which the partner was entitled. The court further held that the giving of the note and third trust deed was but an incidental part of the whole transaction.⁸¹

In analyzing this case one should take particular notice of the work put forth by the alleged lender.⁸² It was he who advertised the property, performed termite preventive work, sought out prospective buyers, and made repairs. Such activity is not to be passed over lightly for these are the actions of an owner, not a lender. No doubt these facts weighed heavily on the judgment of the court.

The same result has been reached in other cases⁸³ where it was shown that the lender expended some effort in the operation of the enterprise, *i.e.* conducted himself in the manner of an owner, rather than in the manner of a lender. The conclusion to be reached is that a lender may escape the wrath of the usury statutes while reaping profits in excess of the maximum rate allowed, and he may enjoy such a position even with an absolute promise to repay the sum advanced, but to do this, he must

79. 142 Cal. App.2d 246, 298 P.2d 147 (1956).

80. *Id.* at 248, 298 P.2d at 149.

81. *Id.*

82. *Id.*

83. See, *e.g.*, *Salter v. Havivi*, 30 Misc.2d 251, 215 N.Y.S.2d 913 (1961); *Korth v. Tumlinson*, 73 S.W.2d 1048 (Tex. Civ. App. 1934).

also make certain efforts not characteristic of a lender. He must show some interest in the enterprise, an interest which is qualitatively different from that expressed by an average lender. The immediate reaction is that lenders will be unwilling or unable to fill the bill. The short answer is that these are the costs of increased profits.

The other avenue of escape from the usury statutes in regard to ownership participation is the contingent profit exception. As discussed in the previous section concerning loan agreements, the contingency rule excepts from the operation of the usury statutes a given transaction if it can be shown that the return was "speculative, indefinite, uncertain, [or] doubtful."⁸⁴ "If, however, the amount of probable profits is estimated in money, and the share the lender is to receive is expressed in money, and not expressed as a part of the profits nor made contingent on the earning of such profits the transaction is usurious."⁸⁵ To fall within this exception, the lender must make his return contingent upon the earnings of the enterprise. He can provide for the loan to be repaid, and he may secure it, but the profits may not be easily ascertainable. A case in point is *Foreman v. Needles*.⁸⁶ It appeared that the three defendants and one Elliott had purchased a tract of land for development and sale as city lots, each to share equally in the net profits of the venture.⁸⁷ As the work progressed, more funds were needed to continue the project. Furthermore, Elliott had seemingly had enough of the venture and wanted to be repaid his contribution and withdraw. Moreover the mortgage on the unpaid balance of the purchase was due. Under these circumstances, the plaintiff, Foreman, was approached for a \$25,000 loan. Plaintiff made the loan under the following terms: (1) out of the proceeds of the loan Elliott would be paid and his interest assigned to plaintiff; (2) the three remaining owners (defendants) would execute their note, with interest at 10 percent to Foreman, secured by the tract of land.⁸⁸ Some four years later Foreman filed his petition for foreclosure of the mortgage and judgment against his co-tenants. They set up the defense of usury claiming that \$5,400 of the \$25,000 loan had been used to purchase Elliott's interest for the plaintiff, Foreman, and as such constituted a usurious bonus for making the loan.⁸⁹ The court answered the charge as follows:

If this agreement had been as stated. . . , and the interest of Elliot had been secured, or had been transferred to the plaintiff, without regard to the remaining three-fourths, then it might be that

84. *Foreman v. Needles*, 78 Okla. 105, 109, 188 P. 1087, 1091 (1920).

85. *Riley v. Sears*, 154 N.C. 509, 518, 70 S.E. 997, 1000 (1911).

86. 78 Okla. 105, 188 P. 1087 (1920).

87. *Id.*

88. *Id.* at 106, 188 P. at 1088.

89. *Id.* at 107, 188 P. at 1089.

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the transaction would be usurious; but when the mortgage was executed to secure the payment of the \$25,000, the plaintiff's one-fourth was included in the mortgage; in other words, when lots were sold and the interest paid, plaintiff paid one-fourth of the amount. If the entire townsite had been sold and only brought sufficient to pay the amount due plaintiff with the interest thereon, then plaintiff would have received only 10 percent upon the amount advanced.⁹⁰

The court then found that the loan was not usurious, noting that the Elliott interest assigned to plaintiff was "purely speculative, indefinite, uncertain, and very doubtful."⁹¹ The *Foreman* case is important because it shows a lender with an unconditional promise to repay, earning 10% interest, and reaping the possible benefit of his ownership interest. Apparently, the distinguishing fact in this case when compared with *Kessing v. National Mortgage Corporation*⁹² is that Foreman was deemed to have contributed a sum comparable in value to the interest he received. Also, the court seemed to be dealing with Foreman as if he were two separate entities. First, there was Foreman the lender who simply advanced a sum of money and demanded a fair rate of interest for its use. Then there was Foreman the investor who was not entitled to any profits until the lender was paid. This is a view which lenders should relish. Placing the facts in the context of a limited partnership, Foreman could not lose. If things went well, he could enjoy the interest from the loan plus whatever profit there was to take. On the other hand, if the deal went bad, Foreman the lender would be secured while, Foreman the partner would be limited in losses to his one-fourth interest which he would re-coup upon payment of the loan. An enviable position, if it could be sustained.

The writer is quick to point out that *Foreman* is not the lone shining star for lenders. Indeed, there have been a number of cases which have allowed the lender to specify a rate of interest in addition to profits from a share of the business.⁹³ To obtain such an enviable position, however, the lender must make certain adjustments and adaptations. The lender must be willing to pay a price which approaches the value of the share taken.⁹⁴ He must be willing to perform tasks which indicate an interest in the business that is qualitatively different from that usually displayed by a lender.⁹⁵ On the other hand, if the agreement specifies a share of the enterprise in addition to a guaranteed rate of interest, then the rate

90. *Id.*

91. *Id.* at 109, 188 P. at 1091.

92. *See*, 278 N.C. 523, 180 S.E.2d 823 (1971).

93. *See, e.g.*, *Thomassen v. Carr*, 250 Cal. App.2d 341, 58 Cal. Rptr. 297 (1967).

94. *See*, 154 N.C. 509, 70 S.E. 997 (1911).

95. *See*, 142 Cal. App.2d 246, 298 P.2d 147 (1956).

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of interest should not be at or very near to the maximum allowed.⁹⁶ Finally, the profits to be taken from the business should not be easily ascertainable, as with rents.⁹⁷ Instead, they should be geared to gross sales, net sales, or the like.

Ownership participation remains a viable alternate in the field of real estate finance. Surely, there have been setbacks, such as *Kessing v. National Mortgage Corp.*,⁹⁸ but they should be viewed as poor examples of draftsmanship and overreaching, not the end of equity participation. If the lender is willing to make some concessions and adaptations, then there should be little difficulty in avoiding the wrath of the usury statutes.

V. CONCLUSION

Consumer protection in the realm of real estate finance is most assuredly a desired end, and no doubt the end to which usury statutes are intended to serve. These statutes have not been serving the consumer, however, but rather depriving business of much needed funds.⁹⁹ Until revisions are made, equity participation appears to be a viable alternative. Lenders will have to take on new roles and care must be taken in drafting the necessary instruments, but it can be done with substantial benefits to all involved. Lenders have made mistakes through what appears to be cupidity, but that does not spell the end for all. The courts are simply unwilling to countenance blatant overreaching. Where the parties have used some discretion, and it does not appear that an unfair advantage has been gained, there has been little reluctance to sustain a transaction as proper. Because of this, equity participation should enjoy continued use at least until some meaningful revisions are made in the now antiquated usury laws.¹⁰⁰

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96. See, 154 N.C. 509, 70 S.E. 997 (1911).

97. See, 430 S.W.2d 293 (Tex. Civ. App. 1968).

98. See, 154 N.C. 509, 70 S.E. 997 (1911).

99. See, note 2 *supra*.

100. Hershman.