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UNIFORM CONSUMER CREDIT CODE

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Administrative Interpretation No. 3.105 and 3.201-8010

A WRAP-AROUND MORTGAGE IS NOT A FIRST MORTGAGE OR DEED OF TRUST WITHIN THE CONTEMPLATION OF SECTION 5-3-105. THE "PRINCIPAL" OF A WRAP-AROUND LOAN FOR PURPOSES OF CALCULATING THE APR IS THE AMOUNT ACTUALLY ADVANCED BY THE WRAP-AROUND LENDER TO THE BORROWER.

The administrator has received several different requests for her opinion as to the proper treatment of various aspects of wrap-around mortgages under the Colorado Uniform Consumer Credit Code. This interpretation deals only with two of the issues raised by the requests received:

(1). Whether a wrap-around mortgage is a first mortgage within the meaning of that term in section 5-3-105?

(2). If the wrap-around mortgage is not a first mortgage within section 5-3-105, what is the "principal" of a wrap-around mortgage for the purposes of calculating the finance charge on the wrap-around loan under section 5-3-201?

Prior to rendering an opinion on the above two issues, it is important to provide some background on the definition, uses and effects of wrap-around financing.

By definition, a wrap-around mortgage loan is a loan secured by a lien on real property upon which there exists one or more prior liens securing prior indebtedness. In other words, the real property securing the wrap-around mortgage loan is subject to a prior (first) mortgage (or mortgages) which remains outstanding and unsatisfied. If the transaction is a sale, the borrower assumes the first mortgage.

The wrap-around loan is evidenced by a note. The face amount of the note equals the sum of the outstanding balance on the prior mortgage loan plus the amount of additional funds advanced by the wrap-around lender. The borrower pays the wrap-around lender the amounts due on this note (i.e., on both loans, the first mortgage loan and the additional advances). The wrap-around "mortgage" is really a covenant contained within a mortgage (or addendum to a deed of trust). Although the wrap-around lender agrees, pursuant to the covenant in the mortgage, to make payments on the first mortgage he does not assume the first mortgage or undertake personal liability to make those payments. The wrap-around lender's agreement to make payments on the first mortgage is conditioned upon the borrower's making payments to the wrap-around lender. The borrower is not released from the obligations on the prior mortgages.

In this administrator's experience, wrap-around financing is used in three categories of consumer credit transactions:

A. A loan made in connection with the refinancing of a first mortgage on a consumer dwelling. There is no sale involved in such a transaction. As an example of such a transaction: assume X owns Blackacre, real estate worth $75,000 subject to a $50,000 first mortgage bearing a finance charge of 8%. X wishes to refinance the first mortgage and borrow an additional $10,000 in conjunction with the refinance on the equity he has in his home; for such purpose X approaches L (lender). Instead of consummating the loan through the issuance of a conventional second mortgage, L offers X the requested loan on the condition that X permit L to "wrap-around" the existing first mortgage which remains in place.

B. Seller financing in connection with a sale of seller's home which is subject to an existing first mortgage. As an example of such a transaction: assume X owns Blackacre worth $75,000 subject to a $50,000 first mortgage bearing a finance charge of 8%. P wishes to buy Blackacre but only has $12,500 as a down payment. X agrees to sell and carry-back the financing in the following manner. L will make the $12,500 advance to X and will execute a wrap-around mortgage which requires leaving the first mortgage in place. X is named as mortgagee. Thereupon, X conveys the property to P and agrees to continue to discharge the remaining obligations under the outstanding first mortgage as they mature.

C. Third party lender financing in connection with the purchase of real property subject to a first mortgage. As an example of such a transaction: assume X owns Blackacre worth $75,000 subject to a $50,000 first mortgage with a finance charge at 8%. P desires to purchase Blackacre but only offers $12,500 as a down payment. X and P approach L to secure financing of the sale. Instead of consummating the loan through the issuance of a conventional second mortgage, L agrees to finance the transaction through a wrap-around mortgage which requires leaving the existing first mortgage in place.

Of course, the particular facts of any wrap-around mortgage may vary within each of these categories. For purposes of the first issue dealt with in this interpretation, the differences between the categories as well as the factual variations within the categories are irrelevant since the *definition* of a wrap-around mortgage is constant. For purposes of the second issue dealt with in this interpretation, only the third category, the purchase money wrap-around mortgage with third party financing, will be discussed since it is that category which has generated the requests.

Issue No. 1: *Whether a wrap-around mortgage is a first mortgage within the meaning of that term in section 5-3-105 of the Colorado Uniform Consumer Credit Code*.

Section 5-3-105, as amended by Senate bill 20, exempts from the provisions of the Uniform Consumer Credit Code (including the rate ceiling and certain other prohibitions) all loans primarily secured by an interest in land if, *inter alia*, a loan is secured by a *first mortgage or deed of trust* against a dwelling to finance the acquisition or construction of a "dwelling."1/ This section defines a "first mortgage or deed of trust" as:

> ... A mortgage or deed of trust *having priority as a lien over the lien of any other mortgage or deed of trust on the same dwelling and subject to the lien of taxes levied on that dwelling*.

By definition, a wrap-around mortgage is only used to wrap around an existing, unsatisfied first mortgage. It is clear, then, that a wrap-around mortgage is not a mortgage having priority as a lien over the lien of any other mortgage or deed of trust on the same dwelling and subject to the lien of taxes levied on that dwelling.

However, some lenders have argued that the adminstrator should find that a wrap-around mortgage is a first mortgage within the meaning of that term in section 5-3-105 since the Federal Home Loan Bank Board has taken the position that wrap-around mortgage loans are "first lien" loans for purposes of the usury preemption provisions in the Depository Institutions Deregulation and Monetary Control Act.

Section 501(a)(1)(A) of the above act has preempted state usury ceilings on certain loans "secured by a first lien on residential real property." The act itself does not define "first lien," nor does the act contain a provision granting authority to the Federal Home Loan Bank Board to define the term "first lien. The act does contain a provision authorizing the Federal Home Loan Bank Board to "issue rules and regulations and interpretations governing the implementation of this section."

Pursuant to the above rulemaking authority the Federal Home Loan Bank Board has issued regulations for federally related mortgage loans which provide the following definition of "first lien:"

> Section 590.2(c) "Loans which are secured by first liens on real estate" means loans on the security of any instrument ... which makes the interest in real estate ... specific security for the payment of the obligation secured by the instrument: _provided_ that the instrument is of such a nature that, in the event of default, _the real estate described in the instrument could be subjected to the satisfaction of the obligation with the same priority as a first mortgage of (sic) a first deed of trust in the jurisdiction where the real estate is located_.

Thus, the board has provided, in essence, that state law (the jurisdiction where the real estate is located) will determine ultimately whether the instrument at issue is a "first lien." This position is in line with the rule of law that state law defines and governs property interests.2/

It is true that in May and August 1980 staff counsel to the Federal Home Loan Bank Board in a letter stated that the phrase loans "secured by a first lien on residential real property" includes a wrap-around mortgage loan.3/ This letter is of course not a regulation and does not carry the force of law. In addition it is not at all clear that the Federal Home Loan Bank Board can by regulation or interpretation validly preempt long settled state law on lien priorities since

1. The creation and definition of property interests have long been the province of state law; and

2. The act itself does not attempt to define or delegate the duty to define "first lien." Further there is no language in the act: (a) evidencing an intent to oust state law as to the definition of liens and their priorities or (b) setting forth purposes or objectives which would be thwarted by retaining state law definitions of "first lien."4/

In sum, the clear and unambiguous language of section 5-3-105 of the code defines a first mortgage or first deed of trust as one having priority over any other mortgage or deed of trust on the same dwelling and subject to the lien of taxes levied on that dwelling. A wrap-around mortgage, by definition, does not have such status.5/

Accordingly, it is my opinion that a wrap-around mortgage is not a "first mortgage or deed of trust" within the meaning of that term in section 5-3-105 as amended by Senate bill 20.

Issue No. 2: If a wrap-around mortgage is not a first mortgage within section 5-3-105, what is the "principal" of wrap-around mortgage for purposes of calculating the finance charge on the wrap-around loan under section 5-3-201?

As noted previously, this analysis of the above issue covers only the calculation of the finance charge on a wrap-around loan which is described generally in paragraph C above:

that is, a purchase money wrap-around mortgage with third party financing.

For purposes of analysis of this issue, assume, pursuant to the earlier example recited in paragraph C, X owns Blackacre worth $75,000 subject to a $50,000 first mortgage with a finance charge at 8%. P desires to purchase Blackacre for the price of $75,000 but only offers $12,500 as a down payment. X and P approach L to secure financing of the sale. L agrees to finance the sale through a loan which wraps around the first mortgage which remains in place. P pays $12,500 as a down payment to seller. P assumes the first mortgage (the result will be the same, however, if P does not assume the first mortgage). L does not assume any liability on the first mortgage, but agrees to make all payments on the first mortgage provided that P makes monthly payments to L sufficient to cover the first mortgage as well as the new advance under the wrap loan.

L makes a wrap-around loan in the face amount of $62,500. This loan is made up of: (a) the $50,000 first mortgage, payments of which L agrees to make if (and only if) P makes monthly payments to L sufficient to cover the amounts due on the $50,000 as well as on the $12,500 (that is, payments on the total amount of $62,500) and (b) the $12,500 in cash actually advanced to P by L. L calculates the finance charge rate on the face amount of the loan, $62,500. In our example, the stated finance charge rate is 12% of $62,500 or $7500.6/

The question now is, has L correctly calculated the finance charge rate on the above transaction? In my opinion, L has not calculated the finance charge rate correctly under the code. Section 5-3-201 provides that:

> (1) With respect to a consumer loan...., a lender may contract for and receive a loan finance charge, ... not exceeding 12% per year on the unpaid balances of the principal.

In the above hypothetical transaction, L has incorrectly assumed that the "principal" of the loan is $62,500.7/ The true "principal" of the above hypothetical loan is $12,500. It is this latter amount upon which the finance charge rate must be calculated. A look at the actual figures in our hypothetical example will illustrate the difference. In our example, L calculated his finance charge rate on the basis of a principal of $62,500 which yielded a finance charge of $7500. The $7500 or 12% APR on $62,500 is within the code rate ceiling under section 5-3-201. If, however, the $7500 finance charge is received on a principal of $12,500, the annual percentage rate is 28%, well above the code rate.8/

In actual fact, the amount of the loan made in the wrap-around transaction is the $12,500 advanced to P by L since this latter amount is the only amount "loaned" by L. L has not "loaned" the $50,000 due under the existing first mortgage on the dwelling. L could not recover from P the face amount of the wrap-around note, but rather could recover only up to the amount of the "new money" provided P. The "principal" of a loan presumes the existence of a loan in the first instance. A "loan" in turn presumes the existence of a debt (see sec. 5-3-106). The $50,000 first mortgage is not a debt of P owed to L; there is no debtor-creditor relationship between P and L. The fact that L has agreed to make all payments on the first mortgage does not change the analysis. The latter agreement is conditioned upon L receiving from P sufficient money each month to meet the monthly payments on the first mortgage. Therefore, L is merely a conduit for the payment of the debt owed by P to the first mortgagee.9/

One commentator has argued that the amount and rate of the finance charge should be viewed from the debtor's perspective instead of from the perspective of the lender.10/ This commentator argues that since the borrower (P in our hypothetical) does not actually pay a total finance charge in excess of 12% on the total amount financed, the fact that the wrap-around lender doesn't actually advance the total face amount of the loan should not preclude that lender from calculating the finance charge on the face amount of the loan. This argument can be expressed as follows:

P pays L 12% on $62,500 or $7500. L, in turn, pays the finance charge on the existing first mortgage in the amount of $4000 ($50,000 x 8%). Thus, the actual yield in this transaction to L is $3500 ($7500 - $4000). P, it is argued, has only paid 12% on the entire transaction. This argument is fallacious. P has, in truth, paid a finance charge far in excess of the 12% stated rate.

A loan finance charge is defined under the code as:

> Section 5-3-109(1) ... the sum of all charges payable directly or indirectly by the debtor and imposed directly or indirectly by the lender as an incident to or as a condition of the extension of credit, whether paid or payable by the debtor, the lender, or any other person on behalf of the debtor to the lender or to a third party....

In our hypothetical example, L has, instead of issuing a conventional second mortgage, required P to give up the advantageous low-interest first mortgage as a condition to granting the loan. The fact that P has been required to give up the benefits of an advantageous agreement is a charge imposed by the lender "as an incident to or as a condition of the extension of credit." This fact can be illuminated by looking at alternative financing for P under our hypothetical. Instead of taking a wrap-around loan, P personally assumes the $50,000 first mortgage at 8%. The finance charge paid by P in this loan is $4000. P then gets a conventional second mortgage loan in the amount of $12,500 at 18% (the highest rate allowed under the Uniform Consumer Credit Code). The finance charge paid by P on this loan is $2250. The total finance charge paid by P on the entire credit transaction is then, $6250, or $1250 less than the finance charge required under the wrap-around transaction.

Looked at another way, it can be stated that as a condition for the extension of credit L required a wrap-around loan which gave L rather than P the benefit of the low rate first mortgage. As a result of the wrap-around transaction, P was required to pay 12% on the $50,000 first mortgage rather than the stated 8% rate. Thus, P paid a rate 4% higher on that %50,000 (or $2000 more in finance charge) than he would have without the wrap-around loan. Such a charge is a "loan finance charge" within the definition of that term under 5-3-109. Thus, it is clear that even from P's point of view, the APR on the wrap-around transaction is 28%.11/

To summarize: It is my opinion that a wrap-around mortgage is not a first mortgage or deed of trust as those terms are used in section 5-3-105; the "principal" of a wrap-around loan for purposes of caluclating the APR as required in section 5-3-201 is the amount actually advanced by the wrap-around lender to the borrower.

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1/ Even exempt loans are subject to sections 5-3-301 and 5-5-201 of the code.

2/ Butner v. United States, 440 U.S. 48 (1979) ("property interests are created and defined by state law."); Hoopeston Co. v. Cullen, 318 U.S. 313 (1943) ("the states have long held great authority over property within their borders ... (state law) is the source of law for ... the construction of wills, trusts, and mortgages and many other legal principles affecting property interests.").

3/ On Friday, December 12, 1980, Milan C. Miskovsky, general counsel to the Federal Home Loan Bank Board, stated in a speech before the Savings and Loan League attorney's conference, that these staff opinion letters were not official opinion letters and are not therefore binding.

4/ See, City of Philadelphia v. New Jersey, 437 U.S. 617 (1978); Ray v. Atlantic Richfield Co., 435 U.S. 151 (1978); Katherine Gibbs School v. F.T.C., 612 F.2d 658 (2nd Cir. 1979); Merrill, Lynch, Pierce Fenner & Smith, Inc. v. Ware, 414 U.S. 117 (1973).

5/ For purposes of this analysis, I have assumed the real estate is subject to one wrap-around mortgage loan. However, there can be (and often are) transactions in which the real estate at issue is "wrapped" a half dozen or more times.

6/ For purposes of this hypothetical I have assumed that the face amount of the loan, $62,500, is due and payable as a lump sum in one year with no monthly installments.

7/ The staff of the Federal Reserve Board has stated that for disclosure purposes, a creditor, involved in a wrap-around financing situation described in paragraph A above, should disclose the finance charge paid by the borrower as a traditional financing (the APR disclosed on the total obligation) 5 Con. Cred. Guide (CCH) para. 31, 763. This opinion deals with the issue of calculating the APR on a wrap-around financing situation described in paragraph C above and with the issue of limitation on finance charge received by the lender.

8/ Under the typical wrap-around loan agreement, the wrap-around lender agrees to pay the interest on the first mortgage loan. Thus, the actual finance charge received by the lender for the hypothetical transaction is $3500 ($7500 received on the wrap loan minus $4000 paid by the lender on the first mortgage loan). A finance charge of $3500 on a loan of $12,500 is a 28% rate.

9/ One of the primary objectives of the code is to insure that credit terms are defined and applied in a uniform manner among lenders within the state and among lenders in the other code states. The word "principal" has always been defined as the money advanced by a lender to a debtor not only in code states but under general tenets of credit law. See Penziner v. West American Finance Co., 133 Cal. App. 578, 24 P.2d 501, (Dist. Ct. App. 1933); American Acceptance Corporation v. Schoenthaler, 391 F.2d 64 (5th Cir.) (1968), cert. denied, 392 U.S. 928 (1968) ("interest may not be charged on portions of principal not disbursed to borrower); Mindlin v. Davis, 74 S.2d 789, (Fla. 1954). If the word "principal" is now interpreted to include monies which are not advanced by a lender and which are not the subject of a debt between lender and borrower, there will no longer be uniformity of definition of the term "principal." Even more serious, there will be no meaningful definition of the term "debt." Where terms used in the code are defined and applied in an inconsistent and meaningless manner, concepts at the heart of the code such as consumer disclosure, consumer comparison shopping and fair competition among creditors (all of which presuppose a reliable basis for comparison) become hollow indeed.

10/ Hershman, Usury and "New Look" in Real Estate Financing, 4 Real Prop., Prob. & Tr. J. 315 (1969).

11/ P has paid 12% on the $12,500 actually loaned by the wrap-around lender for a finance charge of $1500. In addition, as a result of the wrap-around financing P has paid 4% extra on the $50,000 first mortgage (a 12% wrap-around rate minus the 8% actual rate on the first mortgage) for a total finance charge of $2000. On the transaction, then, P has paid a finance charge of $3500 which as noted previously (footnote 8) is a 28% rate. See generally: Schrader, "Wrap-Around Mortgage: A Critical Inquiry," 21 UCLA L. Rev. 1529 (1974); Note, "Wrap-Around Financing: A Technique for Skirting the Usury Laws?" 1972 Duke L.J. 785.

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By ______________________
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This is an official interpretation of the Colorado Uniform Consumer Credit Code as contemplated in C.R.S. 1973, 5-6-104(4), as amended.

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