

INS AND OUTS OF DEED OF TRUST FORECLOSURES

Practical Tips for the Practitioner

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Ins and Outs of Deed of Trust Foreclosure Practical Tips for the Practitioner

by William H. Locke, Jr.

The following article is not intended to be an all inclusive discussion of the law or the practice relating to foreclosure under deeds of trust in Texas. The topics covered are a collection of both some basic topics encountered in all foreclosures (for example, where to conduct the sale and what needs to be included in the notice) and other unusual but all too frequently encountered topics (what if the debtor is in the military?, what if the debtor is deceased at the time of sale?, what happens if the debtor does not pay its property taxes?, what do you do if the debtor calls and advises before the foreclosure sale that it has a contract to sell the property that will blow up if you do not postpone the sale?, how long due you have to give a bidder to come up with the cash?). These materials are a "work in progress" as they are taken from the draft of the Texas Foreclosure Manual (2005) to be published later this year by the State Bar of Texas. This work in progress began in the 1980's when we represented various financial institutions in the Gulf Coast region of Texas. As lending decreased and loan defaults increased, our practice shifted in part from negotiating and drafting loan documents to loan workouts and foreclosures. I recall the feelings I had as I drove the streets of the business sector of my home town and knew of or had a story about many of the properties I passed. Out of this experience grew a degree of "expertise," the kind I guess that the executioner had in France at the time of the fall of the monarchy. The idea about putting this experience in written form grew from our experience in not finding a good source that connected the law, as explained in Texas Jurisprudence, with the practice, as documented in the Bar Forms Manuals. This article does not have attached to it the "forms." For those you will have to purchase the Texas Foreclosure Manual.

1. Status of the Secured Loan

1.1 Contract Rights Restricted by Statute.

Although the deed of trust reads as if it were a conveyance of the title to the mortgaged property and perhaps the collateral to the trustee "in trust," Texas law recharacterizes the

transaction as creating merely a nonpossessory lien on the mortgaged property in favor of the mortgagee. The mortgagee is granted a power of sale exercisable through the trustee. Neither the trustee nor the mortgagee is deemed to have any present right of possession or legal title to the mortgaged property or collateral. *Johnson v. Snell*, 504 S.W.2d 397 (Tex. 1973); *Humble Oil & Refining Co. v. Atwood*, 244 S.W.2d 637 (Tex. 1951). Additional authority on the nature of the deed of trust includes *Carroll v. Edmondson*, 41 S.W.2d 64 (Tex. Comm'n App. 1931, judgm't adopted); *Armenta v. Nussbaum*, 519 S.W.2d 673 (Tex. Civ. App.—Corpus Christi 1975, writ ref'd n.r.e.); *Tarrant Savings Association v. Lucky Homes, Inc.*, 379 S.W.2d 386 (Tex. Civ. App.—Fort Worth 1964), rev'd on other grounds, 390 S.W.2d 473 (Tex. 1965); *Pioneer Building & Loan Association v. Cowan*, 123 S.W.2d 726 (Tex. Civ. App.—Waco 1938, writ dism'd judgm't cor.); *Texas Loan Agency v. Gray*, 34 S.W. 650 (Tex. Civ. App. 1896, writ ref'd). The deed of trust is regarded as a contract binding the mortgagor, the trustee, and the mortgagee, also referred to as the beneficiary. The deed of trust usually is executed by the mortgagor only and not the trustee and the beneficiary. The deed of trust typically contains numerous covenants by the mortgagor (e.g., payment of taxes, maintenance of insurance), the conditions permitting the mortgagee to cause the mortgaged property to be sold (e.g., definitions of default), and the procedures to be followed (e.g., acceleration, notices, waivers, substitutions of trustees, and advertisement of sale). Texas law does not condone extra-judicial seizure of mortgaged real property by the mortgagee, unless the property is voluntarily relinquished by the mortgagor. In other words, Texas does not recognize "self-help repossession" of real estate. The Texas Property Code instead provides an orderly means for resolving disputes. Sometimes security agreements contain provisions authorizing the secured creditor to go on to a debtor's property to take possession of personal property collateral if this can be done without a breach of the peace. In the absence of a similar provision as to real property mortgaged as collateral, absent grounds for a receivership or injunction preforeclosure, the mortgagee's remedy is to seek nonjudicial or judicial foreclosure of its mortgage lien. *Lighthouse Church of Cloverleaf v. Texas Bank*, 889 S.W.2d 595 (Tex. App.—Houston [14th Dist.] 1994, writ denied). The procedures set forth in section

51.002 of the Texas Property Code are generally mandatory and nonwaivable. See Tex. Prop. Code Ann. § 51.002 (Vernon Supp. 2004). If the deed of trust conflicts with the statute, the statute controls. The conditions to exercising the power of sale and the manner of exercising the sale may be made more restrictive or burdensome by contract than the statute provides. See *Ford v. Emerich*, 343 S.W.2d 527 (Tex. Civ. App.—Houston 1961, writ ref'd n.r.e.); *Faine v. Wilson*, 192 S.W.2d 456 (Tex. Civ. App.—Galveston 1946, no writ). Foreclosure transfers title from the debtor to another party, but it does not put the new owner in possession; it gives him a right to possession. If a debtor remains on the property, most deeds of trust treat him as a tenant by sufferance. To remove a tenant at sufferance, the new owner must file a forcible detainer suit.

1.2 Identifying the Secured Debt

The deed of trust may secure a variety of obligations.

There appear to be no Texas cases on whether or not a deed of trust can secure contingent obligations. One commentator has argued that Texas courts will uphold the validity and superior priority of such liens. Danilowicz, *Validity of a Deed of Trust Securing Contingent Obligations (Mortgages for Future Advances and Standby Letters of Credit)*, 50 Tex. B. J. 1086 (1987). The court in *Taylor v. Transcontinental Properties*, 739 S.W.2d 873 (Tex. App.—Tyler 1987, no writ), held that a note and deed of trust given to secure a mortgagor's performance of obligations under a contract were supported by adequate consideration as a matter of law. Taylor had contracted with Transcontinental to purchase notes generated in Transcontinental's time-share sales program. In the note sales agreement, Transcontinental agreed to execute a deed of trust "[t]o guarantee [its] performance under the commitment and to assure SMSC that all taxes, insurance and maintenance costs are timely paid." *Taylor*, 739 S.W.2d at 877. Transcontinental executed a deed of trust to ensure its performance of the note sales agreement "and to further ensure the endorsement of all notes sold by Grantors [Transcontinental] to Beneficiary [Taylor]." *Taylor*, 739 S.W.2d at 877.

1.3 Payment Terms and Payment Default

There are at least three common forms of debt instruments: demand note, term note, and installment note. See M. Baggett, 15 Texas Practice, *Texas Foreclosure Law and Practice* § 1.01 *et seq.* (2001 & Supp. 2004).

1.3:1 Payable on Demand

Section 3.108(a) of the Texas Business and Commerce Code defines payable on demand:

(a) A promise or order is "payable on demand" if it: (1) states that it is payable on demand or at sight, or otherwise indicates that it is payable at the will of the holder; or (2) does not state any time of payment.

Tex. Bus. & Comm. Code Ann. § 3.108(a) (Vernon 2002). A demand note is matured on demand by the holder. However, one case has held that "[a] demand note is due from the moment of execution and actionable immediately without demand." *Stavert Properties v. RepublicBank of Northern Hills*, 696 S.W.2d 278, 281 (Tex. App.—San Antonio 1985, writ ref'd n.r.e.). A note containing "on demand" language may be construed as not being a demand note, if the acceleration language contains explicit conditions of default. *Bank One, Texas, N. A. v. Taylor*, 970 F.2d 16 (5th Cir. 1992).

Formal demand for payment and failure to pay must occur on a demand note before commencement of the foreclosure process. The demand feature of the note involves a number of issues that have not been extensively dealt with by state and federal courts. In *Conte v. Greater Houston Bank*, 641 S.W.2d 411 (Tex. App.—Houston [14th Dist.] 1982, writ ref'd), the court held that language providing for payment on demand, but if no demand was made, in monthly installments with a fixed maturity date was payable in full at time of demand, notwithstanding the provisions concerning monthly payments. *Conte* was followed by *Stavert Properties, Inc. v. RepublicBank of Northern Hills*, 696 S.W.2d 75 (Tex. App.—Dallas 1983, writ ref'd n.r.e.), the court interpreted the phrase "on demand and if no demand is made, then on December 1, 1922" as making the note a demand instrument.

However, a subsequent Fifth Circuit case has distinguished and declined to follow the *Conte* case. In *Bank One Texas, N. A. v. Taylor*, 970 F.2d 16 (5th Cir. 1992), the Fifth Circuit interpreted a promissory note which stated,

This obligation is, as an alternative to the above recited payment schedule, due and payable on demand.

The note also contained default provisions and acceleration clauses whereby the bank could accelerate the note on the occurrence of an event of default. In addition, the security interests securing the note listed various events of default which would allow the bank to declare the entire obligation immediately due and payable. The lender argued, citing *Conte* that this instrument was a demand note. The Fifth Circuit distinguished *Conte* on the grounds that, first, the note in *Conte* did not contain an acceleration clause and apparently was not accompanied by an underlying security agreement or terms which would modify the right of demand.

[H]ere, in contrast, the existence of explicit conditions of demand in the acceleration clause, as well as the related security agreements, shows a clear intention that the note be payable on demand only in the event Taylor failed to meet the installment obligation or the obligations imposed by the security agreement.

Citing to the opinion of the First Circuit in *Reid v. Key Bank of Southern Maine, Inc.*, 821 F.2d 9 (1st Cir. 1987), the Fifth Circuit held that the presence of such conditions in the documents qualified the demand provision and that,

Based upon the testimony and our reading of the loan documents, we determine that although these notes profess to be demand instruments, a fair reading of the notes and related security agreements demonstrates an intention that these installment notes be payable on demand only in the event of default. This construction comports with the common expectation that a promissory note with an installment feature and an acceleration clause is a time obligation and that the bank does not have the right to demand payment in the absence of default.

In view of the conflict between the state and federal case law, the terms of the entire loan transaction should be reviewed before making demand on a “demand” note.

Some commentators have raised a question as to the breadth of the language in Tex. Prop. Code Ann. § 51.002(d) (Vernon Supp. 2004) that

the debtor must be given at least 20 days to cure the default before the entire debt is due and notice of sale is given.

Unquestionably, this provision overrides any waiver or express demand feature without notice contained in a deed of trust encumbering a debtor’s residence.

Giving maker and mortgagor advance notice of the mortgagee’s intention to demand payment of a demand note may be advisable. The trend in some jurisdictions is to find a special relationship between the parties or an implied contractual obligation of “good faith and fair dealing.” For example, the Sixth Circuit, applying New York law, upheld a jury verdict for \$7,500,000 against Irving Trust Company for its breach of an implied obligation of good faith and fair dealing in refusing to advance additional credit under a line-of-credit note that was payable on demand. *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752 (6th Cir. 1984). The Sixth Circuit found support for its position in chapter 2 of the UCC, which deals with sales agreements. (See Tex. Bus. & Comm. Code Ann. § 2.309 comment (Vernon 1994) for the equivalent section of the Texas UCC.) The Sixth Circuit held that

the application of principles of good faith and sound commercial practice normally call for such notification of the termination of a going contract relationship as will give the other party reasonable time to seek a substitute arrangement.

K.M.C., 757 F.2d at 759.

1.4 Default - Insecurity.

Texas Business and Commerce Code § 1.309 provides that when a contract allows a party to accelerate payment of a note “when he deems himself insecure,” the lender may do so only

if he in good faith believes that the prospect of payment or performance is impaired. The burden of establishing lack of good faith is on the party against whom the power has been exercised.

Tex. Bus. & Comm. Code Ann. § 1.309 (Vernon Supp. 2004). The comments to the Section, however, clearly state that the good faith requirement is not applicable to a demand note:

Obviously, this section has no application to demand instruments or obligations whose very nature permits call at any time with or without reason. This section applies only to an agreement or to paper which in the first instance is payable at a future date.

Under Texas Business and Commerce Code § 1.201(20), *good faith* means “honesty in fact and the observance of reasonable commercial standards of fair dealing.” Tex. Bus. & Comm. Code Ann. § 1.201(20) (Vernon Supp. 2004). The Texas Supreme Court has held that the obligation of good faith imposed under Texas UCC § 1.203 (the predecessor to Texas UCC § 1.201(20)) may be breached only by a showing of dishonesty by the creditor, and that the test for “honesty in fact” under Texas UCC § 1.108(19) (now Texas UCC § 1.201) did not include diligence or negligence. *FDIC v. Coleman*, 795 S.W.2d 706 (Tex. 1990). Texas does not recognize a common law duty of good faith and fair dealing in every contract, and such duty arises only if there is a “special relationship” between the parties. *Arnold v. National County Mut. Fire Ins. Co.*, 725 S.W.2d 165 (Tex. 1987).

Where a security instrument authorizes a creditor to accelerate maturity when the creditor deems itself insecure, the insecurity may be found as to the debt itself or as to the collateral. *Jack M. Finley, Inc. v. Longview Bank & Trust Co.*, 705 S.W.2d 206 (Tex. Civ. App.—Texarkana 1986, writ ref’d n.r.e.). Texas courts generally state that “good faith” must be decided on a case by case basis after acceleration has occurred. *American Bank of Waco v. Waco Airmotive, Inc.*, 818 S.W.2d 163 (Tex. App.—Waco 1991, writ denied), citing to *Ford Motor Credit Co. v. Powers*, 613 S.W.2d 30 (Tex. Civ. App.—Corpus Christi 1981, no writ) and cases cited therein. These cases suggest that the question is decided by fact issues, but in the *Finley* case, the court granted summary

judgment on the good faith issue to the lender by finding that “uncontroverted sworn evidence” that the debtor had threatened bankruptcy, was a sufficient basis to establish the Bank’s good faith in exercising an insecurity clause, notwithstanding that the \$750,000 loan at 11% interest was secured by a \$750,000 CD bearing 9% interest.

In *American Bank of Waco v. Waco Airmotive, Inc.*, 818 S.W.2d 163 (Tex. App.—Waco 1991, writ denied), the court stated that insecurity clauses are to be used only to protect the creditor from actions by the debtor which jeopardize or impair the security, and not offensively for the commercial advantage of the creditor. *Id.* at 72, citing to *Brown v. Avemco*, 603 F.2d 1367 (9th Cir. 1979). In this case, the borrower and the lender entered into a promissory note combining and renewing several loans held by the lender at a time when the borrower was delinquent on several installments on a separate SBA loan also held by the lender. Two weeks later, notwithstanding that no material change had occurred to the borrower’s financial situation and that the lender had just agreed to consider the borrower’s proposal for restructuring the delinquent SBA loan, the lender accelerated the delinquent SBA loan under an insecurity clause, cross-defaulted the renewal note, and then offset the borrower’s checking account to pay off the renewal note in full and the delinquent installments on the SBA note. The court in *Airmotive* found the lender’s acceleration of the note’s maturity and offsetting of borrower’s checking account was wrongful and found lender’s reliance on an insecurity clause to be misplaced.

1.5 Identifying the Security

Before writing the first demand letter or notice of intent-to-accelerate letter, the types of collateral securing the obligations should be identified. This first step is to verify perfection of security interests, to determine if the loan is secured by the intended mortgaged property and collateral, and to avoid the assertion of impermissible claims on homestead-exempt assets.

1.5:1 Personal Property

The deed of trust may expressly encumber both real property and personal property. The *Texas Real Estate Forms Manual* contains at Clause 15-9-9 suggested language for inclusion in the

deed of trust as to the creation of a lien as to such mixed collateral. Clause 15-9-9 provides

In addition to creating a deed-of-trust lien on all the real and other property described above, Grantor also grants to Lender a security interest in all of the above-described personal property pursuant to and to the extent permitted by the Texas Uniform Commercial Code.

See below for additional language suggested in the *Texas Real Estate Forms Manual* specifying that Lender may elect to proceed as to both the real property and personal property in a unified deed of trust lien foreclosure sale.

The Texas Uniform Commercial Code, as set out in the Texas Business and Commerce Code, provides an option to the lender if the deed of trust covers both real and personal property. Texas UCC § 9.604(a) (Vernon 2002). A lender may proceed against the personal property under the personal property foreclosure provisions of the Texas UCC as if there is no real property involved, or the lender may elect to foreclose on both real and personal property pursuant to section 51.002 of the Texas Property Code. If the personal property is foreclosed under section 51.002, then the provisions of subchapter F of the Texas UCC covering default do not apply.

Comment 2 of §9.604 states:

In the interest of simplicity, speed and economy, subsection (a) like former Section 9.501(4), permits, (but does not require), the secured party to proceed as to both real and personal property in accordance with its rights and remedies in respect of the real property. Subsection (a) also makes clear that a secured party who exercises rights under Part 6 with respect to personal property does not prejudice any rights under real property law.

Tex. Bus. & Comm. Code Ann. § 9.604 comment 2 (Tex. UCC) (Vernon 2002).

This election between real property and personal property foreclosure procedures is set out in Clause 15-9-9 to the form of Deed of Trust in *Texas Real Estate Forms Manual* Ch. 15, p. 15-50 immediately following the above-quoted

language as to dual deed of trust and security interest liens in mortgaged property. This clause provides:

[If the security agreement covers nonfixtures and other personalty, continue with the following.]

In the event of a foreclosure sale under the deed of trust, Grantor agrees that all the Property may be sold as a whole at Lender's option and that the Property need not be present at the place of sale.

Other states, most notably California, have attempted to reconcile seemingly conflicting real property and personal property foreclosure rules. California replaced the one-sentence provision of former U.C.C. § 9-501(d) with a seven-paragraph treatment of what had become known in California as the "mixed collateral problem." Cal. Comm. Code § 9501(4); see Hetland & Hansen, *The "Mixed Collateral" Amendments to California's Commercial Code—Covert Repeal of California's Real Property Foreclosure and Antideficiency Provisions or Exercise in Futility?*, 75 Calif. L. Rev. 185-216 (1987); Hirsh, Arnold, Rabin & Sigman, *The U.C.C. Mixed Collateral Statute—Has Paradise Really Been Lost?*, 36 UCLA L. Rev. 1-81 (1988). In *Van Brunt v. BancTexas Quorum, N. A.*, 804 S.W.2d 117 (Tex. App.—Dallas 1990, no writ) the court relied upon this section of the Texas UCC to justify not extending the rule announced in *Tanenbaum v. Economics Laboratory, Inc.*, 628 S.W.2d 769 (Tex. 1982) eliminating deficiencies after a defective personal property foreclosure sale to bar a subsequent real property foreclosure sale or suit for deficiency after the subsequent real property foreclosure sale.

In a case of first impression in Texas, we find that, as both real and personal property secured the note, [Lender] had the option under section 9.501(d) [now § 9.604 of the Texas Uniform Commercial Code] to proceed under that Code as to the personal property, and later proceed under the Texas Property Code as to the real property, without being adversely affected by any defects in its personal property foreclosure proceedings.

Van Brunt, 804 S.W.2d at 127.

We hold that any defect in [Lender's] foreclosure under the Code has no effect on its rights under the real property mortgage, including its right to seek a deficiency.

Van Brunt, 804 S.W.2d at 129-30. The defect in *Van Brunt* was the failure of the lender to re-notify the debtor that the lender would sell the collateral at a private sale after the lender held a public sale but rejected the highest bid and later sold to the highest bidder at private sale for a higher price. Additionally, the debt in *Van Brunt* was a series of notes each guaranteed by a guarantor and secured by separate security agreements granting a security interest in accounts, inventory and equipment to secure all indebtedness of the borrower to the lender. One of the notes of the borrower expressly stated that it was secured by a deed of trust but did not refer to any of the security agreements.

Complicating this issue as regards to real property foreclosures is the fact that the *Tanenbaum* rule appears to have been overturned in non-consumer personal property foreclosure cases by Texas legislature's adoption of the revised chapter 9 to the Uniform Commercial Code. Texas Business and Commerce Code § 9.626 provides that in non-consumer transactions, a secured party need not prove compliance with the provisions of subchapter F ("Default") relating to collection, enforcement, disposition, or acceptance unless the debtor or a secondary obligor places the secured party's compliance in issue. Tex. Bus. & Comm. Code Ann. § 9.626(a)(1) (Vernon 2002). If the secured party's compliance is placed in issue, the secured party has the burden of establishing that the collection, enforcement, disposition, or acceptance was conducted in accordance with subchapter F. Tex. Bus. & Comm. Code Ann. § 9.626(a)(2) (Vernon 2002). Except as otherwise provided in Section 9.628, if a secured party fails to prove that the collection, enforcement, disposition, or acceptance was conducted in accordance with the provisions of subchapter F, the liability of a debtor or a secondary obligor for a deficiency is limited to an amount by which the sum of the secured obligation, expenses, and attorney's fees exceeds the greater of: (i) the proceeds of the collection, enforcement, disposition, or acceptance; or (ii) the amount of proceeds that would have been realized had the noncomplying secured party proceeded in accordance with the

provisions of subchapter F. Tex. Bus. & Comm. Code Ann. § 9.626(a)(3) (Vernon 2002). For this purpose, the amount of proceeds that would have been realized is deemed equal to the sum of the secured obligation, expenses, and attorney's fees unless the secured party proves that the amount is less than that sum. Tex. Bus. & Comm. Code Ann. § 9.626(a)(4) (Vernon 2002). If a deficiency or surplus is calculated under § 9.615(f), the debtor or obligor has the burden of establishing that the amount of proceeds of the disposition is significantly below the range of prices that a complying disposition to a person other than the secured party, a person related to the secured party, or a secondary obligor would have brought. Tex. Bus. & Comm. Code Ann. § 9.626(a)(5) (Vernon 2002). Section 9.626 further provides that its limitation to transactions other than consumer transactions is intended to leave to the court determination of the proper rules in consumer transactions, but that "the court may not infer from that limitation the nature of the proper rule in consumer transactions and may continue to apply established approaches." Tex. Bus. & Comm. Code Ann. § 9.626(b) (Vernon 2002). See also *Huddleston v. Texas Commerce Bank—Dallas*, 756 S.W.2d 343 (Tex. App.—Dallas 1988, writ denied) (court refused to require mortgagee to prove that its deed of trust lien foreclosure sale on real property was conducted in commercially reasonable manner, citing (former) section 9.104(10) that excepts from chapter 9 of Texas Business and Commerce Code "creation or transfer of an interest in or lien on real estate").

If the security includes personal property, such as equipment or consumer goods (stoves, furniture), a UCC search should be conducted to determine initial perfection, continued perfection, priority, and junior security-interest holders to be notified. The secured creditor is required to notify other secured creditors with security interests in the same collateral of the proposed personal property foreclosure sale. Tex. Bus. & Comm. Code Ann. § 9.611 (Vernon 2002). The presence of personal property may also affect the type of requests in the initial communication to the debtor (e.g., request for inspection of the collateral, for assembly of collateral, or for voluntary turnover to lender for foreclosure sale).

Commercially Reasonable Sale Requirements: If the lender decides to proceed against the personal property separately, the

lender must repossess the collateral in order to conduct a commercially reasonable sale. Section 9.610(b) of the Texas UCC requires that every aspect of a secured party's disposition of personal property collateral in foreclosure of its security interest be "commercially reasonable," including the method, manner, time, place, and terms of sale. Prior to its revision in 1999, the Texas UCC did not define "commercially reasonable," but revised Texas UCC § 9.627(b) provides rules that assist in the determination of "commercially reasonable" and, in certain circumstances, provide a safe harbor for certain actions.

Inadvertent Omissions from Collateral and Mortgaged Property: Use of the mortgaged property may require the continuation after the foreclosure sale of a variety of contracts, franchises, licenses, permits, leases, and other interests that may not be described by the phrase "TO HAVE AND TO HOLD the above described property, together with the rights, privileges, and appurtenances thereto belonging . . ." in an earlier version of the *Texas Real Estate Forms Manual's* deed of trust. (at 7B (1976 & Supp. 1982)), or the phrase "property (including any improvements)" in the current version of the deed of trust, at ch. 15, form 15-1. Unless the mortgagee is in some manner a party or a legally recognized third-party beneficiary to the contract, franchise, license, permit, lease, or other interest, the mortgagee may not have the benefits or the burdens of such matters. Some permits necessary to continue operation of the mortgaged property may be personal to the mortgagor. See, e.g., Tex. Alco. Bev. Code Ann. §§ 11.03, .05 (Vernon 1995).

Including Unwanted Property: The deed of trust may include an omnibus description of mortgaged property (i.e., "all agreements affecting or benefiting the mortgaged property"). There is no way of knowing at the time of the execution of the deed of trust which present or future agreements will be assets and which will be liabilities. Whether the mortgagee or the purchaser can pick and choose at the foreclosure sale or whether the foreclosure sale documents can specifically exclude undesirable agreements are unsettled issues. Even if they can be excluded, the undesirable agreements may not be identifiable as such at the time of foreclosure.

1.5:2 Real Property

Identifying the real property may not be as easy as it first sounds. Sometimes not enough care is taken at the time of the loan to verify the property's description. If the description is by metes and bounds, a survey should be considered if one was not obtained at the time the loan was made.

Changes In the Security: Since the loan was originally made, the description of the mortgaged property may have changed through platting, replatting, partial release of liens, and condominium declaration. Failure to verify the description may result in clouding the title, inadequately advertising the sale; may be considered as additional evidence of the fraudulent conduct of the lender; and may result in failure to convey title to the lender of portions of the security.

Homestead: If the mortgaged property is the debtor's homestead or the debtor's residence, additional considerations should be given to cure rights, consumer debt-collection laws, and limitations on secured debt.

Two cases emphasize that "a lien cannot be 'estopped' into existence" over the homestead exemption. In *Hruska v. First State Bank*, 747 S.W.2d 783, 785 (Tex. 1988), the debtors misrepresented to the lender, subsequent to the funding of a construction loan on a homestead, that mechanic's lien documents had been prepared. The Texas Supreme Court found that these misrepresentations would not retroactively create a lien by estoppel. In *In re Niland*, 825 F.2d 801 (5th Cir. 1987), the Fifth Circuit held that a mortgagor's misrepresentations in a recorded homestead affidavit and designation identifying another residential property as the debtor's homestead did not estop the debtor from claiming a foreclosed residence as a homestead against a purchaser for value at a foreclosure sale. *But see Templin v. Weisgram*, 867 F.2d 240 (5th Cir. 1989) (borrower's homestead claim, made following simulated sale, barred by 12 U.S.C.A. § 1823(e) (West 1989)).

Additionally, the lender's attorney should ensure that the lender is not attempting to claim that the mortgaged property serves as collateral for debts not permitted to be secured by the homestead. The lender may also be asserting erroneously that the homestead loan, although

not otherwise in default, is in default because of a default on another loan. This problem can occur if the homestead loan documents do not clearly state that a default on other indebtedness is a default on the homestead loan. For example, the homestead loan documents may recite that a default on "any debt secured hereby" is a default permitting acceleration but fail to recite that a default on debt "not secured hereby" is a default permitting acceleration of the homestead loan.

Improvements and Fixtures. The *Texas Real Estate Forms Manual's* form for deed of trust provides for the description of the mortgaged real property by calling for the insertion of a description following the heading "Property (including any improvements):" *Texas Real Estate Forms Manual*, ch. 15, form 15-1. A frequent practice is to insert a description of the land without further reference to the "improvements" encumbered or to "fixtures" and "appurtenances." Although a better practice is to include at least a general description of the improvements and fixtures, this practice in most cases should suffice. Courts have given liberal construction to the scope of the "property" conveyed by deeds merely identifying the property conveyed by description of the land. The general rule is that "[d]eeds are construed to convey to the grantee the greatest estate possible." *Reeves v. Towery*, 621 S.W.2d 209, 212 (Tex. Civ. App.—Corpus Christi 1981, writ ref'd n.r.e.) (citing *Waters v. Ellis*, 312 S.W.2d 231 (Tex. 1958)). A deed that does not except property owned by the grantor conveys the grantor's entire estate. See *Waters v. Ellis*, 312 S.W.2d 231, 234 (Tex. 1958). Reservations must be by clear language. See *Reeves*, 621 S.W.2d at 212 (citing *State v. Black Bros.*, 297 S.W. 213 (Tex. 1927)). No exception or reservation exists absent a manifest intent expressed in the instrument. See *Garvin v. Hudson*, 353 S.W.2d 508, 510 (Tex. Civ. App.—Texarkana 1962, writ ref'd n.r.e.).

The term "improvement" generally includes anything that permanently enhances the value of such real property. See *Karisch v. Allied-Signal, Inc.*, 837 S.W.2d 679, 680 (Tex. App.—Corpus Christi 1992, no writ). The term "improvement" covers a broader range of items than does the term "fixture." See *Logan v. Mullis*, 686 S.W.2d 605, 607 (Tex. 1985); *Cantrell v. Broadnax*, 306 S.W.2d 429, 432 (Tex. Civ. App.—Dallas 1957, no writ). Items which have been held under

Texas law to be improvements include: (i) a building (see *Producers Lumber & Supply Co. v. Olney Bldg. Co.*, 333 S.W.2d 619, 624 (Tex. Civ. App.—San Antonio 1960, writ ref'd n.r.e.)); (ii) a house (see *Dennis v. Dennis*, 256 S.W.2d 964, 966 (Tex. Civ. App.—Amarillo 1952, no writ)); (iii) a fence (see *Jarrell v. Boedeker*, 146 S.W.2d 293, 295 (Tex. Civ. App.—Fort Worth 1940, no writ)); (iv) oil wells (see *Jenkins v. Pure Oil Co.*, 53 S.W.2d 497, 503 (Tex. Civ. App.—Dallas 1932, no writ)); (v) underground petroleum storage tanks (see *Big West Oil Co.*, 836 S.W.2d at 803); and (vi) a heat exchanger bolted to a concrete structure (see *Karisch*, 837 S.W.2d at 681). The permanent aspect of an improvement requires that it be placed on the land so that it is impossible to remove it or carry it away without injuring the real property or that the improvement be annexed to the soil as part of the freehold. See *Big West Oil Co. v. Willborn Bros. Co.*, 836 S.W.2d 800, 803 (Tex. App.—Amarillo 1992, no writ). Many of these examples indicate the difference between a fixture, which must be chattel, and an improvement which encompasses any permanent betterment.

If the property is leased, there are likely to be trade fixtures (items annexed to property that enable a tenant or occupant to carry on a trade or business) affixed to the property. The general rule is that a tenant's trade fixtures can be removed by a tenant if they may be done without injury to the property. See *Sonnier v. Chisolm-Ryder Co.*, 909 S.W.2d 475, 479 (Tex. 1995); *Reames v. Hawthorne-Seving, Inc.*, 949 S.W.2d 758, 761 (Tex. App.—Dallas 1997, writ denied).

"Fixtures" are broadly described under Texas law as items of property that are personal in nature and have been annexed to realty so as to become a part of the realty. See *Houston Bldg. Serv., Inc. v. American Gen. Fire and Cas. Co.*, 799 S.W.2d 308, 311 (Tex. App.—Houston [14th Dist.] 1990, writ denied); *Fenlon v. Jaffe*, 553 S.W.2d 422, 428 (Tex. Civ. App.—Tyler 1977, writ ref'd n.r.e.); *Ruby v. Cambridge Mut. Fire Ins. Co.*, 358 S.W.2d 943, 945 (Tex. Civ. App.—Dallas 1962, no writ). Generally, the term "fixture" includes all chattels or structures attached to realty that cannot be removed without materially damaging the property. See *Melendez v. State*, 902 S.W.2d 132, 137-38 (Tex. App.—Houston [1st Dist.] 1995, no writ). See TEX. BUS. & COMM. CODE ANN. § 9.313(9)(1) (Vernon 2002).

More specifically, a three part test has been developed to determine whether an item of personal property has become a fixture: (i) did the person who annexed the chattel to the realty intend for it to become a fixture? (ii) was the mode and sufficiency of annexation adequate to attach the chattel to the realty? and (iii) has the chattel been adapted to the use of the realty? See *Logan v. Mullis*, 686 S.W.2d 605, 607 (Tex. 1985); *House the Homeless, Inc. v. Widnall*, 94 F.3d 176, 181-82 (5th Cir. 1996). Absent any evidence to the contrary, an owner who affixes improvements onto land is assumed to have intended for such improvements to become fixtures. See *McDaniel v. Pettigrew*, 536 S.W.2d 611, 615 (Tex. Civ. App.—Dallas 1976, writ ref'd n.r.e.); *Clark v. Clark*, 107 S.W.2d 421, 424 (Tex. Civ. App.—Texarkana 1963, no writ). If there was intent that the improvement be temporary in nature, however, such improvements will not be deemed a fixture. See *O'Neil v. Quilter*, 234 S.W. 528, 529 (Tex. 1921). Secret intentions will not be dispositive of an intent for the issue of permanent annexation. See *Ruby*, 358 S.W.2d at 946; *C.D. Shamburger Lumber Co. v. Bredthauer*, 62 S.W.2d 603, 604 (Tex. Civ. App.—Fort Worth 1933, writ dismissed w.o.j.). The second and third prongs of the fixture test are typically used as further evidence of the question of intent. See *Hutchins v. Masterson*, 46 Tex. 551, 554 (Tex. 1887); *Logan*, 686 S.W.2d at 607; *Fenlon*, 553 S.W.2d at 42.

Appurtenances. “**Appurtenance**” means a real property interest that is annexed to, incident to or necessarily connected with the use and enjoyment of a tract of real property. BLACK’S LAW DICTIONARY (West 1999). “**Appurtenance**” includes improvements and easements. *Angelo v. Biscamp*, 441 S.W.2d 524 (Tex. 1969); *Pine v. Gibraltar Savings Association*, 519 S.W.2d 238 (Tex. Civ. App.—Houston [14th Dist.] 1974, writ ref'd n.r.e.) Under the common law, the conveyance of a tract of real property includes appurtenances, unless the deed provides otherwise. *Pollock v. Lowry*, 345 S.W.2d 587 (Tex. Civ. App.—San Antonio 1961, writ ref'd n.r.e.). “**Appurtenance**” does not, however, normally include personal property. *Ogden v. Jones*, 37 S.W.2d 777 (Tex. Civ. App.—Austin 1931, writ dismissed w.o.j.).

The *Texas Real Estate Forms Manual's* form for deed of trust does not attempt to describe the variety of appurtenances or agreements that

give value to the mortgaged property, nor does it refer to “appurtenances” but merely describes the mortgaged property as “Property (including any improvements).” *Texas Real Estate Forms Manual*, ch. 15, form 15-1. Prior to foreclosing on the deed of trust lien, a reexamination should be made to determine whether there are valuable rights associated with the property and whether these rights are appurtenances that pass to the foreclosure sale purchaser with title to the mortgaged property.

Water Rights. Water rights have been held to be included as part of the mortgaged property when the deed of trust did not expressly reserve or except water rights. *Graham v. Kuzmich*, 876 S.W.2d 446 (Tex. App.—Corpus Christi 1994, no writ). The obligation of a municipal utility district to lease and later purchase water, sanitary sewer and drainage facilities installed by the mortgagor have been held to be an appurtenance passing at a foreclosure sale. *Olmos v. Pecan Grove Municipal Utility District*, 857 S.W.2d 734 (Tex. App.—Houston [14th Dist.] 1993, no writ).

Peanut Allotment.

A federal peanut allotment has been held to be appurtenant to farm land. *Lindsey v. FDIC*, 960 F.2d 567 (5th Cir. 1992).

Parking Garage Lease.

A garage parking lease has been held not to be appurtenant to an office building where the leasehold interest in the parking garage was not necessary to the intended function of the building because other parking was available near the building and not every tenant in the building leased parking space in the garage. *Law Offices of C. Kendall Harrell, P.C. v. Commerce Savings Association*, 824 F.Supp. 1159 (W. D. Tex. 1993).

1.5:3 Crops, Crop Rent, and Farm Tenants

The purchaser at a foreclosure sale will take title to crops and crop rent only if there has not been an actual or constructive severance of the crops and rent from the land. This severance may be created by harvest, sale, assignment, or mortgage. Lease of the land creates a severance of the crops under the proper

circumstances. The severance may be subsequent in time to the mortgage and without actual or constructive notice to the mortgagee. Furthermore, a tenant of the debtor's may also have rights in the crops that will survive the foreclosure, notwithstanding the fact that the tenant's lease is junior to the deed of trust.

Crops: Texas case law is well settled that crops produced by annual cultivation, whether growing or matured, are distinct in nature from the land on which they are cultivated and that title to the crops may reside in a person other than the owner of the land. Therefore, unless the deed of trust specifically covers crops, they will pass with the land at a foreclosure sale only if they have not been actually or constructively severed from the land before the foreclosure sale. *Greenland v. Pryor*, 360 S.W.2d 423 (Tex. Civ. App.—San Antonio 1962, no writ); *Gulf Stream Realty Co. v. Monte Alto Citrus Association*, 253 S.W.2d 933 (Tex. Civ. App.—San Antonio 1952, writ ref'd); *Dodson v. Beaty*, 144 S.W.2d 609 (Tex. Civ. App.—Dallas 1940, writ dism'd judgm't cor.); and numerous cases cited in these three opinions. The severance may be by harvesting or constructively by assignment or mortgage. *Willis v. Moore*, 59 Tex. 628 (1883); *Gulf Stream Realty Co.*, 253 S.W.2d at 936; *Dodson*, 144 S.W.2d at 611. There is case authority that even crops not yet planted may be severed by sale or mortgage, *Sanger Bros. v. Hunsucker*, 212 S.W. 514 (Tex. Civ. App.—Fort Worth 1919, no writ), but there is also case authority that an executory contract to sell, which provides that title to the crops shall not pass until they are "picked and prepared for delivery," is not sufficient to create a severance of the crops from the land, and the crops in such case pass to the purchaser at foreclosure. *Gulf Stream Realty Co.*, 253 S.W.2d at 936.

Crop Rent: The same reasoning is applied to crop rent due the mortgagor under a lease. The Crop rent passes to the purchaser at foreclosure only if there has not been a previous assignment of the rent. *Dodson v. Beaty*, 144 S.W.2d 609 (Tex. Civ. App.—Dallas 1940, writ dism'd judgm't cor.); *Standridge v. Vines*, 81 S.W.2d 289 (Tex. Civ. App.—Eastland 1935, no writ); *Hunsucker*, 212 S.W. 514. In *Standridge*, the court stated:

It is immaterial that no constructive notice may be given of the sale, mortgage, assignment, etc. Where not

interdicted by the statute of frauds, the evidence thereof is not required to be in writing. It necessarily follows that the purchaser at the foreclosure sale is charged with knowledge of the law that he gets no title to growing crops and rents if there has been a severance. In other words, a purchaser is under the obligation to ascertain if there has been a severance, and only takes title to the crops and rents if there has been none.

81 S.W.2d at 290.

Rights of Farm Tenants: The distinction between crops and the land is the basis for the common-law doctrine of "**emblems**", an equitable doctrine protecting lessees of farmland.

The doctrine of emblems is the common law right of the tenant, whose lease of uncertain duration has been terminated without his fault and without previous knowledge upon his part, to enter upon the leased premises to cultivate, harvest, and remove the crops planted by him before the termination of the lease.

Dinwiddie v. Jordan, 228 S.W. 126 (Tex. Comm'n App. 1921, judgm't adopted); see also *Miller v. Gray*, 149 S.W.2d 582 (Tex. 1941). In *Dinwiddie*, the three elements of emblems: (1) the existence of a tenancy of uncertain duration, (2) the termination of the tenancy by the act of the lessor, and (3) the planting of the crop by the tenant during his period of legal occupancy without notice were met by (a) a five-year lease subject to earlier termination upon specified conditions, (b) a default by the lessor leading to foreclosure of the lessor's mortgage, and (c) the tenant's planting of crops before he received notice of the pending foreclosure sale. The commission of appeals in *Dinwiddie* stated that the tenant not only retained title to the crop but also had a right of entry onto the land to cultivate the crop until maturity and harvest. The court further quoted with approval a decision by the Supreme Court of Nebraska stating that while the tenant's right was a right of ingress and egress and not of possession of the land, the tenant did have a cause of action for any interference by the owner of the land with this right of entry. 228 S.W. at 128.

The doctrine of emblements does not apply when a lease of certain duration expires, and thus the lessee is not entitled to crops planted so late in the lease term that they do not and cannot mature before expiration of the lease. *Miller v. Gray*, 149 S.W.2d 582 (Tex. 1941); *Beken v. Elstner*, 503 S.W.2d 408 (Tex. Civ. App.—Houston [14th Dist.] 1973, no writ). In *Beken*, however, the court drew an exception to this rule by stating that a lessee is entitled to the crop if the evidence shows that the lessor knew the crop could not mature during the term of the lease and still consented to or acquiesced in the planting and cultivating of the crop. 503 S.W.2d at 410.

1.5:4 Federally Related Farm and Ranch Mortgages

Federal Loan Programs. Various agencies of the United States Department of Agriculture make, guarantee, or service a significant volume of farm and ranch loans. It is estimated that in Texas, for example, the Farm Credit System accounts for approximately thirty percent of all farm and ranch lending in Texas. A farm or ranch loan that is made, guaranteed or serviced under these federal programs cannot simply be foreclosed upon default by the borrower. Instead, the applicable federal law provides the borrower with significantly greater rights than under Texas foreclosure law and the borrower's rights under federal law must be exhausted before the defaulted loan can be referred to the state office of the General Counsel of the United States Department of Agriculture for foreclosure.

The loans originated and/or serviced under the Farm Credit System, the largest of the farm and ranch lenders in Texas, are governed by the regulations at 7 C.F.R. §§ 1951.901-.911 (2004). Because numerous other agencies under the United States Department of Agriculture make, guarantee or service loans under a variety of federal programs, however, it can be a very difficult process to determine the exact provisions of the federal statutes and regulations applicable to the loan in question.

Borrower's Rights. Certain statutes and/or regulations are generally applicable to these federal loan programs. The "borrower's rights" provisions set forth at 12 U.S.C.A. § 2202 *et seq.* (West 2001) are applicable to agricultural loans serviced under the various federal programs. The debt settlement policies and

procedures found at 7 C.F.R. §§ 792.1-.22 (2004) generally apply to all collection efforts involving agricultural loans. Finally, 7 C.F.R. § 1951.911 (2004) generally grants the borrower the right to lease or purchase a ten-acre homestead out of the collateral even in the event of foreclosure of the loan.

The "borrower's rights" granted by 12 U.S.C.A. § 2202 pertain to all "distressed" loans made through a federal lender. Unless the lender reasonably believes that the loan collateral will be destroyed, dissipated, consumed, concealed or permanently removed from the state, the lender cannot proceed with collection or foreclosure without following the procedures set forth to protect the borrower rights. 12 U.S.C.A. § 2202a(j) (West 2001).

A distressed loan is defined as a loan in which the borrower does not have the financial capacity to pay the loan because the loan is past due or there is a high probability of loss to the lender because of inadequate collateralization. See 12 U.S.C.A. § 2202a(a)(3) (West 2001). In situations involving distressed loans made under the Farm Credit System, the regulations at 7 C.F.R. §§ 1951.901-.911 require that prior to any foreclosure action the borrower must be given written notice of eligibility for a restructuring of the loan before the lender can initiate any collection action, accelerate the maturity of the debt, accept a deed in lieu of foreclosure, or foreclose. 7 C.F.R. § 1951.907(c) (2004). The notice advising the borrower of the right to restructure the loan must contain a copy of the lender's distressed loan policy and all the materials necessary for the borrower to submit an application for restructuring the loan. 7 C.F.R. § 1951.907 (2004).

If the borrower files an application to restructure the loan, the lender must use the "Debt And Loan Restructuring System" computer program to determine if a feasible restructure plan is available. 7 C.F.R. § 1951.909(a)(1) (2004). The lender may not accelerate the maturity of the loan until this loan restructure analysis has been completed. If the calculations show that the value of the collateral is equal to or greater than the net recovery value to be derived from foreclosure, as determined in accordance with 7 C.F.R. §§ 1951.909(e), (f) (2004), the lender must make an offer to the borrower to restructure the loan in accordance with 7 C.F.R. § 1951.909(h) (2004). The borrower can appeal

the terms of the proposed restructure offer through mandatory mediation and/or the appellate process set out in 7 C.F.R. §1951.904 (2004), while preserving the right to accept the restructure offer any time within forty-five (45) days after the conclusion of all appeals. Furthermore, if no feasible restructure plan can be worked out, the borrower has the right to buy out the debt at the current market value of the property. Finally, 7 C.F.R. §1951.911 (2004) generally provides that a borrower may retain the 10 acres used as the borrower's principal residence on a lease or purchase basis, notwithstanding the failure to cure the default or restructure the loan.

If no cure, restructuring or buy-out of the defaulted loan occurs and the appeals process is completed, the lender may then refer the loan to the state office of General Counsel of the United States Department of Agriculture for foreclosure. Thereafter, the foreclosure will be conducted in accordance with the terms of the deed of trust, Texas common law, and Chapter 51 of the Texas Property Code.

Limitations. These federal statutes and regulations impose much greater delays in proceeding with foreclosure than under Texas law, but the federal government is not bound by Texas' limitations statutes as to enforcement of the deed of trust. The general federal statutes of limitations are 28 U.S.C.A. §§ 2415 and 2416 (West 1994), which provide that any action for money damages founded upon a contract is not barred unless the complaint is filed (i) more than six years after the cause of action, or (ii) more than one year after final decisions have been rendered in the administrative proceedings. However, certain courts of appeals have held that this six-year limitation applies only to action for money damages and not to the government's right to bring a foreclosure action, indicating that there are no limitations on bringing the federal foreclosure action. *Cracco v. Cox*, 414 N.Y.S.2d (404th Dept. 1979) and *Farmers Home Administration v. Muirhead*, 42nd F 3rd 964 (5th Cir.), *cert. denied* 516 U.S. 806 (1995). The Cracco and Muirhead proceedings were challenged in *U.S. v. Peoples Household Furnishing, Inc.*, 75 F 3d 252 (6th Cir. 1996), but most federal courts seem to follow the U.S. Supreme Court decision in *U.S. v. Summerlin*, 310 U.S. 414 (1940), which held that the United States can enforce a foreclosure claim in its

capacity as a sovereign without regard to statutes of limitation.

Additional Resources: See G. Tommy Bastian *Foreclosure Of Farm And Ranch Real Property*, 25th Annual Advanced Real Estate Law Course (2003) and the websites for the Farm Credit Administration at www.sea.gov and the Farm Servicing Agency at www.fsa.usda.gov.

1.6 Identifying Obligors' Status

Many aspects of the mortgagor's circumstances may affect foreclosure proceedings. For example, the mortgagor's status as a consumer or as a member of the armed services will require the special attention of the attorney.

1.6:1 Consumer

Consumer Protection in Debt Collection. Texas and the federal government have adopted debt-collection laws governing the collection of consumer debt by debt collectors. Both the mortgagee and the mortgagee's attorney must be aware of these laws. Debt collectors, including attorneys, may be subject to fines, civil remedies, or both for employing or attempting to use threats, coercion, harassment, abuse, oppression, unfair or unconscionable means, or fraudulent, deceptive, or misleading representations.

FHA, VA, and Servicer's Loss Mitigation Programs.

FHA.

HUD has adopted policies requiring loss mitigation on all FHA loans. See HUD 2000 Mortgagee Letter ML 00-05 "*Loss Mitigation Program*," dated January 19, 2000 and 24 C.F.R. § 203.501. HUD has proposed regulations to impose treble damages on any servicer of a FHA loan who fails to offer loss mitigation to a borrower in default on a FHA loan. 69 F.R. 19906-01, 2004 WL 783027 (F.R.) Apr. 14, 2004. See HUD website at www.hud.gov under the "Foreclosure" menu and the "Related Information" subsection for an article entitled *Relief Options for FHA Homeowners* that described what homeowners can do to obtain a "loss mitigation" or workout from the mortgagee. Also see the HUD website for another article entitled *Help for Homeowners Facing the Loss of Their Home*.

VA.

VA's loss mitigation requirements are found in the *VA Servicing Guide*, § 3.01-3.06 and Appendix D of the Servicing Guide. The VA program is referred to as the Servicer Loss Mitigation Program ("SLMP").

Home Ownership Counseling.

Home ownership counseling is required on all VA and FHA loans secured by a single-family residence. 12 U.S.C.A. §1701x(c)(5).

Fannie Mae.

See Fannie Mae *Single Family Servicing Guide*, VIII § 501-508 for Fannie Mae's loss mitigation policies.

Freddie Mac.

See Freddie Mac's *Single Family Servicing Guide*, Vol. II, Ch. 65, A 65 and B65 for Freddie Mac's loss mitigation rules.

1.6:2 Bankruptcy

The Bankruptcy Code provides an automatic stay on all actions or proceedings, including nonjudicial foreclosure sales, against the debtor or his mortgaged property. 11 U.S.C.A. § 362(a)(4) (West 2004); see *In re Wheeler*, 5 Bankr. 600 (Bankr. N.D. Ga. 1980) (bankruptcy court invalidated foreclosure sale occurring at 10:05 a.m., chapter 13 petition was filed at 10:34 a.m., and foreclosure sale purchaser's check was not delivered until 11:45 a.m.). *But see In re Butchman*, 4 Bankr. 379 (Bankr. S.D.N.Y. 1980) (foreclosure sale held to be valid because it took place two hours before chapter 13 petition was filed). The court in *Graham v. Pazos De La Torre*, 821 S.W.2d 162 (Tex. App.--Corpus Christi 1991, no writ) set aside a foreclosure sale because at time of sale mortgagor was in bankruptcy though bankruptcy was unknown to mortgage trustee and mortgagee at time of sale. The court also rescinded the resale by foreclosure sale purchaser to a third party and ordered the resale price returned. However, a bankruptcy court has held that a Trustee in bankruptcy may not avoid a foreclosure sale in violation of the automatic stay if the mortgaged property is conveyed at the foreclosure sale purchaser to a good faith purchaser who is unaware of the mortgagor's bankruptcy, relying

on 11 U.S.C.A. section 549(c). The bankruptcy court held that notice of the commencement of the bankruptcy proceedings must be filed in the county's real property records to put foreclosure sale purchasers on notice of the automatic stay *In re Jones*, 172 B.R. 535 (E. D. Tex. 1994).

The stay of action includes a stay of demanding payments, accelerating the debt, posting for or proceeding with foreclosure, filing suit against the debtor, repossessing or otherwise obtaining or perfecting liens against the property of the debtor, exercising any right of offset, and most other collection efforts.

A foreclosure sale conducted in violation of a temporary stay order is not automatically validated by a subsequent termination of the stay. In *Goswami v. Metropolitan Savings & Loan Association*, 751 S.W.2d 487 (Tex. 1988), the Texas Supreme Court held that the bankruptcy court may annul a stay to validate actions taken during the stay or take some action to recognize the invalidity of the stay order. See also *Huddleston v. Texas Commerce Bank—Dallas*, 756 S.W.2d 343 (Tex. App.—Dallas 1988, writ denied) (court held that bankruptcy court's dismissal of bankrupt's petition did not reinstate postpetition foreclosure sale held in violation of bankruptcy stay). The bankruptcy court's order did not specifically annul the automatic stay. In *Huddleston* the first foreclosure sale was held after the mortgagor had transferred the mortgaged property to a corporation that filed a chapter 11 petition on the morning of the foreclosure sale. The mortgagee was unaware of the filing at the time of the foreclosure sale. The bankruptcy was later dismissed as a bad-faith filing, permitting the mortgagee to reforeclose its lien.

A foreclosure sale knowingly made in violation of the automatic stay can expose the mortgagee to liability for actual and punitive damages. 11 U.S.C.A. § 362(h) (West 2004).

1.6:3 Death of Mortgagor

Death Prior to Foreclosure Sale: If the mortgagor dies and a will is not probated with an independent executor appointed before the foreclosure, the lender runs a significant risk that its deed of trust lien foreclosure sale will be voided. As noted below, a dependent administration may be opened up to four years after the mortgagor's death and a foreclosure

sale during such period set aside. A lender contemplating foreclosing in a case in which the mortgagor is deceased and no administration is pending should postpone the foreclosure sale until after the lender attempts to compel production and probate of the decedent's will. The survivors may attempt to thwart a foreclosure action by filing for a dependent administration, conveniently overlooking or discarding a will providing for independent administration, and the lender may be forced to file a discovery action in the probate court. See Tex. Prob. Code Ann. § 75 (Vernon 2003). However, a different rule applies to the vendor lender, which holds a vendor's lien and superior title. *Walton v. First National Bank of Trenton*, 956 S.W.2d 647 (Tex. App.—Texarkana 1997, writ denied).

Probate Code Election.

Section 306 of the Tex. Prob. Code Ann. (Vernon 2003) provides that personal representatives of estates shall pay secured claims in different ways, depending on how a creditor elects to treat his claim. Under § 306, there are two kinds of secured claims that are classified and prioritized differently under §§ 320 and 322. A secured creditor may elect to have his claim treated as either: (1) a matured secured claim; or (2) a preferred debt and lien. § 306(a) Tex. Prob. Code Ann. (Vernon 2003). If a secured creditor makes no claim or does not affirmatively elect otherwise within six months after the original grant of letters testamentary, his claim will be treated as a preferred debt and lien. Tex. Prob. Code Ann. (Vernon 2003) §§ 298(a), 306(b); *Cessna Fin. Corp. v. Morrison*, 667 S.W.2d 580, 583-84 (Tex. App.—Houston [1st Dist.] 1984, no writ). So, within six months a personal representative will be able to fit a secured claim into one of the two categories set forth in § 306. If the claim is a matured secured claim, the representative will treat it as third class and pay it, to the extent of the value of the collateral, after first- and second-class claims, but before other lower-class claims. Tex. Prob. Code Ann. (Vernon 2003) §§ 306, 320, 322. If there is not enough money in the estate to pay the first- and second-class claims, however, the representative will invade the collateral for the matured secured claim to pay the higher-priority claims. Tex. Prob. Code Ann. (Vernon 2003) § 322; see *Wyatt v. Morse*, 102 S.W.2d 396, 398-99 (Tex. 1937). If the entire claim is not satisfied through the collateral, the representative can

pay the deficiency a lower-class claim out of other assets of the estate. Tex. Prob. Code Ann. (Vernon 2003) § 322; see *Wyatt*, 102 S.W.2d at 398-99. If a claim is a preferred debt and lien, the representative may either pay the debt off or continue making payments as per the terms of the contract that secured the debt. Tex. Prob. Code Ann. (Vernon 2003) § 306(a)(2) and (c). Regardless of which method the representative chooses, the creditor will have priority over all other debts, even first- and second-class claims, to the extent of the value of its collateral. Tex. Prob. Code Ann. (Vernon 2003) § 306(a)(2) and (c); see *Wyatt*, 102 S.W.2d 398-99; *Dallas Joint-Stock Land Bank in Dallas v. Maxey*, 112 S.W.2d 277, 280 (Tex. App. App.—Dallas 1937, no writ). *But see San Antonio Sav. Ass'n v. Beaudry*, 769 S.W.2d 277, 280 (Tex. App.—Dallas 1989, writ denied) holding expenses directly related to preserving, maintaining, and selling collateral may be paid out of the sales proceeds of the property. However, if the entire claim is not satisfied through the collateral, the representative cannot pay any deficiency out of other assets of the estate as he could if the claim were a matured secured one. Tex. Prob. Code Ann. (Vernon 2003) § 306(c); see *Wyatt*, 102 S.W.2d at 398-99. In *Texas Commerce Bank National Ass'n v. Geary*, 938 S.W.2d 205 (Tex. App.—Dallas 1997) *judgm't rev'd on other grounds*, 967 S.W.2d 836 (Tex. 1998) the mortgagee elected preferred debt and lien status due to failure to elect otherwise within six months after original grant of letters testamentary.

Death Subsequent to Foreclosure Sale: The death of the mortgagor after a foreclosure sale will not affect the validity of the sale. At the time of death, the mortgagor no longer has an interest in the mortgaged property. See *Smith v. San Antonio Joint Stock Land Bank*, 130 S.W.2d 1070 (Tex. Civ. App.—Eastland 1939, writ ref'd); *Estrada v. Reed*, 98 S.W.2d 1042 (Tex. Civ. App.—Amarillo 1936, writ ref'd).

Death Before Foreclosure Sale with Dependent Administration: A nonjudicial foreclosure sale conducted while an administration of the deceased mortgagor's estate is pending is void and passes no title, because the opening of the administration suspends the power of sale under the deed of trust. *Pearce v. Stokes*, 291 S.W.2d 309 (Tex. 1956); *Robertson v. Paul*, 16 Tex. 472 (1856);

Hury v. Preas, 673 S.W.2d 949 (Tex. App.—Tyler 1984, writ ref'd n.r.e.); *Bozeman v. Follott*, 556 S.W.2d 608 (Tex. Civ. App.—Corpus Christi 1977, writ ref'd n.r.e.). However, a different rule applies to the vendor lender, which holds a vendor's lien and superior title. *Walton v. First National Bank of Trenton*, 956 S.W.2d 647, 652 (Tex. App.—Texarkana 1997, writ denied). The vendor may elect to rescind the sale and is entitled to possession of the property through a district court trespass to try title action. James R. Norvell, *The Vendor's Lien and Reservation of the Paramount Legal Title—The Rights of Vendors, Vendees, and Subvendees*, 44 TEX. L. REV. 22-24 (1965)

If the mortgagor dies intestate, the administration of the decedent's estate is opened when the probate judge signs an order that grants administration and appoints an administrator and the administrator files the required bond and makes and files the oath. *Bozeman*, 556 S.W.2d 608.

Probate Court Procedure To Obtain Sale: A sale during the pendency of a dependent administration may take place only after compliance with the procedures set forth in the Texas Probate Code:

1. Filing the secured creditor's claim with the probate court. See Tex. Prob. Code Ann. §§ 298, 301 (Vernon 2003). If the mortgagee does not wish to pursue the assets in the estate and only wishes to pursue the security for the note, the mortgagee will want to elect preferred debt and lien status. The mortgagee should make that election in the claim. See Tex. Prob. Code Ann. §§ 298, 306 (Vernon 2003). Note that silence of the administrator for thirty days after presentation of the claim to enforce the lien against the mortgaged property is considered a rejection of the claim, and suit must be commenced within ninety days after rejection. See Tex. Prob. Code Ann. §§ 310, 313 (Vernon 2003).

2. Filing an application to sell the mortgaged property. See Tex. Prob. Code Ann. § 338 (Vernon 2003).

Opening Dependent Administration Within Four Years of Death: Under *Pearce v. Stokes*, 291 S.W.2d 309 (Tex. 1956), a dependent administration opened within four years of the

mortgagor's death renders voidable a trustee's nonjudicial sale. Other cases related to the foreclosure of property after the death of the mortgagor: *Shell Oil Co. v. Howth*, 159 S.W.2d 483 (Tex. 1942); see also *Rivera v. Morales*, 733 S.W.2d 677 (Tex. App.—San Antonio 1987, writ ref'd n.r.e.) (cancellation of contract for deed set aside).

Independent Administration: A trustee under a deed of trust can exercise the power of sale after the death of the mortgagor if the mortgagor's estate is being administered by an independent executor. See *Fischer v. Britten*, 83 S.W.2d 305 (Tex. 1935); *Pearce*, 291 S.W.2d 309; *Freece v. Truskett*, 106 S.W.2d 675 (Tex. Comm'n App. 1937, opinion adopted); *Bozeman*, 556 S.W.2d 608.

Conversion to Dependent Administration: Removing the administration from the control of the independent executor and subjecting the estate to regular administration does not negate the prior existence of a valid power of sale conferred under a deed of trust and does not invalidate the acts of the independent executor or change any applicable rules while the executor had independent control of the estate. *Taylor v. Williams*, 108 S.W. 815 (Tex. 1908); *Bozeman*, 556 S.W.2d 608.

Authority Lost: Removing the personal representative of the estate of a decedent, either as executor or administrator thereof, deprives the personal representative of the authority to do anything further with respect to the administration of the estate. See *Bozeman*, 556 S.W.2d 608; *Felton v. Birchfield*, 110 S.W.2d 1022 (Tex. Civ. App.—Fort Worth 1937, writ dism'd w.o.j.).

1.6:4 Armed Services Personnel

The Servicemember's Civil Relief Act ("SCRA") formerly known as the Soldiers' and Sailors' Civil Relief Act of 1940, 50 U.S.C.A. sections 501-596, protects military personnel from foreclosure actions arising out loan defaults attributable to military service. SCRA does not extinguish a borrower's debt, it merely suspends the creditor's collection rights while the servicemember is on active duty and for 3 months after discharge from active duty. SCRA applies to Reservists in all military services, National Guardsmen and Public Health service members whose debt was created while a

civilian and before being called to active duty. If an obligation secured by a deed of trust on real property owned by a service member originated before the period of military service and the service member is still on active duty or has been discharged within ninety days before the date of the proposed foreclosure sale, the foreclosure sale is not valid unless conducted pursuant to (i) a court order granted before the foreclosure, or (ii) an agreement under 50 U.S.C.A. § 517 with the service member. 50 U.S.C.A. § 533(c) (West Supp. 2004). In a suit to enforce the deed of trust filed during or within 90 days after the service member's period of military service, a federal court may upon its own motion and shall upon application by the service member when the service member's ability to comply with the obligation is "materially affected by military service," (i) stay the foreclosure proceedings "for such period of time as justice and equity require," or (ii) "adjust the obligation to preserve the interests of all parties" by restructuring the debt. 50 U.S.C.A. § 533(b) (West Supp. 2004). Thus, the court is not to bar enforcement of the mortgage merely because the mortgagor is in the service; rather the purpose of the hearing is to determine whether active service has materially affected the mortgagor's ability to perform the loan, and a mortgagee who can demonstrate otherwise ought to be allowed to proceed with foreclosure. SCRA freezes the statute of limitation for all actions brought by or against a service member while on active duty. 50 U.S.C.A. § 526 (West Supp. 2004).

A person who knowingly conducts or attempts to conduct a foreclosure in violation of 50 U.S.C.A. section 533(c) may be fined and/or imprisoned for up to one year. 50 U.S.C.A. § 533(d)(1) (West Supp. 2004). These penalties are in addition to any other remedies available to the service member, including damages for wrongful conversion and consequential and punitive damages. 50 U.S.C.A. § 533(d)(2) (West Supp. 2004).

Verification of whether the borrower is in fact performing military service can be obtained by faxing (but not by writing or e-mailing) the Department of Defense, Manpower Data Center ("DMDC"), Military Verification, 1600 Wilson Blvd., Suite 400, Arlington Virginia 22209 Attn: Military Verification at Fax: 703-696-4156 Phone: 703-696-5790. The inquiry should provide the name, address and social security

number of the borrower. It is also possible to obtain verification through the DMDC's website, once preclearance is obtained. Mortgagee's may request a password by writing the DMDC on the mortgagee's letterhead. After completing the paperwork to obtain a password, details on how to use the DMDC's website are provided via email.

FHA, VA and Fannie Mae have detailed procedures in their servicing guidelines on servicing loans owed by servicemembers covered by SCRA.

See JA 260 on the Judge Advocate General's School website under "Publications" menu at the "Legal Assistance" sub-menu and under the "2000" section:

www.jagcnet.army.mil/TJAGLCS. Also see "Operation Enduring LAMP" on www.abanet.org; and discussions at www.military.com, www.defenselink.mil, and www.jagcnet.army.mil.

1.7 Identifying the Mortgagee's Role

Just as the mortgagor's circumstances affect the foreclosure proceedings, the mortgagee's status may affect how the parties proceed. In *Jernigan v. Bank One, Texas, N. A.*, 803 S.W.2d 774, 777 (Tex. App.—Houston [14th Dist.] 1991, no writ), the court recognized that, under certain circumstances, a promissory note can be transferred without a written assignment or proper endorsement. In such cases possession must be accounted for by proving the transaction through which the note was acquired. If all that the foreclosing mortgagee has is an assignment of the lien, but does not hold the note, a non-judicial sale may be wrongful. *Shepard v. Boone*, 99 S.W.3d 263 (Tex. App.—Eastland 2003, no writ). The capacity in which the note is held is particularly important.

1.7:1 Multiple Noteholders

If more than one noteholder exists, all the noteholders must approve the actions to accelerate and to exercise the power of sale, unless the deed of trust provides to the contrary. *Bomar v. West*, 28 S.W. 519 (Tex. 1894) (holders of separate notes each secured *pari passu*); *Rogers v. Boykin*, 298 S.W.2d 199 (Tex. Civ. App. —Eastland 1956, writ ref'd n.r.e.) (required consent of all holders of single note).

1.7:2 Collateral Assignment and/or Endorsement of Note

Collateral Assignee as Holder. Section 3.301 of the Texas UCC provides that the holder of an instrument, whether or not he is the owner of the instrument, may enforce payment in his own name. Tex. Bus. & Comm. Code Ann. § 3.301 (Vernon 2002). Under section 3.203, a transfer of a security interest in an instrument vests in the secured party “any right of the transferor to enforce the instrument including any right as a holder in due course.” The meaning of this provision is expounded in section 3.302(e):

If (i) the person entitled to enforce an instrument has only a security interest in the instrument, and (ii) the person obliged to pay the instrument has a defense, claim in recoupment, or claim to the instrument that may be asserted against the person who granted the security interest, the person entitled to enforce the instrument may assert rights as a holder in due course only to an amount payable under the instrument that, at the time of enforcement of the instrument, does not exceed the amount of the unpaid obligation secured.

Id. § 3.302 comment 4. An instrument is defined as a negotiable instrument. *Id.* § 3.104(b) (Vernon 2002). To be a negotiable instrument, the note must contain a promise “to pay a sum certain,” a requirement that limits the negotiability of notes with variable interest rates. *Id.* §§ 3.104, .106.

Texas courts have interpreted these provisions to mean that a secured party may enforce the collaterally endorsed note in its own name and may be a holder in due course to the extent of the debt secured by the pledged promissory note. If the secured note has been collaterally assigned, endorsed, and delivered to a collateral assignee, then the collateral assignee must direct the acceleration and posting for foreclosure of the mortgaged property securing the collateral note. *Lawson v. Gibbs*, 591 S.W.2d 292 (Tex. Civ. App.—Houston [14th Dist.] 1979, writ ref’d n.r.e.); *Merit Homes, Inc. v. Alltex Mortgage Co.*, 402 S.W.2d 943 (Tex. Civ. App.—Texarkana 1966, writ ref’d n.r.e.) (no endorsement to collateral assignee).

In *Lawson* a borrower named Craig pledged a note executed by Wortham Investments to Main

Bank of Houston to secure a note executed by Craig to Main Bank of Houston. In transferring the Wortham Investments note to the bank, Craig endorsed the note payable to the order of the bank. When the Wortham Investments note subsequently went into default, the bank appointed a substitute trustee and directed the trustee to proceed with foreclosure of the mortgaged property securing the Wortham Investments note. Suit was brought to set aside the foreclosure on the grounds that Craig, not the bank, was the legal owner and holder of the note and, therefore, was the only proper party to appoint a substitute trustee and conduct foreclosure proceedings under the Wortham Investments note.

The court in *Lawson* held that under Texas law the bank became the holder of the Wortham Investments note by reason of Craig’s endorsement and delivery. 591 S.W.2d at 294 (citing former Tex. UCC §§ 3.202(a), .302(a)). The court further stated that, according to (former) section 3.302, a holder of the note may enforce the note in his own name, whether or not he is the owner. The court rejected the argument that even if Craig’s endorsement made the bank a holder of the note, Craig remained the owner of the note and thus was the proper party to direct the sale.

When Craig, as payee of the note, unconditionally indorsed and delivered the note to the bank, the bank acquired the ownership interest of the payee. We hold that the indorsement and delivery of the note to the bank gave it the status of “legal owner and holder.” As that is the definition given of beneficiary [under the deed of trust], and the beneficiary is entitled to appoint a substitute trustee, the appointment by Main Bank of Terrance Baggott as substitute trustee of the deed of trust was valid. Therefore, the trustee’s sale of the property under the terms of the deed of trust, at the direction of the Bank, was valid.

Id. The court distinguished its rulings from those in the earlier cases of *Merit Homes, Inc. v. Alltex Mortgage Co.*, 402 S.W.2d 943 (Tex. Civ. App.—Texarkana 1966 writ ref’d n.r.e.), and *Busbice v. Hunt*, 430 S.W.2d 291 (Tex. Civ. App.—Tyler 1968, writ ref’d n.r.e.), on the grounds that in neither of those cases did the

debtor endorse the notes payable to the secured party as part of the collateral transfer.

In those cases had the assignors indorsed and delivered the collaterally assigned notes to the assignees, the collateral assignee would have been the proper party to appoint the substitute trustee under the terms of the deeds of trust, in the capacity of holder. Absent the indorsement the only rights of the collateral assignee in the collateral are those defined in Article 9 of the UCC . . . Thus, had Main Bank been only a collateral assignee of the note, its remedy upon default would be judicial foreclosure of the assigned note under Tex. Bus. & Comm. Code Ann. § 9.501 (Vernon 1968)[now §9.601]. Only by taking that step could it have acquired the rights of owner and holder.

Lawson, 591 S.W.2d at 295.

Collateral Assignee Not as Holder: Section 9.313(a) provides that a security interest in a promissory note may be perfected by possession of the note. Endorsement of the collaterally pledged note is not required to perfect the secured party's security interest in the pledged note. Tex. Bus. & Comm. Code Ann. § 9.313 (Tex. UCC) (Vernon).

Holding possession makes the secured party a "transferee" for security, not a "holder." *Estrada v. River Oaks Bank & Trust Co.*, 550 S.W.2d 719, 727 (Tex. Civ. App.— Houston [14th Dist.] 1977, writ ref'd n.r.e.). Section 3.203(c) of the Texas UCC grants the secured party as transferee the specifically enforceable right to have the unqualified endorsement of the transferor. Negotiation takes effect only when the endorsement is made, and until that time there is no presumption that the transferee is the owner.

The collateral assignment (security agreement) gives the transferee the right to bring suit on the collaterally assigned note as assignee. As a mere assignee, the secured party is subject to all defenses and equities to which the notes are subject in the hands of the debtor. Tex. Bus. & Comm. Code Ann. §§ 3.305, .306 (Tex. UCC) (Vernon 2002); *Estrada*, 550 S.W.2d at 728. The assignee is entitled to collect on the collaterally assigned note even though the collaterally assigned note has been lost. After crediting the

proceeds derived from collection on the lost collaterally assigned note, the assignee/creditor is entitled to collect from its borrower the deficiency owing on its loan to the borrower. *Bray v. Cadle Co.*, 880 S.W.2d 813 (Tex. App.— Houston [14th Dist.] 1994, writ denied)—the *Bray* court in upholding the collateral assignee's right to collect against its borrower unnecessarily refers to the assignee as a "holder" or "owner" (holder of a lost note?).

Such secured creditors are entitled to have relief from the automatic stay of a bankruptcy of the pledging party, even though at the time of the bankruptcy the secured party does not hold the pledged note by endorsement. See *In re Major Funding Corp.*, 82 Bankr. 443, 449 (Bankr. S.D. Tex. 1987).

In *Carroll v. Kennon*, 734 S.W.2d 34 (Tex. App.—Waco 1987, no writ), the court held that a secured party in possession of a collaterally assigned but not endorsed note was not entitled to enforce payment of the collaterally assigned note without foreclosing on that note. In *Carroll*, after the Hendrickses (the makers of the collaterally assigned note) defaulted, Carroll (the collateral assignee of the defaulted note) foreclosed on the mortgaged property pledged by the Hendrickses to secure the collateral note. Carroll's attorney posted notice of the foreclosure sale, notified the Hendrickses, and mailed notices of the foreclosure sale of the mortgaged property to the Kennons (the collateral assignors of the collateral note). The Kennons sued Carroll for damages. The court held that Carroll was not a holder entitled to enforce payment of the collaterally assigned note in his own name under section 3.301 of the UCC, because the note had not been endorsed, to Carroll. The court held that Carroll's actions amounted to an election to retain the note in satisfaction of the Kennons' indebtedness pursuant to former section 9.505(b) of the UCC (now Texas UCC § 9.620) and that Carroll had not given the Kennons the notice required by that section. (Now Tex. Bus. & Comm. Code Ann. §9.621 (Tex. UCC) (Vernon 2002). The court remanded the case to determine whether the notice of trustee's sale sent to the Kennons put them on notice of Carroll's election to retain the note.

The court in *Carroll* noted that a secured party who disposes of collateral without complying with the notice provisions of the Uniform

Commercial Code is liable for the debtor's actual losses or for the statutory penalty provided in (former) section 9.507(a) [now Texas UCC § 9.625]. The court stated the following method for determining damages:

The Kennons' actual loss, assuming they are entitled to recover any damages under Section 9.507(a), would not be limited just to the difference between the unpaid balances of the two notes. Their actual loss would also include the equity they lost in the 31.25 acres when they were denied the right to redeem the collateral under Section 9.506.

734 S.W.2d at 41.

Serious questions remain unanswered concerning the position of a secured party holding the pledged note by endorsement. Some of these questions are listed below. The creditor should consider whether it is willing to be in the position of holder of the collaterally endorsed note. As holder of the note, the creditor will be the party to institute foreclosure proceedings and demands on the maker of the collaterally endorsed note.

The security agreement (collateral transfer of note and liens) can provide for a consent of the secured party to the debtors foreclosing on the underlying real property collateral and a continuation of the secured party's lien in the proceeds to be derived from any foreclosure on the real property securing the pledge note. Additionally, the security agreement can provide for the debtor to execute a deed of trust on the real property as substitute collateral in lieu of the note if the debtor is the successful bidder at the foreclosure sale. A transfer-for-collection form, designed for use with a previously executed security agreement, can permit the debtor to reacquire the status of the holder of the collateral note for purposes of collection and foreclosure proceedings on the real property security for the collateral note. In such cases the collateral note will need to be endorsed without recourse, but the creditor should retain possession to maintain its security interest.

Unanswered Questions: The Texas UCC and the Texas cases leave the following important questions unanswered:

1. Are proceeds received by the secured party at the foreclosure sale of the mortgaged property to be applied as prepayments on the borrower's note or merely held as cash collateral?

2. Does the secured party's taking title to the mortgaged property at the foreclosure sale constitute an offer under section 9.620 of the Texas UCC to accept the mortgaged property in full satisfaction of the borrower's debt?

3. Is the borrower or the secured party entitled to any equity in the foreclosed mortgaged property?

4. Does a bid at the foreclosure of the collaterally assigned deed of trust affect the debt owed by the borrower to the secured party?

2. Collecting the Debt

2.1 Notices

Before a secured creditor forecloses on mortgaged property, the options available to minimize the loss on the defaulted note should be carefully considered. The creditor will be required to send a variety of notices, depending on the type of note and debtors involved, before proceeding with the collection process. Most loan situations will dictate that, for a demand note, a notice of default be sent or that, for a term loan and installment loan, a notice of intent to accelerate and a subsequent notice of acceleration be sent to the debtors before they are sent the statutorily required notice of foreclosure sale. In the case of consumer debt, the initial communication with the debtor must contain the Miranda-style warning and the statutorily dictated notices provided by the federal Fair Debt Collection Practices Act. In the case of a loan secured by the debtor's residence, the debtor must be provided with written notification by certified mail that the debtor is in default and is given at least twenty days to cure the default before notice of sale can be given. Tex. Prop. Code Ann. § 51.002(d) (Vernon Supp. 2004).

2.2 Notice of Default

Demand for payment and notice of acceleration must not be simultaneous. *Williamson v. Dunlap*, 693 S.W.2d 373 (Tex. 1985). Even in the

absence of a specific provision in the loan documents requiring the mortgagee to make demand on the maker to cure a default, the mortgagee must make demand before acceleration so that the maker or the mortgagor (in the case of defaults on deed of trust covenants) has the opportunity to cure the default. *Id.*; *Alien Sales & Servicer v. Ryan*, 525 S.W.2d 863, 866 (Tex. 1975); *Joy Corp. v. Nob Hill North Properties*, 543 S.W.2d 691, 694 (Tex. Civ. App.—Tyler 1976, no writ); *Crow v. Heath*, 516 S.W.2d 225, 228 (Tex. Civ. App.—Corpus Christi 1974, writ ref'd n.r.e.). The notice must clearly inform the mortgagor of the event that is considered by the mortgagee to be a default. Notice specifying one default (e.g., default in the payment of an note installment) is not sufficient to cover other defaults or other defaults occurring after the notified default. Also, if the mortgagee intends to accelerate the maturity of the debt, the notice must unequivocally inform the mortgagor of the mortgagee's intention. *Ogden v. Gibraltar Savings Association*, 640 S.W.2d 232, 234 (Tex. 1982)—statement that "failure to cure such breach on or before [September 16, 1978] may result acceleration of the sums secured by the Deed of Trust and sale of the property standing as security there under", was not "clear and unequivocal notice that Gibraltar would exercise the option, but merely restated the existence of the option originally given in the deed of trust". The mortgage must "bring home to the [mortgagor] that failure to cure will result in acceleration of the note and foreclosure under the power of sale." *Ogden*, 640 S.W.2d 232, 233 (Tex. 1982). In *Purnell v. Follett*, 555 S.W.2d 761 (Tex. Civ. App.—Houston [14th Dist.] 1977, no writ) the court found that notice informing the mortgagor that default in "any of [his] monthly payments" would result in acceleration and the sale of the mortgaged property, was not sufficient notice to the mortgagor that its subsequent failure to pay its taxes would result in acceleration of the note. *Accord Motor & Indus. Fin. Corp. v. Hughes*, 302 S.W.2d 386, 394 (Tex. 1957).

Any grace or cure periods provided the debtor in the loan documents must be honored as a condition to accelerating the loan or exercising the remedies of the deed of trust. *Joy Corp.*, 543 S.W.2d 691. In certain loan transactions, the mortgagee may have granted others, such as junior lienholders or tenants, notice and cure rights.

If the mortgaged property is the debtor's homestead or the debtor's residence, additional consideration should be given to cure rights, consumer debt-collection laws, and limitations on secured debt. Section 51.002(d) of the Texas Property Code requires that the debtor be given twenty days to cure the default before notice of foreclosure sale is given:

Notwithstanding any agreement to the contrary, the mortgage servicer of the debt shall serve a debtor in default under a deed of trust or other contract lien on real property used as the debtor's residence with written notice by certified mail stating that the debtor is in default under the deed of trust or other contract lien and giving the debtor at least 20 days to cure the default before notice of sale is given under Subsection (b).

Tex. Prop. Code Ann. § 51.002(d) (Vernon Supp. 2004). The debtor is entitled to the notice even though the loan originated prior to the passage of the statute. *Rey v. Acosta*, 860 S.W.2d 654 (Tex. App.—El Paso 1993, no writ). Section 51.002(d) of the Texas Property Code is a procedural requirement for accelerating a debt and therefore can be applied retroactively. The notice requirement raises numerous questions that unfortunately will have to be answered through litigation or legislative amendment. The following is a discussion of some of the questions that have already been raised by commentators.

What is "real property used as the debtor's residence"?

Section 51.002(d) does not specify when the mortgaged property is to be classified as the debtor's residence. It could be as of the execution of the deed of trust, as of the default, as of the foreclosure sale, or anytime in between. Nor does the statute define what type of properties can constitute the debtor's residence. Second homes and rent properties, such as houses, apartment projects, small self-operated motels, high-rise hotels, office buildings with or without a penthouse, or time-shares, could all possibly be defined as residences. Other questions are raised by this phrase as well. Suppose the owner of a rent house is the sixth owner after the loan was closed. If the term *debtor* includes all persons who have personal liability on the note, is the notice requirement triggered if any one of the

five previous owners used the property as his residence at any time during the term of the loan?

Who is the debtor in section 51.002(d)?

Usually the maker and the owner of the mortgaged property are the same person, and usually the maker remains the owner at the time of foreclosure. Does section 51.002(d) require notice by the lender to the maker on the note but not to the owner of the mortgaged property if they are not the same person? Does section 51.002(d) require notice to a “subject to” purchaser? What if the lender is aware of the purchase? Is there a situation when the lender could be held to have constructive knowledge of the purchase, requiring notice? See *National Commerce Bank v. Stiehl*, 866 S.W.2d 706 (Tex. App.—Houston [1st Dist.] 1993, no writ) involving multiple notes with different makers.

When does the twenty-day curative period begin? Does the twenty-day curative period begin when the certified-mail notice is deposited in the mail or when it is received by the debtor? Counting the 20 days has been clarified by an amendment in 1993 to section 51.002(d) which provides

The entire calendar day on which the notice required by this subsection is given, regardless of the time of day at which the notice is given, is included in computing the 20-day notice period required by this subsection, and the entire calendar day on which notice of sale is given is under Subsection (b) is excluded in computing the 20-day period.

Tex. Prop. Code Ann. § 51.002(d) (Vernon Supp. 2004). In a situation where there are multiple debtors because the mortgaged property has changed hands and the loan has been assumed several times, there may be more than one twenty-day cure period. See *Newman v. Woodhaven National Bank*, 762 S.W.2d 374 (Tex. App.—Fort Worth 1988, no writ) (involving a twenty-day notice sent to debtor after loan ballooned).

How is the address of the debtor determined? Is the address of the debtor for purposes of section 51.002(d) “the debtor’s last known address as shown by the records of the holder of the debt” as is the case for the notice

of foreclosure sale provided in section 51.002(e)?

2.2:1 Consumer Debt-Collection Laws

The debt will be classified as consumer debt and the notice requirements and restrictions of the Texas Debt Collection Act and the federal Fair Debt Collection Practices Act will apply if the property securing the loan is the debtor’s residence.

The Texas Debt Collection Act (Tex. Fin. Code Ann. §§ 392.001 - .404 (Vernon 1998 & Supp. 2004) defines several of the key terms as follows:

(1) “Consumer” means an individual who has a consumer debt.

(2) “Consumer debt” means an obligation, or an alleged obligation, primarily for personal, family, or household purposes and arising from a transaction or alleged transaction.

(3) “Debt collection” means any action, conduct, or practice in collecting, or in soliciting for collection, consumer debts that are due or alleged to be due a creditor.

(4) “Debt collector” means a person who directly or indirectly engages in debt collection and includes a person who sells or offers to sell forms represented to be a collection system, device, or scheme, intended or calculated to be used to collect consumer debts.

Tex. Fin. Code Ann. § 392.001(1), (2), (5), (6) (Vernon Supp. 2004).

Prohibited Practices: Some of the practices that the Texas Debt Collection Act prohibits are the following:

1. Representing or threatening to represent to any person other than the consumer that a consumer is willfully refusing to pay a non-disputed consumer debt when the debt is in dispute and the consumer has notified in writing the debt collector of the dispute. Tex. Fin. Code Ann. § 392.301(a)(3) (Vernon 1998).

2. Threatening to file a charge, complaint, or criminal action against a debtor when the debtor has not violated a criminal law. Tex. Fin. Code Ann. § 392.301(a)(6) (Vernon 1998); see *Brown v. Oaklawn Bank*, 718 S.W.2d 678 (Tex. 1986) (court found creditor-bank in violation of former provision for threatening debtor with criminal prosecution).

3. Threatening that nonpayment of a consumer debt will result in the seizure, repossession, or sale of any of the person's property without proper court proceedings, except that this prohibition does not affect a statutory or contractual right of seizure, repossession, or sale that does not require court proceedings. Tex. Fin. Code Ann. § 392.301(a)(7), (b)(3) (Vernon 1998).

4. Using profane or obscene language or language that is intended to unreasonably abuse the hearer or reader. Tex. Fin. Code Ann. § 392.302(1) (Vernon 1998)

5. Causing a telephone to ring repeatedly or continuously, or making repeated and continuous telephone calls, with the intent to harass a person at the called number. Tex. Fin. Code Ann. § 392.302(4) (Vernon 1998). Failing to disclose clearly in any communication with the debtor that the debt collector is attempting to collect a consumer debt unless the communication is for the purpose of discovering the location of the debtor. Tex. Fin. Code Ann. § 392.304(5) (Vernon 1998)

7. Using a written communication that fails to indicate clearly the name of the debt collector and the debt collector's street address or post office box and telephone number if the written notice refers to a delinquent consumer debt. Tex. Fin. Code Ann. § 392.304(6) (Vernon 1998)

8. Misrepresenting the character, extent, or amount of a consumer debt against, or misrepresenting the consumer debt's status in a judicial or governmental

proceeding. Tex. Fin. Code Ann. § 392.304(8) (Vernon 1998)

9. Representing that a consumer debt may be increased by the addition of attorney's fees, investigation fees, service fees, or other charges if a written contract or statute does not authorize the additional fees or charges. Tex. Fin. Code Ann. § 392.304(12) (Vernon 1998)

10. Representing that a consumer debt will definitely be increased by the addition of attorney's fees, investigation fees, service fees, or other charges if the award of the fees or charges is subject to judicial discretion. Tex. Fin. Code Ann. § 392.304(13) (Vernon 1998)

11. Collecting or attempting to collect interest or a charge, fee, or expense incidental to the obligation the interest or incidental charge, fee, or expense is expressly authorized by the agreement creating the obligation or is legally chargeable to the consumer. Tex. Fin. Code Ann. § 392.303(a)(2) (Vernon 1998)

Federal Fair Debt Collection Practices Act: Debt-collection practices are also regulated by the federal Fair Debt Collection Practices Act. 15 U.S.C.A. §§ 1692–1692o (West 1998).

Attorneys as Debt Collectors: Before 1986, attorneys were exempt from the FDCPA, but the exemption was voided by statutory amendment. Pub. L. No. 99-361, 100 Stat. 768 (effective July 9, 1986). An attorney is a debt collector if the attorney uses any instrumentality of interstate commerce or the mails in any business the principal purpose of which is the collection of debts, or who regularly collects or attempts to collect, directly or indirectly, debts owed or due or asserted to be owed or due another when the debt was incurred primarily for personal, family or household purposes. See 15 U.S.C.A. § 1692a(5), (6) (West 1998).

In determining whether an attorney "regularly" collects debts, the courts may consider the nature and volume of the attorney's case load. *Crossley v. Lieberman*, 868 F.2d. 566 (3rd Cir 1989) One federal district court has held that an attorney whose collection cases averaged less than two per year over a ten year period and

constituted less than one percent of his practice did not “regularly” collect debts. *Mertes v. Devitt*, 734 F. Supp 872 (W. D. Wis. 1990). However, another federal district court has held that since “regular” is not synonymous with “substantial,” a law firm can “regularly” collect debts even though such services were less than four percent of the firm’s total business. *Stojanovski v. Strobl & Manoogian, P.C.*, 783 F. Supp. 319 (E.D. Mich. 1992). In the only Fair Debt Collection Act case to reach the Supreme Court, the court ruled that the Act applies to lawyers who engage solely in consumer debt-collection litigation. *Heintz v. Jenkins*, 514 U.S. 291, 115 S. Ct. 1489 (1995).

An individual who is directly or indirectly involved in the collection of the debt will be personally liable under the Act, even if the collection effort is being performed by the corporation that employees the individual. *Newman v. Checkrite California, Inc.*, 912 F. Supp. 1354 (E.D. Cal. 1995). This personal liability extends to persons who supervise or train the collection employees or review the debt accounts. *Id.* The same court held that the creditor was not vicariously liable for violations of its third party debt collector, but that the debt collector was vicariously liable for the actions of its attorney. *Id.*

Prohibited Practices: The FDCPA covers some areas not included under the Texas statute. Although not a comprehensive listing, the following are significant matters to be avoided by the attorney:

1. In acquiring information from third parties concerning the location of the debtor, the attorney must not state that the consumer owes a debt. See 15 U.S.C.A. § 1692b(2) (West 1998).
2. The Act places some general limitations on communications with consumer debtors, including a prohibition against communicating with a debtor represented by an attorney with respect to the debt. See 15 U.S.C.A. § 1692c(a)(2) (West 1998).
3. If a debtor requests that the collecting attorney cease communicating with the debtor or if the debtor refuses to pay the debt, the attorney must cease communicating, except to notify the debtor that certain remedies may or will

be pursued. See 15 U.S.C.A. § 1692c(c) (West 1998).

4. Generally, the attorney may not—

- a. with some exceptions, communicate about collection of the debt with any person except the consumer, the consumer’s attorney, a consumer credit reporting agency, and the creditor, see 15 U.S.C.A. § 1692c(b) (West 1998);
- b. make any false representation, see 15 U.S.C.A. § 1692e (West 1998);
- c. solicit or handle postdated checks in a manner harmful to the consumer, see 15 U.S.C.A. § 1692f(2)–(4) (West 1998);
- d. take or threaten to take any action to dispossess the consumer of property, unless the creditor employing the attorney has a clear right and intention of doing so, see 15 U.S.C.A. § 1692f(6) (West 1998); or
- e. use a postcard to communicate with a consumer regarding the debt, see 15 U.S.C.A. § 1692f(7) (West 1998).

Notices to Consumer: The FDCPA requires that the debt collector provide the following written notice to the debtor within five days of the debt collector’s initial communication to the debtor:

1. The written notice must clearly disclose that the attorney is attempting to collect a debt and that any information obtained may be used for that purpose (a Miranda-style warning). 15 U.S.C.A. § 1692e(11) (West 1998).
2. The written notice must include the following information and statements:
 - a. the amount of the debt;

b. the name of the creditor to whom the debt is owed;

c. a statement that unless the consumer, within thirty days after receipt of the notice, disputes the validity of the debt or any portion thereof, the debt will be assumed to be valid by the debt collector;

d. a statement that if the consumer notifies the debt collector in writing within the thirty-day period that the debt or any portion thereof is disputed, the debt collector will obtain verification of the debt or a copy of a judgment against the consumer, and a copy of such verification or judgment will be mailed to the consumer by the debt collector; and

e. if requested within the thirty-day period, the debt collector will provide the consumer with the name and address of the original creditor, if different from the current creditor.

15 U.S.C.A. § 1692g(a)(1)-(5) (West 1998).

If within the thirty-day period allowed in the notice the debtor disputes any part of the debt or requests the name and address of the original creditor, the attorney must cease collection of the debt until proper supporting documents have been mailed to the debtor. See 15 U.S.C.A. § 1692g(b) (West 1998).

2.2:2 Recommended Procedure

For loans not secured by the debtor's residence, a reasonable time under the circumstances should be afforded the debtor to cure a default before acceleration of the secured debt. A good practice is to give the debtor at least ten days after receipt of the demand letter to cure the default. Two courts have held cure periods of ten days or less to be reasonable. *Hammond v. All Wheel Drive Co.*, 707 S.W.2d 734 (Tex. App.—Beaumont 1986, no writ) (relying on the presentation requirements of Section 3.504 of the Texas UCC, requiring payment by the close of the next business day following presentment,

the court); *Investors Realty Trust v. Carlton Corp.*, 541 S.W.2d 289, 290–91 (Tex. Civ. App.—Dallas 1976, no writ) (found ten-day period was sufficient under circumstances). Under certain circumstances, a court may hold that a ten-day cure period is unreasonable. An important objective is to minimize the lender's exposure for unreasonable conduct or for conduct deemed unreasonable by a court or jury after the fact. Since the purpose of the demand letter is to inform the debtor of the actions the debtor needs to take in order to cure the default, the demand letter should state the amount of attorneys' fees incurred in the collection effort or inform the debtor of the means of obtaining such information. The letter should advise the debtor that acceptance by the mortgagee of the delinquent installment payment is only partial performance on the mortgagor's part and does not excuse payment of the attorneys' fees or avoid acceleration of the note's maturity due to payment default. See generally, *Harbert v. Owen*, 791 S.W.2d 627 (Tex. App.—Beaumont 1990, no writ).

The attorney should not assume that the note accurately reflects the terms of the debt or the method of performing the cure. A clear mutual understanding must exist in the minds of the mortgagee and the attorney as to what it would take to cure the default and, therefore, what the default is.

Some banks have their computers programmed not to run interest on past-due installments or to continue to run interest both on delinquent installments and on the matured principal balance after acceleration at the predefault rates. Many lenders, including banks, and certainly private individuals providing seller financing have never charged interest at the default rate. Some banks charge the default rate only selectively and in retrospect. The attorney, immediately before mailing any notice to the debtor, must check with the lender to verify that the lender has not accepted late payment or agreed to a delay in accelerating the debt. Posting notice of foreclosure when the lender and the debtor have agreed to some form of repayment could expose the lender to liability. Accurately determining what is due is imperative to avoid discharging a debtor who tenders performance. See Tex. Bus. & Comm. Code Ann. § 3.603 (Vernon 2002). In loans involving personal property, a secured party is obligated to account to a debtor with a statement of

amounts owed within two weeks of a written request of the debtor. *Id.* Tex. Bus. & Comm. Code § 9.210(b) (Vernon 2002). The lender should be cautioned not to send notices of payoff due or computer-generated dunning letters to the debtor once the matter is placed with the attorney.

If possible, the form and content of all correspondence to the debtor from the attorney should be screened by the client.

All correspondence should be sent (and must be sent in the case of a loan secured by the debtor's residence) by certified mail. To substantiate mailing, the notice letters should be sent with return receipt requested. Additionally, the white slip should be stamped by the post office to prove mailing. These procedures are necessary to counter the argument that the debtor never received notice. See *Hensley v. Lubbock National Bank*, 561 S.W.2d 885, 891 (Tex. Civ. App.—Amarillo 1978, no writ) (held that sworn denial of receipt of notice is some evidence of non-notification of sale).

The attorney should also send a duplicate demand letter by regular mail at the same time the certified letter is sent. Usually when the certified letter is returned marked "refused," the letter sent by regular mail is not returned. A certificate of mailing (PS Form 3817) stamped at the post office serves as proof of mailing the letter by regular mail. If the attorney does not have all notice mail stamped at the post office, at the least, special procedures should be adopted in the law firm's mail room to substantiate mailing. A good practice is to have the mail-room clerk log the actual deposit of the mail (time, date, and place) and to have the clerk sign a mailing affidavit at the time of mailing. Six weeks after the event, the clerk will not remember the specific mailed item and may not even still work at the firm. Both the certified mail and regular mail envelopes should be marked "Forwarding and Address Correction Requested."

The records of the lender should be carefully reviewed for all addresses of the maker, guarantor, and mortgagor. Any addresses obtained from the lender need to be crosschecked against telephone books and zip code directories. The attorney should personally check the envelopes against the correct address. Too many times the perceived

deadlines and haste to post notices have resulted in needless errors.

At least two objectives should be paramount in the notice process: (1) getting notice to the debtor in a reasonable time to cure the default and (2) minimizing the debtor's trial defenses based on perceived unreasonable conduct of the lender. The lender should be prepared to restart the notice process if any of the multitude of possible mailing and mail-receipt problems develop (e.g., wrong address, changed address, divorce, and separate addresses). Acceleration and foreclosure are harsh remedies strictly construed against the lender. Delaying the process by a month is much less costly than defending the propriety of the sale and the entitlement to a deficiency because of mailing problems.

Receipts of certified mail should be monitored to determine if address problems exist before actually foreclosing. The client should be informed of the attorney's receipt of green return-receipt cards. Copies of the green cards may simply be mailed to the lender as they are received.

2.3 Notice of Intent To Accelerate

Makers

The loan documents may provide that certain types of default automatically trigger acceleration, and other defaults permit the mortgagee the option to accelerate maturity.

Unless the right to notice of intent to accelerate is waived by the debtor, the mortgagee must give clear and unequivocal notice of its intent to accelerate. *Shumway v. Horizon Credit Corp.*, 801 S.W.2d 890, 893 (Tex. 1991) (held waiver of notice waived notice of acceleration but not notice of intent to accelerate); *Ogden v. Gibraltar Savings Association*, 640 S.W.2d 232, 233 (Tex. 1982) held the following notice to be defective:

[F]ailure to cure such breach on or before [September 16, 1978] may result in acceleration of the sums secured by the deed of trust and sale of the property standing as security there under.

Additional cases on notice of intent to accelerate: *Motor & Industrial Finance Corp. v.*

Hughes, 302 S.W.2d 386, 394 (Tex. 1957); *Tampion v. Bryeans*, 640 S.W.2d 421 (Tex. App.—Waco 1982, no writ) (failure to give notice of intent to accelerate can result in foreclosure sale's being set aside); *Purnell v. Follett*, 555 S.W. 2d 761, 765 (Tex. Civ. App.—Houston [14th Dist.] 1977, no writ) (letter to debtor advising that default "in any of [mortgagor's] monthly payments" would result in acceleration, was held not broad enough to cover subsequent default in tax payments); *Crow v. Heath*, 516 S.W.2d 225 (Tex. Civ. App.—Corpus Christi 1974, writ ref'd n.r.e.) (required notice of intention to accelerate to state explicitly that failure to cure default would result in foreclosure and would entail possibility of deficiency judgment). A fact issue sufficient to go to the jury was raised by the debtor's testimony that he did not receive a letter notice of intention to accelerate in *Dillard v. Broyles*, 633 S.W.2d 636 (Tex. App.—Corpus Christi 1982, writ ref'd n.r.e.).

The debtor may contractually waive demand and notice if the note or deed of trust provides for such a waiver. However, "where there is a reasonable doubt as to the meaning of the terms employed, preference should be given to that construction which will avoid forfeiture and prevent acceleration of maturity." *Purnell v. Follett*, 555 S.W.2d 761, 764 (Tex. Civ. App.—Houston [14th Dist.] 1977, no writ) (citing *Ramo, Inc. v. English*, 500 S.W.2d 461, 466 (Tex. 1973)). Cases reviewing waiver clauses: *Donaldson v. Mansel*, 615 S.W.2d 799 (Tex. Civ. App.—Houston [1st Dist.] 1980, writ ref'd n.r.e.) (debtors "waive presentment, protest and demand, notice of protest, demand and of dishonor and of nonpayment this note"); *Whalen v. Etheridge*, 428 S.W.2d 824, 827 n.l (Tex. Civ. App.—San Antonio 1968, writ ref'd n.r.e.) (found effective provision allowing mortgagee to declare note "immediately due and payable without notice"); *Phillips v. Whiteside*, 426 S.W.2d 350, 351 (Tex. Civ. App.—Houston [14th Dist.] 1968, no writ) (note may be declared "immediately due and payable" upheld); see also *Cruce v. Eureka Life Insurance Co.*, 696 S.W.2d 656 (Tex. App.—Dallas 1985, writ ref'd n.r.e.). But see *Bodiford v. Parker*, 651 S.W.2d 338, 339 (Tex. App.—Fort Worth 1983, no writ) (holding that provision that "the entire indebtedness hereby secured . . . may, at the option of the Beneficiary, . . . be immediately matured and become due and payable without demand or notice of any character" was not

waiver of notice of intent to accelerate but was only waiver of notice that debt had been accelerated); *Purnell v. Follett*, 555 S.W.2d 761, 765 (Tex. Civ. App.—Houston [14th Dist.] 1977, no writ) (holding that provision that mortgagee "shall have the option to declare all of the indebtedness immediately due and payable without demand upon, or notice to, the Grantors, to foreclose the lien of this Deed of Trust ..." did not waive notice of intent to accelerate but did waive demand for payment and presentment).

Assuming that the loan documents do not contain further provisions requiring posting of the property for foreclosure sale as a condition to a finding that a debt has in fact been accelerated after giving of notice of intent to accelerate due to debtor's default, there is no statutory or common law requirement that the property be posted for foreclosure sale subsequent to giving of the notice of intent in order to find that the debt has been accelerated. *Holy Cross Church of God in Christ v. Wolf*, 44 S.W.3d 562 (Tex. 2001) disapproving of *Swoboda v. Wilshire Credit Corp.*, 975 S.W.2d 779 (Tex. App.—Corpus Christi 1998, writ denied), *Shepler v. Kubena*, 563 S.W.2d 382, 385 (Tex. Civ. App.—Austin 1978, no writ), and *National Debenture Corp. v. Smith*, 132 S.W.2d 429 (Tex. Civ. App.—Galveston 1939, writ dism'd judgm't cor.).

Compliance with the express provisions of the loan documents and the Texas Property Code are all that is required. As was stated by the court in *Lambert v. First National Bank of Bowie*, 993 S.W.2d 833 (Tex. App.—Ft. Worth 1999, writ denied):

By statute, the bank was required to (1) notify Lambert by certified mail that the deed of trust was in default and give him at least 20 days to cure and (2) give Lambert at least 21 days' notice of the sale by certified mail... Lambert concedes that all of the statutory requirements were met, but argues that his prior relationship with the bank entitles him to some sort of additional notice of the bank's intent to accelerate. We do not agree. The bank assiduously followed the statutory requirements to foreclose on Lambert's property. Nothing further is required.

Guarantors

Absent contractual language to the contrary, there appears to be no requirement that notice of intent to accelerate be given to a guarantor of the debt. *Long v. NCNB-Texas National Bank*, 882 S.W.2d 861 (Tex. App.—Corpus Christi 1994); *Miller v. University Savings Association*, 855 S.W.2d 3 (Tex. App.—Houston [14th Dist.] 1993, no writ).

The State Bar's form for promissory note provides:

If Maker defaults in the payment of this note or in the performance of any obligation in any instrument securing or collateral to it, and the default continues after Payee gives Maker notice of the default and the time within which it must be cured, as may be required by law or by written agreement, then Payee may declare the unpaid principal balance and earned interest on this note immediately due. Maker and each surety, endorser, and guarantor waive all demands for payment, presentations for payment, notices of intention to accelerate maturity, notices of acceleration of maturity, protests, and notices of protest to the extent permitted by law.

State Bar of Texas, *Texas Real Estate Forms Manual* Form 14-1, pp. 14-11 and 14-12 (1999). (emphasis added).

Prudence dictates, however, that notice additionally be sent to each guarantor. No case that unequivocally holds that notice must be sent to guarantors has been found. *Cf. Goff v. Southmost Savings & Loan Association*, 758 S.W.2d 822, 824–25 (Tex. App.—Corpus Christi 1988, writ denied) (waiver in guaranty upheld); *Micrea, Inc. v. Eureka Life Insurance Co. of America*, 534 S.W.2d 348 (Tex. Civ. App.—Fort Worth 1976, writ ref'd n.r.e.) (notice to guarantor of acceleration waived and not properly pleaded). A guarantor is a debtor within the meaning of sections 9.102(a)(28) and (60) and 9.611 of the Texas UCC. *See Carroll v. General Electric Credit Corp.*, 734 S.W.2d 153 (Tex. App. Houston [1st Dist.] 1987, no writ) (failure to notify guarantor of nonjudicial foreclosure sale of personal property bars assertion of deficiency claim on behalf of creditor); *Peck v. Mack Trucks, Inc.*, 704 S.W.2d 583 (Tex. App.—Austin

1986, no writ); *Hernandez v. Bexar County National Bank*, 710 S.W.2d 684 (Tex. App.—Corpus Christi), writ ref'd per curiam, 716 S.W.2d 938 (Tex. 1986).

However, the Fifth Circuit after noting a split among Texas court of appeals has upheld a guarantor's contractual waiver of notice of disposition of collateral by a secured party. In *Stenberg v. Cinema N' Draftthouse Systems, Inc.*, 28 F.3d 23 (5th Cir. 1994) the Fifth Circuit held that §9.501's restriction on waivers is inapplicable to guarantors. The court noted that the Texas Supreme Court had reserved judgment on this issue.

Curing Defective Notices

A defective notice may be cured by a subsequent corrected notice. *Slusky v. Coley*, 668 S.W.2d 930 (Tex. App.—Houston [14th Dist.] 1984, no writ).

Acceptance of Late Payments after Acceleration and Waiver by Mortgagee

The waiver-of-notice provision of the loan documents may be nullified by the mortgagee. If the mortgagee agrees that installments becoming due during the pendency of a sale may be paid at closing, injunctive relief against foreclosure may be granted. *Musso v. Lodwick*, 217 S.W.2d 165 (Tex. Civ. App.—Dallas 1949, no writ).

Acceptance of late payments has been held to preclude the mortgagee from accelerating maturity because of a subsequent late payment without giving a second notice of default and opportunity to cure. *Dhanani Investments v. Second Master Bilt Homes*, 650 S.W.2d 220 (Tex. App.—Fort Worth 1983, no writ) (accepted seven late payments and attempted to accelerate without notice of intent to accelerate); *see also Highpoint of Montgomery Corp. v. Vail*, 638 S.W.2d 624 (Tex. App.—Houston [1st Dist.] 1982, writ ref'd n.r.e.) (still required notice of intent to accelerate even though note contained clause providing that "time is of the essence" and that waiver of one opportunity to accelerate "shall not constitute a waiver on the part of the holder of the right to accelerate the same at any other time."); *Ince v. Herskowitz*, 630 S.W.2d 762 (Tex. App.—Houston [1st Dist.] 1982, writ ref'd n.r.e.); *McGowan v. Pasol*, 605 S.W.2d 728 (Tex. Civ. App.—Corpus Christi 1980, no writ); *In re Rutherford*, 573 S.W.2d 299 (Tex. Civ.

App.—Amarillo 1978, no writ). Once the note's maturity has been accelerated, the mortgagee may be put to an election, if the maker tenders past due installments—either accept the past due installments and cancel the acceleration or refuse the tendered installments, return them to the maker and proceed with the foreclosure. *Stergiouis v. Babcock*, 568 S.W.2d 707, 708 (Tex. Civ. App.—Fort Worth 1978, writ ref'd n.r.e.).

A mortgagee is prevented from accelerating maturity of a note if the mortgagor's default was the result of accident, mistake, or the inequitable conduct of the mortgagee. In *Hiller v. Prosper Tex, Inc.*, 437 S.W.2d 412 (Tex. Civ. App.—Houston [1st Dist.] 1969, no writ), the mortgagee failed to provide information to the mortgagor regarding the amount of the substantial, excess proceeds in the escrow account, which the mortgagor had requested be used to pay the accruing monthly installments.

Cases have upheld waivers of notice of intent to accelerate even after acceptance of late payments if the note contains an express waiver in such circumstances. *Emfinger v. Pumpco, Inc.*, 690 S.W.2d 88, 89 (Tex. App.—Beaumont 1985, no writ) (clause provided,

Failure to exercise this option upon any default shall not constitute a waiver of the right to exercise it in the event of any subsequent default.

disapproved on other grounds, Shumway v. Horizon Credit Corp., 801 S.W.2d 890, 893 (Tex. 1991); see also *Zeiler v. University Savings Association*, 580 S.W.2d 658 (Tex. Civ. App.—Houston [14th Dist.] 1979, no writ). *But see McGowan*, 605 S.W.2d at 732 (acceptance of several late payments precluded holder from accelerating maturity because of single late payment, since note did not provide that failure to exercise option to accelerate on default did not constitute waiver of right on subsequent default).

Waiver of the contract terms by the mortgagee does not occur merely because the holder of the note does not immediately declare default. *Slaughter Investment Co. v. Cooper*, 597 S.W.2d 455 (Tex. Civ. App.—Dallas 1980, no writ).

Waiver by mortgagee of some rights is not waiver of strict performance of other rights.

Bluebonnet Sav. Bank v. Grayridge Apartment Homes, Inc., 907 S.W.2d 904 (Tex. App.—Houston [1st Dist] 1995)—bank repeatedly passing on posted foreclosure sales did not waive right to finally foreclose where bank's attorney's notified maker that passing of sale did not constitute a waiver by bank of its right to foreclose.

Notice of Mortgagee's Reestablishment of Strict Compliance

A mortgagee may reestablish the waiver of notice of intent-to-accelerate provisions by giving the debtor notice that no further late payments will be accepted and that the mortgagee will insist on strict compliance with the terms of the note. *Bowie National Bank v. Stevens*, 532 S.W.2d 67 (Tex. 1975); *Slivka v. Swiss Avenue Bank*, 653 S.W.2d 939 (Tex. App.—Dallas 1983, no writ), *disapproved on other grounds, Shumway*, 801 S.W.2d 890, 893; *Highpoint*, 638 S.W.2d 624.

However, even if the mortgagee has notified the mortgagor that strict performance will be required in the future and that the mortgagee will in such cases rely on the contractual waiver of notice of mortgagee's intention to accelerate the maturity of the loan, the mortgagee will be found again to have waived the waiver provisions, if it accepts late payments. *Highpoint of Montgomery Corp. v. Vail*, 638 S.W.2d 624, 627 (Tex. App.—Houston [1st Dist.] 1982, no writ).

2.4 Notice of Acceleration of Debt

After acceleration of secured debt, the debtor must be told that the secured debt has been accelerated. The notice that the secured debt has been accelerated is distinct from and must be given after the notice of intent to accelerate. *Shumway v. Horizon Credit Corp.*, 801 S.W.2d 890, 893 (Tex. 1991); *Joy Corp. v. Nob Hill North Properties*, 543 S.W.2d 691, 695 (Tex. Civ. App.—Tyler 1976, no writ) (held that a letter stating that legal action will be taken is not notice that acceleration has occurred).

Texas law is unclear whether a mere notice of foreclosure sale can serve as notice of acceleration. The Texas Supreme Court reserved judgment on this issue in *Ogden v. Gibraltar Savings Association*. The court stated,

We do not decide whether, after proper notice of intent to accelerate, a notice of trustee's sale is sufficient to give notice that the debt has been accelerated.

640 S.W.2d 232, 234 (Tex. 1982). In *McLemore v. Pacific Southwest Bank, F.S.B.*, 872 S.W.2d 286 (Tex. App.—Texarkana 1994, writ dismissed by agreement) the court found that the notice of foreclosure sale was effective as a notice of acceleration. Also see *Meadowbrook Gardens, Ltd. v. WMFMT Real Estate Ltd. Partnership*, 980 S.W.2d 916 (Tex. App.—Ft. Worth 1998, writ denied), *Phillips v. Allums*, 882 S.W.2d 71 (Tex. App.—Houston [14th Dist.] 1994, writ denied). The court may have been indicating that there is in the court's mind a difference between merely posting a trustee's notice of foreclosure sale as establishing the fact of acceleration and the giving of notice of such acceleration to the mortgagor, and in filing suit for judicial sale.

The **safest practice** is to give a separate notice of acceleration in addition to the notice of foreclosure sale and the notice of intent to accelerate. Notice of acceleration which is not preceded by notice of intent to accelerate is insufficient. In *Star Food Processing, Inc. v. Killian*, 954 S.W.2d 124 (Tex. App.—San Antonio 1997, writ denied) the court found that a maker's mailing of a past due payment at 1:30 p.m. was sufficient to defeat the lender's attorney's faxed letter to maker at 3:01 p.m. that stated the maturity of the note was accelerated. The court in *Star Food* also found that as matter of law that the following provision was not sufficient to waive notice of acceleration:

expressly waive all notices, demands for payment, presentations for payment, notices of intention to accelerate the maturity, protest, and notice of protest, as to this Note.

See *Ackley v. FDIC*, 981 F. Supp. 457 (S. D. Tex. 1997) finding affidavits of mortgagee's employee and attorney who actually mailed notice of acceleration and notice of foreclosure sale as establishing proof of notice being given.

It is not clear if the letter giving notice of intent to accelerate may also notify the debtor that the note automatically accelerates at the end of the curative period if not cured.

The **safest practice** is to send a separate notice of acceleration at the end of the curative period, even if the notice-of-intent letter contains automatic acceleration language.

Since acceleration of the maturity begins the running of the statute of limitations, if the parties desire to undo the acceleration, a written reinstatement agreement should be executed. In some circumstances the mortgagee may be deemed to have reinstated the loan without a written reinstatement agreement, thereby waiving acceleration. Such conduct might involve acceptance of a late or partial payment. However, in the case of *Dillard v. Broyles*, 633 S.W.2d 636 (Tex. App.—Corpus Christi 1982, writ refused n.r.e.), the court found that a substantial delay between the date of the notice of acceleration and the date of notice of sale (twenty-two months) did not invalidate the sale since “[l]aches and stale demand are peculiarly available against the assertion of equitable rights, and may not be invoked to resist the enforcement of a purely legal right.” *Id.* at 645. Acceleration of maturity was held not to have been waived where a mortgagee accepted 2 years' payments on the note pending the mortgagor's bankruptcy. *Thompson v. Chrysler First Business Credit Corp.*, 840 S.W.2d 25 (Tex. App.—Dallas 1992, no writ). A creditor may revoke its acceleration of a debt's maturity, if the debtor has not detrimentally relied on the acceleration. *Swododa v. Wilshire Credit Corp.*, 975 S.W.2d 770 (Tex. App.—Corpus Christi, 1998).

Waiver of Presentment

Most notes which contain a laundry list of items waived contain a waiver of presentment. For example, the Promissory Note in the Texas Real Estate Forms Manual contains a waiver of presentation for payment. *Texas Real Estate Forms Manual* Form 14-1. A bankruptcy court found that a general waiver and a waiver of presentment was effective to waive the requirement that the mortgagee give the maker notice of the actual amount overdue. *In re Davis Chevrolet, Inc.*, 135 B.R. 29 (N. D. Tex. 1992).

2.5 Statute of Limitations

Four Year Statute

Under section 16.035(e) of the Texas Civil Practices and Remedies Code, the four year

statute of limitations does not begin to run on past due installments until the entire debt is due. Section 16.035(e) provides for a special rule applicable as to "lien debt on real property", which is different than the general rule applicable to debts, including installment debts, not secured by a lien on real property. Section 16.035(e) provides:

If a series of notes or obligations or a note or obligation payable in installments is secured by a real property lien, the four-year limitations period does not begin to run until the maturity date of the last note, obligation, or installment.

Tex. Civ. Prac. & Rem. Code Ann. § 16.035(e) (Vernon 2002). Section 16.035(e) applies not only to suits to foreclose a deed of trust lien, but also to suits on the real property secured debt since the lien is an incident of and inseparable from the debt even though the suit is merely on the debt and not for foreclosure of the lien securing the debt. *Palmer v. Palmer*, 831 S.W.2d 479 (Tex. App.—Texarkana 1992, no writ); *McLemore v. Pacific Southwest Bank, FSB*, 872 S.W.2d 286 (Tex. App.—Texarkana 1994, no writ). Once the four year period has run, the power of sale under the deed of trust is barred. Tex. Civ. Prac. & Rem. Code Ann. § 16.035 (Vernon 2002). See also *Mercer v. Daoran Corp.*, 676 S.W.2d 580 (Tex. 1984) and *Yates v. Darby*, 131 S.W.2d 95 (Tex. Civ. App.—Austin 1978, no writ). The limitations period may be extended by execution of a written extension agreement executed by the parties primarily liable for the payment of real property secured debt and its filing for record with the county clerk where the mortgaged real property is located. Tex. Civ. Prac. & Rem. Code §§ 16.036 and 16.037 (Vernon 2002).

Six Year Statute

However, if the creditor is suing only on the real property secured debt and not to foreclose its lien, the six-year statute of limitations of § 3.118 of the Texas UCC is applicable. Tex. Bus. & Comm. Code Ann. §3.118 (Vernon 2002). *Aguero v. Ramirez*, 70 S.W.3d 372 (Tex. App.—Corpus Christi 2002, writ denied).

A different rule applies in personal property secured debts. The four year statute runs on

each installment from its maturity. However, it appears that the bar to the debt may not apply to the power to foreclose a creditor's security interest. Older Texas cases have found that a secured party's right to foreclose its lien on personal property is not barred even though suit on the debt is barred. In *Central National Bank v. Latham & Co.* the court held:

The fact that an action for the recovery of a debt is barred by the statute of limitations does not destroy the debt. The law affects the remedy only. The right of the creditor to receive payment continues after the bar, and will support a new promise of payment or justify the sale of pledged property by the pledge under the power either express or implied, and the application of the proceeds of such sale to the discharge of such debt.

Central National Bank v. Latham & Co., 22 S.W.2d 765 (Tex. Civ. App.—Waco 1929, writ ref'd). See also *Barlow v. Barlow*, 139 S.W.2d 139 (Tex. Civ. App.—Waco 1940, no writ). But see *Hoarel Sign Co. v. Dominion Equity Corp.*, 910 S.W.2d 140 (Tex. App.—Amarillo 1995, writ denied) noting that if debt is barred so is the power to foreclose on personalty (in this case the personalty was readily removable fixtures and the lien was a constitutional mechanic's lien).

As to the rule for installment debts not secured by a lien on real property, see the following cases: *Gabriel v. Alhabbal*, 618 S.W.2d 894, 897 (Tex. Civ. App.—Houston [1st Dist.] 1981, writ ref'd n.r.e.); *Lufkin Nursing Home, Inc. v. Colonial Inv. Corp.*, 491 S.W.2d 459, 463 (Tex. Civ. App.—Amarillo 1973, no writ); and *Goldfield v. Kassoff*, 470 S.W.2d 216, 217 (Tex. Civ. App.—Houston [14th Dist.] 1971, no writ).

Maturity and Acceleration of Maturity

The statute of limitations begins to run upon the acceleration of the maturity of an installment note. *Holy Cross Church of God in Christ v. Wolf*, 44 S.W.3d 562 (Tex. 2001) disapproving *Shepler v. Kubena*, 563 S.W.2d 383, 385 (Tex. Civ. App.—Austin 1978, no writ). The limitations

period begins to run on the day after maturity of the debt, whether by acceleration or by its terms. See Tex. Civ. Prac. & Rem. Code Ann. § 16.035(e) (Vernon 2002); see also *Yates v. Darby*, 131 S.W.2d 95, 100-01 (Tex. 1939); *Mercer v. Daoran Corp.*, 676 S.W.2d 580 (Tex. 1984).

In the case of a demand obligation, limitations begins to run upon demand, or if no date is stated, on the date of issue. Tex. Bus. & Comm. Code Ann. § 3.122(a) (Vernon 2002). Whether a note will be treated as a demand instrument or a time instrument subject to acceleration depends upon the language of all the loan documents and the circumstances. *Reid v. Key Bank of S. Maine, Inc.*, 852 F.2d 9, 14 (1st Cir. 1987).

It is conclusively presumed that the debt has been paid after the expiration of four years after the maturity of the debt. The deed of trust power of sale, lien and the debt are thereafter unenforceable. See Tex. Civ. Prac. & Rem. Code Ann. §16.035(d) (Vernon 2002).

An issue may exist as to whether or as of when an installment note has had its maturity accelerated in circumstances where the creditor has sent a series of notices of intent to accelerate. In *McLemore v. Pacific Southwest Bank, F.S.B.*, 872 S.W.3d 286 (Tex. App.—Texarkana 1994, writ *dism'd by agreement*) the creditor had sent three notices of intention to accelerate over a several year period. The subsequent holder of the note, an assignee of a failed savings and loan, eventually prevailed pursuant to the federal six year statute of limitations applicable to the FSLIC, the FDIC and the RTC noted below. The court held in *dictum* that it was not reasonable to infer that Charter Savings had in fact accelerated the maturity of the note by either of the first two notices of intent to accelerate. The court presumed that the maturity was accelerated by the third notice since foreclosure followed.

Suit Against Guarantor

The four year statute of limitations barring recovery against a guarantor begins running the day the cause of action accrues. The question of when the cause of action accrues on a guaranty is a question of law for the court to decide. *Moreno v. Sterling Drust*, 787 S.W.2d 348, 351 (Tex. 1990). In the case of a guaranty

of payment which provides that the payee may sue the guarantor without first bringing a cause of action to recover on the note against the maker, the statute of limitations runs independently on the obligation of the guaranty. *Willis v. Chowning*, 49 S.W. 395, 396-97 (Tex. 1987); *Beddall v. Reader's Wholesale Distributors, Inc.*, 408 S.W.2d 237, 240 (Tex. Civ. App.—Austin 1966, no writ); *Western Casket Co. v. Estrada*, 116 S.W. 113, 113-14 (Tex. Civ. App.—El Paso 1909, no writ)—applied principles announced in *Willis* to guarantors; and *Ford v. Darwin*, 767 S.W.2d 851, 854 (Tex. App.—Dallas 1989, writ denied).

The provisions of the guaranty must be reviewed to determine when the cause of action accrues. *Vastine v. Bank of Dallas*, 808 S.W.2d 463, 464 (Tex. 1991); and *FDIC v. Attayi*, 745 S.W.2d 939, 944 (Tex. App.—Houston [1st Dist.] 1988, no writ). If the guaranty agreement provides that the guarantor's obligations do not accrue until written demand is made on the guarantor, then the four year statute of limitations does not begin running until written demand for payment is made by the note holder on the guarantor, unless the demand is waived or unreasonably delayed. *Intermedics, Inc. v. Grady*, 683 S.W.2d 842, 845 (Tex. App.—Houston [1st Dist.] 1985, writ *ref'd n.r.e.*); *Gabriel v. Alhabbal*, 618 S.W.3d 894, 896 (Tex. Civ. App.—Houston [1st Dist.] 1981, writ *ref'd n.r.e.*). One court determined that the note holder's waiting three weeks after having made demand on the note maker to make demand on the guarantor was not an unreasonable delay preventing bringing suit against the guarantor after the four year statute of limitations would have run on the claim against the maker but before four year had elapsed after the demand on the guarantor. *Wilman v. Tomaszewicz*, 877 S.W.2d 1 (Tex. App.—Dallas 1944, no writ)—*dictum* as court remanded for determination whether alleged note holder was in fact the note holder.

Suit by Guarantor for Reimbursement by Borrower

The guarantor as a surety has a cause of action against the maker running from the date the surety pays the obligation, even though four years has run since the maturity of the note. *Western Casket v. Estrada*, 116 S.W. 113, 113-14 (Tex. Civ. App.—El Paso 1909, no writ); and *Willis v. Chowning*, 49 S.W. 395, 396-97 (Tex. 1987). Annot. *Bar of Statute of Limitations as*

Against Primary Debtor as Release or Discharge of, or Defense Available to, Guarantor, 58 A.L.R. 2d 1272 (1958).

Two Year Limitation on Deficiency Action

Texas Property Code section 51.003 provides that the creditor must bring suit to recover a deficiency within two years of the foreclosure sale. See Tex. Prop. Code § 51.003 (Vernon 1995).

Federal Six Year Statute

The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), Pub. L. No. 101-73, § 212(d)(14) 103 Stat. 183, 232-33 (1989) established a six year limitations period for the Federal Deposit Insurance Corporation and the Resolution Trust Corporation to bring suit on delinquent promissory notes acquired from failed banks and savings associations. The six years runs from the later of (i) the date the FDIC was appointed conservator or receiver for the failed institution, or (ii) the date on which the cause of action on the promissory note accrues. The six year limitations period is transferred to persons that purchase such promissory notes from the FDIC or its successors in interest. *Jackson v. Thweatt, consolidated with Federal Debt Management, Inc. v. Weatherly*, 883 S.W.2d 171 (Tex. 1994). In the event, however, that holder of a note purchased from the FDIC conveys the note by an instrument that expressly states that the seller does not intend to convey and the buyer does not intend to purchase any of the rights, causes of action or defenses given the holder as a transferee of the FDIC under applicable federal law, it is not an abuse of discretion for a court to enjoin the buyer's attempt to thereafter foreclose the deed of trust securing the note, as an issue exists as to whether the buyer was subject to the state law four year limitations period, rather than the six year federal limitations period. *General Financial Services, Inc. v. Practice Place, Inc.*, 897 S.W.2d 516 (Tex. App.—Ft. Worth 1995, no writ).

Waiver of Statute of Limitations

An agreement in advance to waive or not plead the defense of limitations on a particular obligation is void as against public policy. *Duncan v. Lisenby*, 912 S.W.2d 857 (Tex. App.—Houston [14th Dist.] 1995, no writ).

Limitations are the Legislature's procedural device for establishing a point of repose for past actions and for "ensur[ing] that the search for truth is not impaired by stale evidence or the loss of evidence." *Childs v. Haussecker*, 974 S.W.2d 31, 38-39 (Tex. 1998); accord *Stewart Title Guar. Co. v. Hadnot*, 101 S.W.3d 642, 644 (Tex. App.—Houston [1st Dist.] 2003, writ denied).

3. Background Searches

3.1 Title Insurance

On receiving the request to foreclose, the attorney should immediately determine if the lender has title insurance. Generally the warranty of title in the deed of trust and the subsequent foreclosure sale deed are of little comfort to the foreclosing lender absent mortgagee title insurance.

3.1:1 Status—Commitment, Binder, or Policy

Many times the lender will have extended additional credit to the borrower with little consideration of whether the existing title insurance policy covers the additional loans. Sometimes the policy relates only to a loan long since paid off or the owner's policy does not insure the lien status of the loans in default. Sometimes the policy is no more than an expired commitment for title insurance or an expired mortgagee title policy binder on an interim construction loan, which is of little value after the fact. If review of the lender's files reveals that the liens are not insured, the lender should be advised to consider purchasing a mortgagee title insurance policy before foreclosing.

After foreclosure, a number of standby provisions in the lender's mortgagee title insurance policy come into effect; as a result, the mortgagee policy closely parallels an owner's title insurance policy as of the date the mortgagee policy was originally issued.

3.1:2 Title Search

Before proceeding with the foreclosure sale, it is vital to secure a title report, abstractor's certificate, or other endorsement reflecting the current status of title and listing all encumbrances of record on the mortgaged

property since the date of the existing mortgagee title insurance policy. This report must cover the status of the payment of ad valorem taxes, tax suits or sales, filed mechanic's liens, filed federal tax liens, condominium or subdivision assessments, franchise tax liens, foreclosure posting of prior liens, subsequent junior liens and abstracts of judgment, notices of bankruptcy, receiverships, and divorce proceedings.

Attorneys and lenders should be aware of the limitations of liability that most title companies place on the issuance of foreclosure certificates and should rely on these certificates as backups to their own federal tax lien searches and title searches.

3.2 Federal Tax Liens

The federal tax lien records of the county in which the real property is located should be examined at least twenty-five days before the foreclosure sale. If any personal property secures the loan, the federal tax lien records of the secretary of state's office or other appropriate office also should be examined. A nonjudicial foreclosure sale will extinguish a junior federal tax lien, subject to certain redemptive rights of the IRS, provided the notice provisions of the Internal Revenue Code and the Treasury Regulations have been followed. See 26 U.S.C.A. § 7425 (West 2002).

3.2:1 Internal Revenue Code

The Internal Revenue Code of 1986 provides in part as follows:

(b) Other Sales. Notwithstanding subsection (a) a sale of property on which the United States has or claims a lien, or a title derived from enforcement of a lien, under the provisions of this title, made pursuant to an instrument creating a lien on such property, pursuant to a confession of judgment on the obligation secured by such an instrument, or pursuant to a nonjudicial sale under a statutory lien on such property—

(1) shall, except as otherwise provided, be made subject to and without disturbing such lien or title, if

notice of such lien was filed or such title recorded in the place provided by law for such filing or recording more than 30 days before such sale and the United States is not given notice of such sale in the manner prescribed in subsection (c)(l); or

(c) Special Rules.

(1) Notice of sale. Notice of a sale to which subsection (b) applies shall be given (in accordance with regulations prescribed by the Secretary) in writing, by registered or certified mail or by personal service, not less than 25 days prior to such sale, to the Secretary.

26 U.S.C.A. § 7425(b)(l), (c)(l) (West 2002).

3.2:2 Place for Filing Federal Tax Liens

Real Property: State Law for the state in which the real property is located determines where the tax lien is filed. 26 U.S.C.A. § 6323(f)(l)(A)(i) (West 2002). The Uniform Federal Tax Lien Registration Act (1978) as adopted in Texas provides that notice of a federal tax lien on real property and certificates and notices affecting the liens are to be filed in the county clerk's office of the county in which the real property is located. Tex. Prop. Code Ann. §§ 14.001–.007 (Vernon 2004); see also Tex. Tax Code Ann. §§ 113.201–.206 (Vernon 2004) (formerly Tex. Tax.–Gen. Ann. art. 1.07C), repealed by Uniform Federal Tax Lien Registration Act, ch. 945, § 2, 1989 Tex. Sess. Law Serv. 4010, 4011.

Personal Property: Notices of federal tax liens on personal property and certificates and notices affecting the liens are filed at the office designated by the laws of the state in which the property is situated. 26 U.S.C.A. § 6323(f)(l)(A)(ii) (West 2002). For the purpose of section 6323(f)(l), personal property is deemed to be situated at the residence of the taxpayer at the time the notice of lien is filed. 26 U.S.C.A. § 6323(f)(2)(B) (West 2002). The residence of a corporation or partnership is deemed to be the principal executive office, and the residence of a taxpayer who resides outside

the United States is deemed to be the District of Columbia. 26 U.S.C.A. § 6323(f)(2) (West 2002).

The IRS treats a corporation's principal executive office as the office where the major executive decisions are made and not necessarily as the principal office for filing tax returns. Rev. Rul. 74-571, 1974-2 C.B. 398. A district court in the Ninth Circuit, in *In re J.E. Hall Contractors Inc.*, 1973-1 U.S. Tax Cas. (CCH) H 9375 (D.C. Idaho 1972), has held that although 90 percent of a corporation's employees and production activity were located in Idaho, the principal executive office was in Washington, where the corporate officers lived, maintained their offices, and kept the corporation records. The Fifth Circuit, in *S. D'Antoni Inc. v. Great Atlantic & Pacific Tea Co.*, 496 F.2d 1378 (5th Cir. 1974), held that the principal executive office of a Louisiana corporation was located in the parish in which the only business of the corporation was located and not in the parish of the registered office designated in its incorporation papers. See also *Dimmitt & Owens Financial v. United States*, 787 F.2d 1186 (7th Cir. 1986) (site of corporate executive offices and not site of corporate manufacturing facility controls location for filing of lien notice).

3.2:3 Identity and Interest of Taxpayer

Name of Taxpayer: The names of the taxpayers affected by the tax lien must be disclosed "with reasonable preciseness" on the notice of lien. The misspelling of a taxpayer's name through the transposition of two letters has been held immaterial, *Richter's Loan Co. v. United States*, 235 F.2d 753 (5th Cir. 1956). However, the wrong middle initial for an individual, *Continental Investments v. United States*, 142 F. Supp. 542 (W.D. Tenn. 1953), and the omission of the first initial of a corporation, *United States v. Ruby Luggage Corp.*, 142 F. Supp. 701 (S.D.N.Y. 1954), have been held material. The filing of a lien notice against a name used before marriage is not effective against lienholders who claim against the taxpayer under a married name. *United States v. Clark*, 1981-1 U.S. Tax Cas. (CCH) H 9406 (S.D. Fla. 1981). But if the IRS files the notice against a single person while the person is single, the IRS does not have to refile if the taxpayer marries and takes a new name. *Pioneer National Title Insurance Co. v. United States*, 1981-2 U.S. Tax Cas. (CCH) IT 9482 (N.J. 1981).

Taxpayer's Interest in Property: The Internal Revenue Code creates a lien in favor of the United States on all real or personal property belonging to a person who neglects or refuses to pay any tax for which that individual is liable. 26 U.S.C.A. § 6321 (West 2002). The lien attaches to property belonging to the taxpayer only on the assessment date, which may be either the date of a self-assessment based on the amount a taxpayer reports on his return or a deficiency assessment made by the IRS. See 26 U.S.C.A. § 6322 (West 2002). Even though federal law governs the right of the United States to enforce a tax lien, the nature and extent of the taxpayer's interest in property are determined by state law. *Aquilino v. United States*, 363 U.S. 509 (1960); *United States v. Bess*, 357 U.S. 51 (1958). Even the slightest interest under state law will be sufficient for the lien to attach, however. In *United States v. Creamer Industries*, 349 F.2d 625 (5th Cir. 1965), a taxpayer sold real property to a *bona fide* purchaser by deed recorded before the filing of a tax lien. A corrective deed was filed after the tax lien filing to pick up property described in the contract for sale but inadvertently omitted from the original deed, and the federal tax lien was held to attach to the omitted property.

In *Prewitt v. United States*, 792 F.2d 1353 (5th Cir. 1986), the Fifth Circuit held that the failure to record a divorce decree granting an interest in real property to the wife before the filing of the IRS lien notice against the husband resulted in the attachment of the tax lien to the wife's real property interest, notwithstanding the fact that the divorce was final before the assessment of the tax lien. Holding that the IRS was entitled to the benefits of the Texas recording statutes just as any other good-faith third party, the court stated that "the right of certain of James' creditors to reach property he formerly owned until the disposition is properly recorded is sufficient to support a tax lien on the property." 792 F.2d at 1355-56; see also *Southern Bank v. IRS*, 770 F.2d 1001 (11th Cir. 1985) (taxpayer's equitable right of redemption of real property in "title theory" mortgage state was sufficient for tax lien to attach to fee title of property and not just to right of redemption).

Until the tax lien is actually filed of record, *bona fide* third parties may acquire an interest in the taxpayer's property still free of the tax lien after the assessment date. Section 6323(a) states: "The lien imposed by section 6321 shall not be

valid as against any purchaser, holder of a security interest, mechanic's lien or, or judgment lien creditor until notice thereof which meets the requirements of subsection (f) has been filed by the Secretary." 26 U.S.C.A. § 6323(a) (West 2002); see also *Sgro v. United States*, 609 F.2d 1259 (7th Cir. 1979).

Partnership: State law determines the nature of the legal interest the taxpayer has in property sought to be reached by the federal tax lien under 26 U.S.C.A. section 6321. Under Texas law, a partner's interest in the partnership is his share of the profits and surplus, and a partner's rights in specific partnership property are not subject to attachment or execution, except for partnership claims. The tax lien against an individual partner will therefore not attach to specific partnership property. See Rev. Rul. 73-24, 1973-1 C.B. 602; *Economy Plumbing & Heating Co. v. United States*, 456 F.2d 713 (Ct. Cl. 1972); *United States v. Woodward*, 444 F.2d 752 (10th Cir. 1971); *United States v. Balanovski*, 236 F.2d 298 (2d Cir. 1956); *United States v. Worley*, 213 F.2d 509 (6th Cir. 1954). *Contra Lidberg v. United States*, 375 F. Supp. 631 (D. Minn. 1974); *Adams v. United States*, 328 F. Supp. 228 (D. Neb. 1971).

Tenants in Common: The distinct and separate interest of a tenant in common is subject to a federal tax lien. See e.g. Rev. Rul. 79-55, 1979-1 C.B. 400 (lien attaches to a delinquent taxpayer's interest in a time-sharing condominium unit and related areas but not to the interest of any other owners in the unit or the condominium itself).

Joint Tenants: A tax lien will attach to the interest of a joint tenant in property. *United States v. Kocher*, 468 F.2d 503 (2d Cir. 1972); *United States v. Trilling*, 328 F.2d 699 (7th Cir. 1964). On the death of the joint tenant, the tax lien will follow a transfer of the joint-tenancy interest, but the lien will be extinguished if the interest is extinguished, not transferred, upon death. *United States v. Bess*, 357 U.S. 51 (1958); see *Hedlund v. Brellenthin*, 520 F. Supp. 81 (W.D. Wash. 1981) (lien was extinguished when interest was extinguished by cancellation of real estate contract).

Community Property: If only one spouse is liable for the tax debt, the separate property and one-half community-property interest of that spouse are subject to the tax lien, but the lien

does not attach to the separate property or one-half community-property interest of the other spouse. The property may be sold, however, and the nondelinquent spouse compensated for his interest from the proceeds. *United States v. Rodgers*, 461 U.S. 677 (1983); *Brodav v. United States*, 455 F.2d 1097 (5th Cir. 1972).

Homestead Property: Federal tax liens attach and are effective against homestead interests created under state law. A nondelinquent taxpayer's homestead right under state law does not prevent the levy on and sale of the homestead to pay federal taxes owed by the taxpayer's spouse. *Rodgers*, 461 U.S. 677. The nondelinquent taxpayer is entitled to receive compensation for his separate homestead interest from the sale proceeds. *Id.*

Leasehold Estate: The tax lien attaches to the tenant's leasehold estate, even though the lease may require the lessor's consent for the transfer of an interest in the leasehold estate. See *Carolina Apartment Investors "A" v. United States*, 1977-1 U.S. Tax Cas. (CCH) 9262 (E.D. Cal. 1977).

3.2:4 Effective Period of Filing

Tax liens generally become unenforceable ten years after the date of assessment, but the lien may be extended by agreement between the IRS and the taxpayer. 26 U.S.C.A. § 6502 (West 2002). Also, the running of the ten years is suspended during a taxpayer's bankruptcy proceedings. 26 U.S.C.A. § 6503(h) (West 2002). The Internal Revenue Code further provides that the filed lien may be extended and renewed by the refiling of the lien within the one-year period ending thirty days after expiration of the ten-year period. If the lien notice is not refiled during the one-year period, the effective date of the notice for priority purposes is the date of the refiling and not the date of the original filing. 26 U.S.C.A. § 6323(g) (West 2002).

3.2:5 Notice to the Federal Government

Even though a federal tax lien is filed after the record filing of the deed of trust, the federal tax lien is elevated to a superior lien position over the deed of trust lien if the federal tax lien is filed more than thirty days before the scheduled nonjudicial foreclosure sale and notice of the foreclosure sale is not given to the district

director for the district where the real property is located as agent for the Secretary of the Treasury at least twenty-five days before the foreclosure sale.

Failure to Give Notice

The Federal Courts of Appeal have issued differing opinions as to the exact positions of the parties in such a case. The 9th and 11th Circuits have held that without notice to the Treasury, the sale will be made subject to and without disturbing the federal tax lien. Subsequently, the same Circuit Courts distinguished their own prior opinions, and held in favor of the senior lienholders in *Tompkins v. United States of America*, 946 F.2d 817 (11th Cir. 1991) and *First American Title Insurance v. United States of America*, 848 F.2d 969 (9th Cir. 1988). In essence, the later opinion of each court held that the prior decisions had been based on fact situations where the equitable exceptions to the rule of "merger of liens and title" were either not argued or not recognized by the applicable state law. Both courts agreed that where the applicable state law recognizes an exception to the merger doctrine so that merger of fee and lien will not be presumed when it is adverse to the interests of the holder of the interests, the equitable exception will be recognized and enforced against the IRS, even though the IRS was not properly notified of the foreclosure. Since Texas recognizes an exception to the merger rule when either there is an intervening estate or it is disadvantageous to the owner of the two estates to effect the merger, *Flag-Redfern Oil Co. v. Humble Exploration Co., Inc.*, 744 S.W.2d 6 (Tex. 1987), presumably the *Tompkins* and *First American Title Insurance* opinions would favor the lienholder in a Texas foreclosure. However, even under these two opinions, the federal tax lien is not extinguished; rather the lien survives against the property, in a junior position.

The survival (not the elevation) is the penalty Congress intended to impose on senior lienholders who fail to give the presale notice prescribed by section 7425 This penalty allows the IRS to maintain the status quo of its lien, as well as benefit from future increases in the value of the property.

Tompkins v. U.S., 946 F.2d at 821. Furthermore, neither of these later opinions addressed the issue of whether the first lienholder could again foreclose on the property after having already conducted a valid foreclosure. Because the tax lien attaches to the interest of the taxpayer under state law, one can argue that the right to conduct a second foreclosure would be governed by state law. One older Texas case has permitted a second sale of the property where all prerequisites of the sale have been complied with *Ellis v. Michigan Realty Co.*, 138 S.W.2d 880 (Tex. Civ. App.--Galveston 1940, writ ref'd n.r.e.). The Fifth Circuit, in *dicta* concerning Texas law applicable to the validity of a second foreclosure sale after the first foreclosure sale has been unilaterally rescinded by the lienholder and substitute trustee because "there might have been certain deficiencies" in the notice of sale, has said, "it is not necessarily the case that a trustee under a deed of trust cannot resell after an initial sale is found to have been invalid." *Savers Federal Savings & Loan Association v. Reetz*, 888 F.2d 1497 (5th Cir. 1989), and cases cited therein at footnote 6, p. 1501-02. Since the case law is not well developed, a practical solution would be to draft the deed of trust so as to explicitly grant such powers to the Beneficiary and/or Trustee. If the mortgagee fails to properly notify the government, the mortgagee may not rescind the foreclosure sale and reforeclose the property after proper notice to the IRS; rather, the deed of trust lien is extinguished and the federal tax lien survives. *United States v. Polk*, 822 F.2d 871, 875 (9th Cir. 1987); *Southern Bank v. IRS*, 770 F.2d 1001 (11th Cir. 1985). The special procedures staff of the Austin district of the IRS has permitted postforeclosure discharges of IRS liens in cases in which a twenty-five-day advance notice was not given to the IRS. In such cases the Austin district has permitted the creditor to apply for a certificate of discharge. The creditor will have to establish to the satisfaction of the IRS that there was no equity available to the IRS at the time of the foreclosure sale. Such proof may involve submitting written appraisals by two disinterested persons qualified to appraise the property. There is no assurance that this procedure will continue to be followed by the IRS.

Method of Notice: The notice must be in writing and be sent by registered or certified mail or be delivered by personal service to the district

director for the Internal Revenue district in which the sale is to be conducted. 26 C.F.R. § 301.7425-3(a)(1) (2003).

Contents of Notice: The notice must contain the following:

(i) The name and address of the person submitting the notice of sale;

(ii) A copy of each notice of Federal Tax Lien (Form 668) affecting the property to be sold, or the following information as shown on each such Notice of Federal Tax Lien—

(A) The internal revenue district named thereon,

(B) The name and address of the taxpayer, and

(C) The date and place of filing of the notice;

(iii) With respect to the property to be sold, the following information—

(A) A detailed description, including location, of the property affected by the notice (in the case of real property, the street address, city, and State and the legal description contained in the title or deed to the property and, if available, a copy of the abstract of title),

(B) The date, time, place, and terms of the proposed sale of the property, and

(C) In the case of a sale of perishable property described in paragraph (c) of this section, a statement of the reasons why the property is believed to be perishable; and

(iv) The approximate amount of the principal obligation, including interest, secured by the lien sought to be enforced and a description of the other expenses (such as legal expenses, selling costs, etc.) which

may be charged against the sale proceeds.

26 C.F.R. § 301.7425-3(d) (2003)

Calculation of Deadline: General rules of the Internal Revenue Code are applicable in determining the notice filing deadline. The notice must be post marked at least 25 days before the foreclosure sale. 26 C.F.R. § 301.7502-1. The date of sale is not included in the 25-day calculation. 26 C.F.R. § 301.7425-2. If the last day for filing notice falls on a Saturday, Sunday, or legal holiday, the filing deadline is the next succeeding day that is not a Saturday, Sunday, or legal holiday. 26 C.F.R. § 301.7503-1(a)(2003). Holidays are defined as any legal holiday in the District of Columbia and any statewide holiday observed in the state in which the applicable Internal Revenue district is located. 26 C.F.R. § 301.7503-1(b) (2003).

In Texas, since the twenty-one-day posting period begins on a Tuesday, the twenty-fifth day before foreclosure falls on a Friday (unless that Friday is a holiday).

Timely Mailing May Mean Timely Filing: The filing date is the date of the postmark stamped on the appropriate wrapper enclosing the notice, properly addressed with sufficient postage prepaid. See 26 C.F.R. § 301.7502-1 (2003). Metered mail is not equivalent to having postage stamps canceled by the post office with a cancellation stamp that includes the date. Also, since the IRS throws away the envelope, neither stamped nor metered envelopes alone will prove mailing. The notice should be sent by certified mail and the white slip stamped by the post office to show the date of deposit. Merely dropping a metered envelope in the mailbox and keeping the white slip with a notation of the date of deposit will not suffice.

3.2:6 Postponements of Foreclosure Sale

If notice of a scheduled sale has been timely given, the mortgagee is "required to give notice of the postponement to the district director in the same manner as is required under local law with respect to other secured creditors." 26 C.F.R. § 301.7425-3(a)(2)(i) (2003). The example given in the regulations is one where local law required an oral announcement of postponement at the original place and time of

the scheduled sale. The regulations would recognize this type of notice for such states. The only rule in Texas regarding notice appears to be section 51.002 of the Texas Property Code (which does not require notice to other secured creditors) and section 9.611 of the Texas Business and Commerce Code concerning personal property and notification of the time and place of any public sale or reasonable notification of the time after which any private sale shall be held. See Tex. Prop. Code Ann. § 51.002 (Vernon 1995); Tex. Bus. & Comm. Code Ann. § 9.611 (Tex. UCC) (Vernon 2002).

Prudence dictates that the IRS be renotified before the expiration of the twenty-five-day deadline before the rescheduled sale date.

Notice of sale must be given to the IRS if a federal tax lien is filed after the original thirty-day search cutoff and if the lien is filed more than thirty days before the new foreclosure sale date. 26 C.F.R. § 301.7425-3(a)(2)(ii) (2003). Therefore, an updated federal tax lien search should always be conducted in connection with postponed sales.

3.2:7 Federal Government's Right, of Redemption

Even though proper advance notice of the foreclosure sale is given to the Treasury, the federal government is additionally granted a statutory right of redemption for a period of 120 days after the date of the deed of trust foreclosure sale. See 26 C.F.R. § 301.7425-4 (2003). The tender of the amount of the tax lien to the IRS after the foreclosure does not void the government's right of redemption. The IRS may reject the tender and enforce its redemption right. *Olympic Federal Savings & Loan Association v. Regan*, 648 F.2d 1218 (9th Cir. 1981).

To redeem the property from the purchaser at the foreclosure sale, the federal government must pay the sum of the actual amount paid at the foreclosure sale, plus the following:

1. 6 percent interest from the date of sale;
2. an amount equal to the excess of the purchaser's maintenance expenses since the sale date over income realized by the purchaser since the sale date;

3. a reasonable rent value under certain defined circumstances; and

4. if applicable, amounts paid to senior lienholders after the foreclosure.

See 26 C.F.R. § 301.7425-4(b) (2003).

The amount paid does not include costs and expenses incurred before foreclosure except to the extent actually bid; for example, the amount paid does not include title-search expenses. See 26 C.F.R. § 301.7425-4(b)(2) (2003).

If the mortgagee bids less than the full amount of the debt, the redemption price does not include any deficiency. *Equity Mortgage Corp. v. Loftus*, 504 F.2d 1071 (4th Cir. 1974); *Republic Bank v. United States*, 527 F. Supp. 415 (W.D. La. 1981).

3.2:8 Certificates

Certificate of Discharge of Property from Federal Tax Lien: If the mortgagee believes that the property being foreclosed has no equity (in excess of the secured debt with filing priority over the federal tax lien) available to the IRS, an application for a certificate of discharge of property from federal tax lien may be filed with the district director of the IRS. The purchaser at a foreclosure sale for which the lender has given the required advance notice to the IRS may similarly file for a certificate of discharge with the IRS. If the district director determines that there is no equity in the property, a certificate of discharge may be issued discharging the federal tax lien (and right of redemption) from the property. See 26 C.F.R. § 301.6325-1(b) (2003).

Consent to Sale: Before the foreclosure sale, the district director may consent to the sale free and clear of the federal tax lien (but for such purposes reserving the right of redemption) notwithstanding the notice requirements. Such written consent shall be on terms and conditions as the district director in his discretion shall determine. See 26 C.F.R. §§ 301.7425-3(b), 301.7425-4(a) (2003). This procedure may be useful if the IRS received inadequate notice or did not receive notice before the advance notice deadline.

The **best alternative** may be to postpone the sale and to give proper advance notice of the sale.

Certificate of Release: The district director may issue a certificate of release if an appropriate bond is furnished. 26 C.F.R. § 301.6325-1(a)(2) (2003).

3.3 Ad Valorem Tax Liens

On January 1 of each year, a tax lien attaches to real property to secure the payment of all taxes, penalties, and interest ultimately imposed for the year on the real property, whether or not the taxes are imposed in the year the lien attaches. The lien exists in favor of each taxing unit having power to tax the property. Tex. Tax Code Ann. § 32.01(a) (Vernon 2001). This statutory lien is superior to almost all preexisting liens and encumbrances, including deed of trust liens, regardless of when the preexisting lien arose or was filed for public record. Tex. Tax Code Ann. § 32.05(b) (Vernon 2001). Most of the exceptions are set out in section 32.05(c) and are of limited impact, such as the exception for funeral expenses against a decedent's estate. However, in 1991 the Legislature expressly made ad valorem tax liens inferior to recorded restrictive covenants running with the land or valid easements of record which were recorded prior to January 1 of the year the tax lien arose. See Tex. Tax Code Ann. § 32.05(c) (Vernon 2001).

The property taxes are the personal obligation of the person who owns or acquires the property on January 1 of the year for which the tax is imposed, and the person is not relieved of the obligation because he no longer owns the property. Tex. Tax Code Ann. § 32.07(a) (Vernon 2001). Thus, although a person who purchases real property at a foreclosure sale after January 1 is not personally liable for the ad valorem taxes for the year of purchase, the mortgaged property can subsequently be sold at a judicially ordered tax sale to pay the delinquent assessment.

The State Bar's form for deed of trust does not provide that the mortgagor will remain liable to the mortgagee for unpaid ad valorem taxes and for the pro rata share of the taxes that accrue up to the date of foreclosure. State Bar of Texas, *Texas Real Estate Forms Manual*, Form 15-1, p. 15.19 *et seq.* (1999).

If the loan is nonrecourse, an exception should be made in the exculpation provision for the failure to pay ad valorem taxes. See *Smart v. Tower Land & Investment Co.*, 597 S.W.2d 333 (Tex. 1980); *Wood v. Henry S. Miller Co.*, 597 S.W.2d 332 (Tex. 1980). However, the nonrecourse nature of the loan will not prohibit the lender from stepping into the shoes of the taxing authority by taking an assignment of the personal judgment obtained by the taxing authority for such taxes. *BW Village, Ltd. v. Tricon Enterprises, Inc.*, 879 S.W.2d 205 (Tex. App.—Houston [14th Dist.] 1994, writ denied).

The creditor should compare the tax account descriptions against the descriptions of the mortgaged property. A frequent problem is that the taxing authority includes the mortgaged property as a part of a larger tax account. For example, Texas Tax Code section 32.01(c) provides that if an owner's real property is described with certainty by metes and bounds in one or more instruments of conveyance and part of that property is the owner's residence homestead taxed separately and apart from the remainder of the property, each of the liens that secures the taxes imposed on that homestead and on the remainder of that property extends "*in solido*" to all the real property described in the instrument or instruments of conveyance, unless the homestead is identified as a separate parcel and is separately described in the conveyance or another instrument recorded in the real property records. See Tex. Tax Code Ann. § 32.01(c) (Vernon 2001). The joining of one tract within another as a single tax account on the tax rolls may result in the foreclosing creditor's paying the tax bill on the larger section of property in order to clear title to the smaller mortgaged property. A tax lien foreclosure on an adjoining tract may also jeopardize the title to appurtenant easements, such as access and private utility easements.

3.3:1 Tax Suits

Occasionally, the preforeclosure title search will reveal that an ad valorem tax suit has been filed, and perhaps even a judgment taken, without the secured lienholder's ever having been made a defendant in the suit. The Texas Tax Code (Tex. Tax Code Ann. tit. 1 (Vernon 2001)) as currently written does not specifically state that lienholders of record must be made defendants to the suit, in contrast to the earlier statute, Tex. Rev. Civ. Stat. Ann. art. 7689 (Vernon 1911),

which so required. Tax cases under the earlier statute had held that since all parties having an interest in land, including the record lienholders, should be made defendants in an ad valorem tax suit, a judgment would not bind parties not before the court, although the failure to serve an interested party did not deprive the court of the power to render judgment against the defendants actually before the court. These earlier cases have been followed by at least one case addressing the failure of the Texas Tax Code to expressly require service on lienholders. *Murphree Property Holdings, Ltd. v. Sunbelt Savings Assn.*, 817 S.W.2d 850 (Tex. App.—Houston [1st Dist.] 1991, no writ). Accordingly, the lien of a party not made a defendant in the tax suit would remain superior to the interest in land purchased at the sheriff's tax sale. *Sanchez v. Hillyer-Deutsch-Jarratt Co.*, 27 S.W.2d 634 (Tex. Civ. App.—San Antonio 1930, writ ref'd), and numerous cases cited therein at 635. Subsequent cases modified this rule in those instances where a judgment was rendered against a named owner of the property who was not properly served with notice. In those circumstances the court would set aside a sheriff's sale and deed but leave the judgment itself intact. See, e.g., *Anderson v. Collum*, 514 S.W.2d 230 (Tex. 1974), and cases cited therein. This exception was based in equity, because under the rules of procedure, setting aside a judgment would require that the taxpayer implead the state as a defendant and present a meritorious defense to the judgment. Since under normal circumstances the taxpayer could not show a meritorious defense to a suit for delinquent taxes, the courts felt it only equitable to set aside the sheriff's deed and sale and grant the improperly served taxpayer the opportunity to pay the tax judgment, without disturbing the judgment itself.

3.3:2 Payment of Taxes by Mortgagee

An owner of real property may enter into a contract with the mortgagee for payment of taxes due on the mortgaged property. Tex. Tax Code Ann. 32.065(a) (Vernon 2001). Typically, this agreement is embodied in the deed of trust. Payments made by mortgagee are secured indebtedness when made in connection with a deed of trust containing a provision permitting mortgagee to pay delinquent taxes and to add such payments to the secured debt. *World Help v. Leisure Lifestyles, Inc.*, 977 S.W.2d 662 (Tex. App.—Fort Worth 1998), *reh'g* overruled, and

rev. denied, and *reh'g of pet. for rev.* overruled. However, whether or not the mortgagee is entitled to step into the taxing authority's lien priority by equitable subrogation is not automatic as subrogation is an equitable doctrine. In *World Help* the court found that the mortgagee purchased the secured note with knowledge that taxes were delinquent on the property and under such circumstances, it could have protected itself by taking such factor into account in the amount it paid for the loan. *World Health* at 681-82 citing *Smart v. Tower Land and Inv. Co.*, 597 S.W.2d 333, 337 (Tex. 1980). Unlike contracts for payment by third-party nonlienholders, there are no special requirements for the contract with the lienholder, but the Tax Code does provide that "the first written communication by the lender to its prospective borrower shall disclose the types of possible additional charges or fees that may be incurred by the borrower in connection with the loan or contract under this section." Tex. Tax Code Ann. § 32.065(f) (Vernon 2001). It has been held that a mortgagee could recover from a mortgagor for delinquent taxes that the mortgagee paid after the foreclosure sale on the theory that the mortgagee is subrogated to the rights of the taxing authority. *Vista Development Joint Venture II v. Pacific Mutual Life Insurance Co.*, 822 S.W.2d 305 (Tex. App.—Houston [1st Dist.] 1992, writ denied). The promissory note contained a carve-out from the non-recourse provisions of the note for property taxes and contained the borrower's covenant to pay ad valorem taxes. The court found that the lender's rights against the borrower under the note survived the foreclosure under the deed of trust and was independent of the same covenants in the deed of trust. However, in *Georgetown Associates, Ltd. v. Home Federal Savings & Loan Assn.*, 795 S.W.2d 252 (Tex. App.—Houston [14th Dist.] 1990, writ dism'd w.o.j.) the court held that the non-recourse provisions of the note would not permit the lender to obtain a personal judgment for taxes the borrower had failed to pay. The court found that the only remedy due to the non-payment of taxes was foreclosure under the deed of trust in the absence of a "clear promise" of personal reimbursement when coupled with the non-recourse language. Also, the court in *Jackson v. Stonebriar Partnership*, 931 S.W.2d 635 (Tex. App.—Dallas 1996, writ denied) held that a mortgagee was not entitled to sue mortgagor for reimbursement for taxes paid by mortgagee after foreclosure for period accruing from

January 1 of year of foreclosure sale to date of sale.

3.3:3 Payment of Taxes by Third Party

An owner may authorize a third party to pay the ad valorem taxes imposed on his property, if the authorization meets the requirements set forth in section 32.06 of the Tax Code. On payment and recording of the transfer of lien in the deed records of each county in which the land is located. One year after the transfer of lien is filed in the county deed records, the third-party lienholder may institute suit to foreclose on the property. Within six months of the recording of the transfer of the tax lien, the holder of a preexisting lien on the property is entitled to pay the amount of the lien, accrued interest, and recording expenses to the tax lienholder and become subrogated to all rights in the lien. Within one year of any judicial foreclosure and sale pursuant to the transferred tax lien, the property owner or the preexisting *first* lienholder may redeem the property upon payment of the lesser of 118 percent of the amount of the judgment or the tax sale purchase price, costs, and interest. See Tex. Tax Code Ann. § 32.06 (Vernon 2001).

3.3:4 Redemption

A property owner may pay a tax judgment before the sheriff's tax lien foreclosure sale. If the property owner does not tender the taxes before the sheriff's sale, in contrast to a deed of trust foreclosure, the property owner has a right to redeem the property in accordance with Texas Tax Code § 34.21. The length of the redemption period varies from as little as 180 days to two years, depending upon the prior use of the property and the identity of the purchaser at the sale.

Sale to Other than the Taxing Unit. The owner of real property sold at a tax sale to a purchaser other than a taxing unit that was used as the residence homestead of the owner or that was land designated for agricultural use when the suit or the application for the warrant was filed, or the owner of a mineral interest sold at a tax sale to a purchaser other than a taxing unit, may redeem the property on or before the second anniversary of the date on which the purchaser's deed is filed for record by paying the purchaser the amount the purchaser bid for the

property, the amount of the deed recording fee, and the amount paid by the purchaser as taxes, penalties, interest, and costs on the property, plus a redemption premium of 25 percent of the aggregate total if the property is redeemed during the first year of the redemption period or 50 percent of the aggregate total if the property is redeemed during the second year of the redemption period. Tax Code § 34.21(a)

Sale to the Taxing Unit. If property that was used as the owner's residence homestead or was land designated for agricultural use when the suit or the application for the warrant was filed, or that is a mineral interest, is bid off to a taxing unit under Tax Code § 34.01(j) or (p) and has not been resold by the taxing unit, the owner having a right of redemption may redeem the property on or before the second anniversary of the date on which the deed of the taxing unit is filed for record by paying the taxing unit: (1) the lesser of the amount of the judgment against the property or the market value of the property as specified in that judgment, plus the amount of the fee for filing the taxing unit's deed and the amount spent by the taxing unit as costs on the property, if the property was judicially foreclosed and bid off to the taxing unit under Tax Code § 34.01(j); or (2) the lesser of the amount of taxes, penalties, interest, and costs for which the warrant was issued or the market value of the property as specified in the warrant, plus the amount of the fee for filing the taxing unit's deed and the amount spent by the taxing unit as costs on the property, if the property was seized under Subchapter E, Chapter 33, and bid off to the taxing unit under Tax Code § 34.01(p). Tax Code § 34.21(b)

If real property that was used as the owner's residence homestead or was land designated for agricultural use when the suit or the application for the warrant was filed, or that is a mineral interest, has been resold by the taxing unit under Tax Code § 34.05, the owner of the property having a right of redemption may redeem the property on or before the second anniversary of the date on which the taxing unit files for record the deed from the sheriff or constable by paying the person who purchased the property from the taxing unit the amount the purchaser paid for the property, the amount of the fee for filing the purchaser's deed for record, the amount paid by the purchaser as taxes, penalties, interest, and costs on the property, plus a redemption premium of 25 percent of the

aggregate total if the property is redeemed in the first year of the redemption period or 50 percent of the aggregate total if the property is redeemed in the second year of the redemption period. (d) If the amount paid by the owner of the property under Subsection (c) is less than the amount of the judgment under which the property was sold, the owner shall pay to the taxing unit to which the property was bid off under Tax Code § 34.01 an amount equal to the difference between the amount paid under Subsection (c) and the amount of the judgment. The taxing unit shall issue a receipt for a payment received under this subsection and shall distribute the amount received to each taxing unit that participated in the judgment and sale in an amount proportional to the unit's share of the total amount of the aggregate judgments of the participating taxing units. Tax Code § 34.21(c). If the amount paid by the owner of the property under Tax Code § 34.21(c) is less than the amount of the judgment under which the property was sold, the owner shall pay to the taxing unit to which the property was bid off under Tax Code § 34.01 an amount equal to the difference between the amount paid under Subsection (c) and the amount of the judgment. The taxing unit shall issue a receipt for a payment received under this subsection and shall distribute the amount received to each taxing unit that participated in the judgment and sale in an amount proportional to the unit's share of the total amount of the aggregate judgments of the participating taxing units. The owner of the property shall deliver the receipt received from the taxing unit to the person from whom the property is redeemed. Tax Code § 34.21(d).

The owner of real property sold at a tax sale other than property that was used as the residence homestead of the owner or that was land designated for agricultural use when the suit or the application for the warrant was filed, or that is a mineral interest, may redeem the property in the same manner and by paying the same amounts as prescribed by Subsection (a), (b), (c), or (d), as applicable, except that: (1) the owner's right of redemption may be exercised not later than the 180th day following the date on which the purchaser's or taxing unit's deed is filed for record; and (2) the redemption premium payable by the owner to a purchaser other than a taxing unit may not exceed 25 percent. Tax Code § 34.21(e).

The owner of property who is entitled to redeem the property under Tax Code § 34.21 may request that the purchaser of the property, or the taxing unit to which the property was bid off, provide that owner a written itemization of all amounts spent by the purchaser or taxing unit in costs on the property. The owner must make the request in writing and send the request to the purchaser at the address shown for the purchaser in the purchaser's deed for the property, or to the business address of the collector for the taxing unit, as applicable. The purchaser or the collector shall itemize all amounts spent on the property in costs and deliver the itemization in writing to the owner not later than the 10th day after the date the written request is received. Delivery of the itemization to the owner may be made by depositing the document in the United States mail, postage prepaid, addressed to the owner at the address provided in the owner's written request. Only those amounts included in the itemization provided to the owner may be allowed as costs for purposes of redemption. Tax Code § 34.21(i).

Party Entitled to Redeem. The current statute states that “[t]he owner of real property sold at a tax sale to a purchaser other than a taxing unit that was used as the residence homestead of the owner or that was land designated for agricultural use when the suit or the application for the warrant was filed may redeem the property...” Tex. Tax Code Ann. § 34.21(a) (Vernon 2001), and that “[a] person asserting ownership of real property sold for taxes is entitled to redeem the property if he had title to the property or he was in possession of the property in person or by tenant either at the time suit to foreclose the tax lien on the property was instituted or at the time the property was sold.” Tex. Tax Code Ann. § 34.22(a) (Vernon 2001). Because there have been no cases construing sections 34.21 and 34.22 since the codification of the statutes, it is not clear whether these sections override the *Macha* and *Lipscomb* cases and exclude the right of the lienholder to redeem the property. The codification of the Property Tax Code (title 1 of the Tax Code) in 1979 was a substantive revision, however, not a part of the nonsubstantive recodifications done by the Texas Legislative Council. See Prop. Tax Code ch. 841, § 6(b), Acts 1979, 66th Leg. (located immediately before Tex. Tax Code Ann. § 1.01 (Vernon 2001)); Tex. Gov’t Code Ann. § 323.007 (Vernon 1998). See, however,

Murphree Property Holdings, Ltd. v. Sunbelt Savings Assn., 817 S.W.2d 850 (Tex. App.—Houston [1st Dist.] 1991, no writ) where a lien holder which took title to the property by deed of trust foreclosure after the judicial foreclosure of an ad valorem tax lien was allowed to exercise a right of redemption.

Tax Code § 34.22(b) now provides that a person who establishes title to real property that is superior to the title of one who has previously redeemed the property is entitled to redeem the property during the redemption period by paying the amounts provided by law to the person who previously redeemed the property.

Passage of Redemption Right Upon Death.

This right of redemption will pass to the heirs of the property owner. *McGuire v. Bond*, 271 S.W.2d 508 (Tex. Civ. App.—El Paso 1954, writ ref'd n.r.e.).

Assignment of Right of Redemption. Under the pre-Tax Code statute, the property owner could assign this right of redemption. See, e.g., *Macha v. Carameros*, 674 S.W.2d 491 (Tex. App.—El Paso 1984, no writ). Texas courts held that any lienholder expressly authorized by its deed of trust to pay delinquent taxes on the collateral was also entitled to redeem the property, even though the lienholder was not a party to the original tax suit. E.g., *Lipscomb v. Japhet*, 18 S.W.2d 786 (Tex. Civ. App.—San Antonio 1929, writ dism'd w.o.j.).

Lienholders. Because of the steep redemption price, the lienholder almost always should pay delinquent taxes on the collateral before foreclosure of the tax lien. While pending tax suits are not shown in the state tax lien or deed records, the docket records of each district court in the applicable county can be examined to determine the existence of such suits.

3.5 Acquisition of Prior Liens

From time to time, the attorney will be asked to arrange for the acquisition of a prior lien against the property held by a third party as part of representing the client in the foreclosure. Typically this prior lien is also in default, and the prior lienholder may have already initiated its own foreclosure proceedings. In this situation the attorney must be wary to avoid several potential pitfalls.

3.5:1 Verification of Foreclosure Procedures by Prior Lienholders

The attorney should not assume that the prior lienholder has followed proper procedure in accelerating the debt and processing the deed of trust for foreclosure. The attorney should approach the negotiations for purchase of the prior lien with the idea that, to the greatest extent possible, he will arrange not merely for the transfer of the note and liens but also for the review of the underlying loan documentation. The attorney must confirm that the prior lienholder has, in fact, notified all obligors on the debts, followed the statutory posting and noticing requirements, examined the federal tax lien records, provided appropriate notice to the IRS, and in general dealt with all the various matters discussed in this manual. This point cannot be overemphasized, inasmuch as if the attorney's client purchases a note known to be in default, the client cannot be a holder in due course of the note through its own actions. If there were intervening holders between the original payee and the party from whom the client is obtaining the note, the client may be able to claim holder-in-due-course status through an intervening holder. If not, the knowledge of existence of default means that the client will acquire the note subject to all defenses that the maker could raise against the prior holder.

3.5:2 Survival of Borrower's Defenses on Transfer of Lien

An important issue arising with the transfer of the lien is whether the transfer or subsequent foreclosure of the lien cuts off equitable claims and defenses of the borrower, the grantor of the lien, or third parties. The Texas Supreme Court has held, for example, that the equitable doctrine of subrogation may not be asserted by a subsequent lender that attempts to use the doctrine as "an offensive tool" to create "inequitable results" by negotiating with non-obligor parties (i.e., persons who acquired the property subject to the note and lien, and not in assumption thereof) to contract away rights of an obligor on the note. See the discussion of *First National Bank of Kerrville v. O'Dell*, 856 S.W.2d 410 (Tex. 1993). With regards to contractual transfers of the lien, the better law in Texas appears to be that when a transfer of a note and deed of trust occurs after maturity of the note, neither the transfer itself nor a

subsequent foreclosure of the lien cuts off defenses to payment of the note or equitable claims in the pledged property.

Defenses of Note Maker

A good-faith mortgagee for value takes its lien position free from undisclosed claims and equities of which it had no actual or constructive notice. See, e.g., *Gordy v. Morton*, 624 S.W.2d 705 (Tex. App.—Houston [14th Dist.] 1981, no writ), and cases cited therein. The owner of the note who is not a holder in due course, however, faces the defenses that may be imposed against the earlier noteholder.

Claims of Third Parties

Several early Texas cases held that, while a mortgagee who was not a holder in due course might be subject to any defenses of the maker on the note, the mortgagee still held its lien position free and clear of the “secret equities of third parties.” *Little v. Shields*, 63 S.W.2d 363, 366 (Tex. Comm’n App. 1933, opinion adopted); see *Etheridge v. Campbell*, 215 S.W. 441 (Tex. Comm’n App. 1919, judgment adopted); *Gee v. Parks*, 193 S.W. 767 (Tex. Civ. App.—Austin 1917, no writ). In general, these cases accepted the argument that the mortgagee was entitled to rely on the recordation statutes for the claims of third parties against the collateral.

An alternative line of Texas cases, however, rejected the foregoing cases and adopted the principle that the priority of the lien status *vis-à-vis* third-party claims was dependent on the mortgagee’s status as a holder of the note. See, e.g., *Continental National Bank v. Conner*, 214 S.W.2d 928 (Tex. 1948); *Pope v. Beauchamp*, 219 S.W. 447 (Tex. 1920). This conflict in the Texas cases was discussed in detail by the Fifth Circuit in *Kirby Lumber Corp. v. Williams*, 230 F.2d 330 (5th Cir. 1956), which, following *Continental National Bank* and *Pope*, interpreted Texas law as holding that “the holder in due course of a negotiable note is also the holder of the lien securing it without notice of secret equities, while the purchaser of such note after maturity is not.” *Id.* at 336. Accordingly, the Fifth Circuit held that when a bank acquires a note and deed of trust after maturity, foreclosure of the note under the deed of trust does not cut off the equitable title of third parties in the collateral property.

All the foregoing cases concerning the position of a mortgagee who acquires the note after default were decided before the adoption of the Uniform Commercial Code. The case law appears to be consistent with the Uniform Commercial Code, which provides that a person who is not a holder in due course of the note takes the note subject to all defenses “that would be available if the person entitled to enforce the instrument were enforcing a right to payment under a simple contract.” Tex. Bus. & Comm. Code Ann. § 3.305(a)(2) (Tex. UCC) (Vernon 2002) (emphasis added).

The Fifth Circuit’s opinion in *Kirby Lumber Corp.* and the Texas Supreme Court cases cited by the Fifth Circuit looked to negotiable instrument law rather than to the recordation and notice statutes. The line of reasoning is different in cases of the original lender’s taking a mortgage while the property is occupied by a party other than the grantor under the deed of trust. In these cases, the courts held that when a party other than the grantor of the deed of trust occupies the land, the prospective mortgagee has a duty of inquiry to determine the nature and claim of the party in possession. See, e.g., *First Savings & Loan Association v. Avila*, 538 S.W.2d 846 (Tex. Civ. App.—El Paso 1976, writ ref’d, n.r.e.). Even here, however, there is a question about what inquiry is proper. In *Avila* the court specifically stated that the nature of the mortgagee’s inquiry was solely to examine the real property records, as any requirement that the prospective mortgagee actually speak with the party in possession worked to defeat the public policy expressed by the recordation statutes. Following *Avila* are a number of cases that have held that a mortgagee is not charged with notice of secret equities merely because the mortgaged property is occupied by third parties. *In re Yamin*, 65 B.R. 938 (Bank. S. D. Tex. 1986); *McGahey v. Ford*, 563 S.W.2d 857 (Tex. Civ. App.—Ft. Worth 1978, writ ref’d, n.r.e.) Other cases have held that the duty of inquiry is to go to the possessor of the property to ascertain the nature and extent of any claim. See, e.g., *Collum v. Sanger Bros.*, 82 S.W. 459 (Tex. 1904); *Boyd v. United Bank, N. A.*, 794 S.W.2d 839 (Tex. App.—El Paso 1990, writ denied); *Texas Life Insurance Co. v. Texas Building Co.*, 307 S.W.2d 149 (Tex. Civ. App.—Fort Worth 1957, no writ); *Brown v. Moss*, 265 S.W.2d 613 (Tex. Civ. App.—Fort Worth 1954, writ ref’d n.r.e.).

3.5:3 Deed of Trust Liens

Junior liens are extinguished on the foreclosure of a superior deed of trust lien, except to the extent that junior lienholders have claims on excess foreclosure sale proceeds. *Mortgage & Trust v. Bonner & Co.*, 572 S.W.2d 344, 352 (Tex. Civ. App.—Corpus Christi 1978, writ ref'd n.r.e.); *Baccus v. Westgate Management Corp.*, 981 S.W.2d 383 (Tex. App.—San Antonio 1998, writ denied) third lienholder entitled to “leapfrog priority” over second lienholder, but only to the extent of balance owing on first lien purchased and foreclosed by it and proceeds in excess of first lien debt belong to second lien creditor. There is no obligation to give notice of foreclosure sale to the holder of a second lien deed of trust. *TMS Mortgage, Inc. v. Golias*, 102 S.W.3d 768 (Tex. App.—Beaumont 2003, no writ). There is no right of redemption after foreclosure in Texas. *Hampshire v. Greeves*, 143 S.W. 147 (Tex. 1912), *Scott v. Dorothy B. Schneider Estate Trust*, 783 S.W.2d 26 (Tex. App.—Austin 1990, no writ).

3.5:4 Mechanic’s Liens

Texas law provides a preference lien for mechanics and materialmen who have perfected their lien claims on readily removable fixtures. This preference lien is superior to the lien granted by a previously recorded deed of trust and is not extinguished by the foreclosure of the deed of trust lien.

Section 53.123 of the Texas Property Code provides:

(a) Except as provided by this section, a mechanic’s lien attaches to the house, building, improvements ... in preference to any prior lien, encumbrance, or mortgage on the land on which it is located, and the person enforcing the lien may have the house, building, improvement ... sold separately.

(b) The mechanic’s lien does not affect any lien, encumbrance, or mortgage on the land or improvement at the time of the inception of the mechanic’s lien, and the holder of the lien, encumbrance, or mortgage need not be made a party to a suit to foreclose the mechanic’s lien.

Tex. Prop. Code Ann. § 53.123 (Vernon 1995).

The mechanic’s lien attaches to fixtures and not to nonfixture personal property. In *First National Bank v. Whirlpool Corp.*, the court found that dishwashers and disposals attached to the realty were fixtures that were removable under the preference-lien rule, whereas refrigerators and ranges, which were not built into or in any other manner affixed or incorporated into the building so as to lose their identity as personal property, were not fixtures and not subject to the statutory lien. 517 S.W.2d 262 (Tex. 1974).

The preference lien has been limited by case-law interpretation of the mechanic’s lien statute to apply only to readily removable fixtures. As stated in *Whirlpool*: “[A] mechanic’s and materialman’s statutory lien upon improvements made is superior to a prior recorded deed of trust lien where the improvements made can be removed without material injury to the land and pre-existing improvements, or to the improvements removed.” *Id.* at 269. Cases finding items were readily removable fixtures include the following: *First National Bank v. Whirlpool Corp.*, 517 S.W.2d 262, 266 (Tex. 1974) (garbage disposals and built-in dishwashers); *Richard H. Sikes, Inc. v. L & N Consultants*, 586 S.W.2d 950, 954 (Tex. Civ. App.—Waco 1979, writ ref’d n.r.e.) (carpets, appliances, air-conditioning and heating components, smoke detectors, burglar alarms, light fixtures, and door locks); *First Continental Real Estate Investments Trust v. Continental Steel Co.*, 569 S.W.2d 42, 47 (Tex. Civ. App.—Fort Worth 1978, no writ) (windows and doors could be removed by temporarily displacing brick and trim without any material damage); *American Amicable Life Insurance Co. v. Jay’s Air Conditioning & Heating*, 535 S.W.2d 23, 25 (Tex. Civ. App.—Waco 1976, writ ref’d n.r.e.) (compressors and air-handling units inside of air-conditioning units); *Houk Air Conditioning v. Mortgage & Trust*, 517 S.W.2d 593, 595 (Tex. Civ. App.—Waco 1974, no writ) (heating and air-conditioning systems); *Freed v. Bozeman*, 304 S.W.2d 235, 241 (Tex. Civ. App.—Texarkana 1957, writ ref’d n.r.e.) (ticket booth, speaker poles, and screen at drive-in theater); *Wallace Gin Co. v. Burton-Lingo Co.*, 104 S.W.2d 891, 892 (Tex. Civ. App.—Austin 1937, no writ) (frame building); *Mogul Producing & Refining Co. v. Southern Engine & Pump Co.*, 244 S.W. 212, 214 (Tex. Civ. App.—Beaumont 1922, no writ) (pumps [or machinery] attached to concrete foundation); *R.B. Spencer & Co. v. Brown*, 198

S.W. 1179, 1180 (Tex. Civ. App.—El Paso 1917, writ ref'd) (rock house).

Cases finding items were not removable include the following: *Exchange Savings & Loan Association v. Monocrete Property, Ltd.*, 629 S.W.2d 34, 37 (Tex. 1982) (roofing tiles); *Cameron County Lumber Co. v. Al & Lloyd Parker, Inc.*, 62 S.W.2d 63, 64 (Tex. 1933) (lumber used to build house); *Houk Air Conditioning v. Mortgage & Trust*, 517 S.W.2d 593, 595 (Tex. Civ. App.—Waco 1974, no writ) (cabinets); *Chamberlain v. Dollar Savings Bank of New York*, 451 S.W.2d 518, 519–20 (Tex. Civ. App.—Amarillo 1970, no writ) (brick used to veneer house and construct fireplace and chimney); *Irving Lumber Co. v. Alltex Mortgage Co.*, 446 S.W.2d 64, 69 (Tex. Civ. App.—Dallas 1969), *aff'd*, 468 S.W.2d 341 (Tex. 1971) (shell home); *McCallen v. Mogul Producing & Refining Co.*, 257 S.W. 918, 923 (Tex. Civ. App.—Galveston 1923, writ dism'd) (window frames).

The proper procedure for a mechanic or materialman to exercise his claim is through judicial foreclosure of the preference lien. The court will have to determine as a factual matter that the materials may be removed without injury to the land, other preexisting improvements, and the materials themselves. Tex. Prop. Code Ann. § 53.154 (Vernon 1984); *Exchange Savings & Loan Association v. Monocrete Property, Ltd.*, 629 S.W.2d 34, 36–37 (Tex. 1982); *P&T Manufacturing Co. v. Exchange Savings & Loan Association*, 633 S.W.2d 332 (Tex. App.—Dallas 1982, writ ref'd n.r.e.).

3.6 Tenants

Before foreclosing, the mortgagee may need to consider the terms and dates of any leases on the property and the status of any security deposits.

3.6:1 Priority

Leases Superior to Deed of Trust: A lease on a portion of the mortgaged property (e.g., apartment tenant, office tenant, or laundry lease) executed before the deed of trust was recorded is superior to it and not extinguished by foreclosure, unless the lease has been subordinated by its own terms. *F. Groos & Co. v. Chittim*, 100 S.W. 1006, 1010 (Tex. Civ. App. 1907, no writ). The rule is that, when a lienholder takes a lien in good faith and for a

valuable consideration and without notice of outstanding claims or equities, a purchaser at the lien foreclosure sale, regardless of the knowledge or notice the purchaser has, takes good title from the bona fide mortgagee. *Moran v. Adler*, 570 S.W.2d 883, 885 (Tex. 1978); *B. F. Avery & Sons' Plow Co. v. Kennerly*, 12 S.W.2d 140 (Tex. Comm'n App. 1927, judgment adopted); *ICM Mortgage Corp. v. Jacob*, 902 S.W.2d 527 (Tex. App.—El Paso 1994, writ denied); *Bateman v. Brown*, 297 S.W. 773 (Tex. Civ. App.—Amarillo 1927, writ dism'd); and see *Gainesville Oil & Gas Co., Inc. v. Farm Credit Bank of Texas*, 847 S.W.2d 655 (Tex. App.—Texarkana 1993, no writ)—oil and gas lease with producing well subsequent to deed of trust extinguished by foreclosure sale irrespective of knowledge of foreclosure sale purchaser of existence of well. The purchaser at the foreclosure sale becomes the new landlord.

Leases Inferior to Deed of Trust: Leases executed after the recording of the deed of trust may be terminated at the election of the foreclosure sale purchaser. *Peck & Hills Furniture Co. of Texas v. Long*, 68 S.W.2d 288, 289 (Tex. Civ. App.—Fort Worth 1934, no writ) (“The sale under foreclosure gave the right to the purchaser to either terminate the lease or to continue it in force with the tenant’s consent.”); *Chittim*, 100 S.W. 1006. In *United General Insurance Agency v. American National Insurance Co.*, 740 S.W.2d 885 (Tex. App.—El Paso 1987, no writ), the court held that a lease executed subsequent to the deed of trust was terminated by a foreclosure sale unless both the foreclosure sale purchaser and the tenant expressly or impliedly agreed to continue the lease. The court held that “the continuation in possession by the tenant, without anything else, does not establish an agreement to pay rent on the rental contract.” *Id.* at 886. The court stated the rule as follows: “Where the lease is executed after the mortgage, the sale under foreclosure gives the right to the purchaser to either terminate the lease or continue it in force with the tenant’s consent, but does not of necessity terminate the lease.” *Id.* at 887. The court found that there was no express agreement between United General (tenant) and American National (mortgagee) to continue the lease, and that “the circumstances do not evidence that *both* parties consented to [United General’s] paying rent subsequent to the foreclosure.” *Id.* On the foreclosure sale day, United General sent American National a letter stating that United

General did not attorn to American National and that it was not bound by the lease.

The lease in *United General* did not contain an attornment agreement or agreement recognizing the right of the mortgagee at its option to ratify the lease or unilaterally subordinate the deed of trust lien to the lease without further consent of the tenant.

Reaffirmation of Inferior Lease or New Lease.

If the purchaser at the foreclosure sale accepts rent from a tenant of a subordinate lease without executing a new lease, the purchaser will be deemed to have ratified the lease. *Peck & Hills Furniture Co.*, 68 S.W.2d at 289; see also *F. Groos & Co. v. Chittim*, 100 S.W. 1006 (Tex. Civ. App. 1907, no writ). In one case the court held that a tenant's payment of four consecutive monthly rent payments in response to a letter from the foreclosure purchaser requesting rent pursuant to the original lease and with knowledge of the foreclosure sale was sufficient to constitute an implied agreement reaffirming the lease notwithstanding the foreclosure sale. *Peterson v. NCNB National Bank*, 838 S.W.2d 263 (Tex. App.—Dallas 1992, no writ); *Twelve Oaks Tower I, Ltd. v. Premier Allergy, Inc.*, 938 S.W.2d 102 (Tex. App.—Houston [14th Dist.] 1997, no writ) finding that payment of rent by tenant's assignee after foreclosure sale constituted a new lease with the foreclosure sale purchaser on the same terms as the original lease with the original tenant. But see *FDIC v. Inducto-Bend, Inc.*, 753 F.Supp. 651 (S.D. Tex. 1991) holding that a mortgagee/foreclosure sale purchaser's acceptance of rent from the tenant, without more, did not ratify the lease but merely represented the payment of rent by a tenant at sufferance.

Mortgagee's Unilateral Subordination of Lien to Lease. If the deed of trust is prior to a lease that the mortgagee wishes to retain and there is neither an attornment agreement between mortgagee and tenant nor a provision in the lease binding the tenant to continue the lease after a foreclosure, some commentators have suggested that the mortgagee unilaterally subordinate the deed of trust to the lease or leases. This approach has some support in court decisions holding that in a judicial foreclosure in which a tenant is not made a party to the proceeding there is no termination of the lease. In *B.F. Avery & Sons' Plow Co. v. Kennerly*, 12 S.W.2d 140 (Tex. Comm'n App. 1929, opinion

adopted), the court stated: "It is true that lessee, not being a party to the foreclosure proceeding, was not bound by the decree rendered therein." See also *McDonald v. Miller*, 39 S.W. 89 (Tex. 1897). *Contra Yarbrough v. John Deere Industrial Equipment Co.*, 526 S.W.2d 188 (Tex. Civ. App.—Dallas 1975, no writ); *Alford v. Carver*, 72 S.W. 869 (Tex. Civ. App. 1903, no writ).

An alternate means of elevating an inferior lease or interest is for the mortgagee to accept a deed in lieu of foreclosure.

A mortgagee who elects to continue a subordinate lease after foreclosure or who unilaterally subordinates its lien before foreclosure or who accepts a deed in lieu of foreclosure may become liable to the tenant on the mortgagor's landlord-lease covenants. In an analogous situation, the court in *Amco Trust, Inc. v. Naylor*, 317 S.W.2d 47 (Tex. 1958), considered the question of the liability of a leasehold mortgagee for the tenant's rent obligation. The court held that merely by taking possession of the mortgaged property after default and before foreclosure the mortgagee did not become liable for the tenant's covenants, because it had not become an assignee of the tenant (foreclosed) or otherwise assumed the lease. Apparently the court would have held the mortgagee liable for the rent if the mortgagee had foreclosed on the mortgagor's leasehold estate. See Annot., *Liability of Mortgagee or Lienholder of a Lease with Respect to Rents or Covenants Therein*, 73 A.L.R.2d 1118 (1960). See the forms of letter to a tenant by the successful bidder at the foreclosure sale accepting the tenant's lease or giving notice that although rent may be accepted by the bidder, such action is not to constitute an acceptance of the lease.

3.6:2 Security Deposits

The Texas Property Code exempts a "real estate mortgage lienholder who acquires title by foreclosure" from liability for return of a residential tenant's security deposit. Tex. Prop. Code Ann. § 92.105(c) (Vernon 1995). The tenant's only recourse is against the mortgagor (the prior owner/ landlord). However, there is no express exemption for persons other than the real estate mortgage lienholder who purchase at the foreclosure sale. Presumably subordinate leases are terminated by the foreclosure, and a

purchaser at the foreclosure sale does not assume liability for the return of security deposits received by the mortgagor under a residential lease that is terminated by foreclosure. There does not appear to be any strong policy reason to grant a preferential position to a real estate mortgage lienholder who purchases at the foreclosure sale over any other purchaser at the sale. If the foreclosure sale purchaser impliedly continues a subordinate lease by accepting rent from the tenant, as opposed to terminating the lease, the purchaser may have assumed liability for the return of the security deposit even though the purchaser did not receive it in the foreclosure. If the foreclosure sale purchaser on a residential project assumes that it is not liable for the security deposits and consequently fails to either return a security deposit or to provide a written statement of any deductions there from on or before thirty days after the premises are surrendered, then such purchaser may be presumed to have acted in bad faith, if subsequently determined to be liable for the security deposit. See Tex. Prop. Code Ann. § 92.109(d) (Vernon 1995). A purchaser who wrongfully withholds a security deposit is liable for an amount equal to the sum of \$100, three times the portion of the deposits wrongfully withheld, and the tenant's reasonable attorney's fees in a suit to recover the deposit. Tex. Prop. Code Ann. § 92.109(a) (Vernon 1995). Also, the purchaser may find that it has forfeited its right "to bring suit against the tenant for damages to the premises." Tex. Prop. Code Ann. § 92.109(b) (Vernon 1995).

In *Consolidated Capital Special Trust v. Summers*, 737 S.W.2d 327, 333 (Tex. App.—Houston [14th Dist.] 1987), *rev'd*, 783 S.W.2d 580 (Tex. 1989), the court of appeals refused to award the security deposits to the foreclosing lender apparently on the grounds that since section 92.105(c) exempts the foreclosing lender from successor-owner liability for the return of security deposits, the lender was not entitled to the deposits. The court of appeals also noted that the notice of foreclosure sale did not list security deposits as part of the mortgaged property being sold. The appellate court's holding in this regard is consistent with its holding that the lender was also not entitled to preforeclosure rent, because it had not undertaken any preforeclosure affirmative action to impound the rent. The supreme court reversed the decision, saying, "As to rents, it is

difficult to imagine what [the lender] could have done beyond foreclosing on the property, purchasing it at sale and promptly taking possession of it." *Id.* at 583. As to prepaid rent (e.g., monthly rent paid on the first day of the month for the ensuing month as opposed to in arrears), the supreme court adopted an apportionment rule. The supreme court held the foreclosure sale purchaser was entitled to obtain a judgment against the mortgagor as a matter of law for the rent collected before foreclosure and attributable to a time after the foreclosure. The supreme court did not discuss the disposition of security deposits, noting that the lender had abandoned its claim for security deposits. *But see Skyland Developers, Inc. v. Sky Harbor Associates*, 586 S.W.2d 564 (Tex. Civ. App.—Corpus Christi 1979, no writ) (construing post sale term cash-flow reservation by seller as failing to retain security deposits). The supreme court in *Consolidated Capital* was not adjudicating the rights and liabilities between the new landlord and tenants. The apportionment rule was announced in a case in which the mortgagee-purchaser sued for rent relating to the postforeclosure period and therefore elected to treat the leases as surviving foreclosure. It would follow from the supreme court's holding that the new landlord would be required in situations governed by the apportionment rule to give the tenant credit for rent prepaid to the mortgagor before foreclosure, whether or not the new landlord was able to realize on its judgment for rent.

3.6:3 Dilemmas

The mortgagor, mortgagee, and the tenants of the mortgaged property face several dilemmas in the foreclosure process that are not addressed in section 92.105(c) of the Texas Property Code.

Deposit Refunds: At the least, the court of appeals approach in its *Consolidated Capital* interpretation of section 92.105(c) places the responsibility for the deposits with the party who received the deposits. However, tenants may find it impossible or impractical to regain their deposits from an insolvent mortgagor whose sole asset was the project and who has already spent the deposits. On the other hand, the mortgagee-purchaser may not want to focus the tenants' attention on the problem and may just accept rent from the tenants as if nothing happened. The mortgagee-new owner may

learn that security deposits retained by the mortgagor-former owner in fact serve as a deposit against tenant damage occurring after the foreclosure.

Conflicting Claims to Rent: Before the foreclosure sale the tenant may receive conflicting demands from the mortgagor-landlord and the mortgagee for the rent due on the ensuing first of the month. If the tenant pays the mortgagor, the tenant may find that on the fifth of the month a new landlord will demand rent for the remaining twenty-five days of the month (resulting in the tenant's paying rent twice) and the tenant will have only an unsecured claim against an insolvent mortgagor. In a subordinate lease, the new landlord may treat the lease as terminated and insist that any rent paid to the former landlord is not applicable to the term of any new lease required by the new landlord. If the tenant pays the mortgagee, the sale may be postponed or canceled, leaving the rent still due the mortgagor. The tenant who does nothing may find the lease terminated because of a breach of the lease. The tenant and the mortgagee-purchaser may also have problems with prepaid rent in the possession of the foreclosed mortgagor.

3.7 Junior Easements and Protective Covenants

The foreclosure sale extinguishes subordinate burdening easements. See *Cousins v. Sperry*, 139 S.W.2d 665 (Tex. Civ. App.—Beaumont, 1940, no writ) (foreclosure sale terminated access right-of-way granted by mortgagor to an adjoining landowner subsequent to filing of mortgage). See *generally* Annot., *Foreclosure of Mortgage or Trust Deed as Affecting Easement Claimed In, On, Over, or Under Property*, 46 A.L.R.2d 1197 (1956).

The mortgaged property may have the benefit of valuable rights, interests, easements, and protective covenants granted subsequent to the lien of the deed of trust that the mortgagee would want to preserve. The foreclosure sale, however, may extinguish these subordinate rights, interests, easements, and covenants unless the trustee and the beneficiary take steps before the foreclosure sale to preserve them. If the mortgagee has not expressly ratified subsequent-in-time restrictive covenants imposed on the mortgaged property or subordinated its lien thereto, purchasers from

the mortgagor may claim that the foreclosure sale extinguished such restrictions. See *Remberk v. Wood*, 41 S.W. 525 (Tex. Civ. App. 1897, writ ref'd) (involved judicial foreclosure where mortgagee took no steps to preserve valuable water and access easement). In holding that the foreclosure extinguished the easement, the court stated:

[W]hen Mrs. Remberk foreclosed her mortgage, in order to have preserved her water rights or easement in the premises sold, she should have set them up in her pleadings, and had the decree of foreclosure to show that the estate ordered to be sold was burdened with such easement, and had the property sold subject to it. Failing in this, she is estopped from asserting such a claim, because, when she sold under her mortgage, she, having this water right and being a party to the suit, sold not only all the estate which the mortgagor, Hamlin, had in the property at the date of the mortgage, but also all the estate which her testator has therein, or acquired afterwards, up to the date of foreclosure; and the purchaser at such sale gets the title as it existed at the time the mortgage was executed, unless it is foreclosed subject to subsequent encumbrances.

Id. at 527; *cf. Smith v. Harris*, 311 P.2d 325 (Kan. 1957) (court held that driveway easement appurtenant to mortgaged property continued in effect for benefit of purchaser at foreclosure sale, even though grant of easement was inferior in time to deed of trust and was not mentioned in foreclosure sale deed). *Motel Enterprises v. Nobani*, 784 S.W.2d 545 (Tex. App.—Houston [1st Dist.] 1990, no writ) -- case remanded for determination of fact issue as to whether purchaser at foreclosure sale had ratified subordinate easement. Trustee's deed which conveyed property "subject to any and all ... easements ... to the extent, and only to the extent, that the same may still be in force and effect," did not constitute a ratification of the junior easement.

If the subordinate rights, interests, easements, or covenants are not beneficial in the judgment of the mortgagee or foreclosure sale bidder, the mortgagee should consider promptly disclaiming the continuation of such rights. The foreclosure

sale deed should not list these items. But if they are beneficial to the mortgaged property, the mortgagee should consider stating in the foreclosure sale deed that the mortgaged property is being conveyed subject to the restrictive covenants or other rights. The foreclosure sale deed might also recite that the foreclosure sale does not extinguish the specific instrument to be carried forward.

3.8 Environmental Issues

In general, federal and state environmental liability laws are not fault-based as in common law. Under these laws liability is based on one's status in relation to the property or activities associated with the property. Liability is strict and without fault as applied to persons that are or deemed to be "owners," "operators," "generators," or "transporters." Secured creditors under this approach may be deemed to have an "indicia of ownership" or to have "participated in management" and be deemed to be an "owner." Persons who are deemed "owners" or "operators" of contaminated property are strictly liable, jointly and severally with the record owner of the property. Strict liability applies whether or not the owner, operator, deemed owner, or deemed operator had anything to do with the presence of the contamination on the property, or whether the contamination originated on the property or from some other source.

Federal Regulation

The Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA), as amended in 1986 by the Superfund Amendments and Reauthorization Act (SARA), 42 U.S.C.A. §§ 9601-9675 (West 1995 & Supp. 2004), imposes strict and joint and several liability upon persons classified under the statute as "**responsible parties**" for cleanup costs for hazardous waste sites. See 42 U.S.C.A § 9601 (West 1995 & Supp. 2004). Responsible parties include the "owner or operator" of the site and a "generator or transporter" of hazardous waste. See 42 U.S.C.A §§ 9601(20), 9607(a)(1) (West 1995 & Supp. 2004). The owner or operator of a contaminated site is deemed to be a responsible party even though the contamination occurred without its fault and even if the contamination occurred without its knowledge. *New York v. Shore Realty Corp.*, 759 F.2d 1032, 1044 (2nd

Cir. 1985); *United States v. Conservation Chemical Co.*, 619 F.Supp 162 (W.D. Mo. 1985).

Secured Creditor Exemption. CERCLA exempts from the definition of "owner or operator" any "person, who without participating in the management of a ... facility, holds *indicia of ownership* primarily to protect his security interest in the ... facility." 42 U.S.C.A. § 9601(20)(A) (West Supp. 2004). Therefore, a secured creditor needs to establish that it has not "participated in the management" of the borrower in order to avoid being classified as an "owner or operator". Some cases prior to the 1996 amendments to CERCLA interpreted the secured creditor exemption narrowly and extended CERCLA liability to creditors exercising traditional measures designed to ensure loan payment or collateral protection.

The court in *United States v. Maryland Bank and Trust Co.*, 632 F. Supp. (D. Md. 1986) held that a lender, which acquired property through foreclosure, became an "owner" and became "responsible person" with CERCLA liability and strictly liable for the borrower's activities, if the property were contaminated at the time the lender acquired title to the property. Previously in 1985 a federal district court in *United States v. Mirabile*, 15 Env'tl. L. Rep. 20994 (E.D. Pa. 1985) found a lender to have participated in the operation of the facility and was an "operator" under CERCLA, though no foreclosure had occurred, and was an "operator" will full Superfund legal exposure. In 1990 the Eleventh Circuit Court of Appeals *United States v. Fleet Factors Corp.*, 901 F.2d 1550 (11 Cir. 1990), *cert. denied*, 111 S.Ct. 752 (1991) held that "a secured creditor will be liable if its involvement with the management of the facility is sufficiently broad to support the inference that it could affect hazardous waste disposal decisions if it so chose." *Id.* The court stated that CERCLA liability would extend to the creditor even if the creditor had not participated in the day-to-day operations of the facility, so long as the creditor could influence hazardous waste disposal decisions.

EPA "Safe Harbor" Rule.

Thereafter in 1992, in response to political pressure, the Environmental Protection Agency ("EPA") issued a rule (known as the "*Lender Liability Rule*" or "*Safe Harbor Rule*") defining certain activities pre-foreclosure as not

constituting participation in management and establishing criteria for lenders to follow post foreclosure in order to avoid CERCLA liability for pre-existing contamination. 57 Fed. Reg. 18344 (April 29, 1992), codified at 49 C.F.R. §300.1100. The EPA Lender Safe Harbor Rule was held not to be within the authority of the EPA under the rule making authority granted to the EPA by CERCLA in *Kelley v. EPA*, 15 F.3d 1100 (D.C. Cir. 1994), *cert denied* (1995). For additional reading on the EPA "Safe Harbor" Rule, see Heath, *The EPA's Final Rule on the Security Interest Exemption Under CERCLA*, 26th ANNUAL MORTGAGE LENDING INSTITUTE (1992).

Legislative Safe Haven. Congress responded in 1996 by amending CERCLA to provide a "safe haven" for secured creditors in many common situations. Asset Conservation, Lender Liability and Deposit Insurance Protection Act of 1996, Title II, Subtitle E of Pub. L. No. 104-208, 110 Stat. 309 (1996). Congress defined "*participation in management*" of real property as follows:

(i) the term "participate in management" —

(a) means actually participating in the management or operational affairs of ... facility; and

(b) does not include merely having the capacity to influence, or the unexercised right to control, ... facility operations;

(ii) a person that is a lender and that holds indicia of ownership primarily to protect a security interest in a ... facility shall be considered to participate in management only if, while the borrower is still in possession of the ... facility encumbered by the security interest, the person—

(a) exercises decision making control over the environmental compliance related to the ... facility, such that the person has undertaken responsibility for the hazardous substance handling or disposal practices related to the ... facility; or

(b) exercises control at a level comparable to that of a manager of the ... facility, such that the person has assumed or manifested responsibility —

1. for the overall management of the ... facility encompassing day-to-day decision making with respect to environmental compliance; or

2. over all or substantially all of the operational functions (as distinguished from financial or administrative functions) of the ... facility other than the function of environmental compliance;

(iii) the term "participate in management" does not include performing an act or failing to act prior to the time at which a security interest is created in a ... facility; and

(iv) the term "participate in management" does not include —

(a) holding a security interest or abandoning or releasing a security interest;

(b) including in the terms of an extension of credit, or in a contract or security agreement relating to the extension, a covenant, warranty, or other terms or condition that relates to environmental compliance;

(c) monitoring or enforcing the terms and conditions of the extension of credit or security interest;

(d) monitoring or undertaking 1 or more inspections of the ... facility;

(e) requiring a response action or other lawful means of addressing the release or threatened release of a hazardous substance in connection with the ... or facility prior to, during, or on the expiration of the term of the extension of credit;

(f) providing financial or other advice or counseling in an effort to mitigate, prevent, or cure default or

diminution in the value of the ... facility;

- (g) restructuring, renegotiating, or otherwise agreeing to alter the terms and conditions of the extension of credit or security interest, exercising forbearance;
- (h) exercising other remedies that may be available under applicable law for the breach of a term or condition of the extension of credit or security agreement; or
- (i) conducting a response action under section 9607(d) of this title or under the direction of an on-scene coordinator appointed under the National Contingency Plan, if the actions do not rise to the level of participating in the management (within the meaning of clauses (i) and (ii)).

42 U.S.C.A. § 9601(20)(F) (West Supp. 2004).

Although arising before the 1996 amendments to CERCLA, some guidance may still be found in the decisions of various courts after the invalidation of the EPA "Safe Harbor" Rule, holding certain actions of lenders as not triggering lender liability. *Z & Z Leasing, Inc. v. Graying Reel Inc.*, No. 94-73636-DT (E.D. Mich. 1995)—the court held that lender's ordering of an environmental assessment, the removal of underground storage tanks, contacting state environmental authorities concerning contamination at the property and requiring compliance with environmental laws was insufficient to render the lender an "owner" or "operator" under CERCLA; *Waterville Indus. v. Finance Auth. of Me.*, 984 F.2d 549 (1st Cir. 1993)—the court held "... so long as the secured party makes a reasonably prompt effort to divest itself of its unwelcome ownership, we think continued coverage under the exception serves its basic policy: to protect *bona fide* lenders and to avoid imposing liability on owners who are not in fact seeking to profit from the investment opportunity presented by prolonged ownership."); *Northeast Doran, Inc. v. Key Bank of Maine*, 15 F.3d 1 (1st Cir. 1994)—the court held that a secured lender which purchased the property at its foreclosure sale and failed to disclose to the person to whom it later sold the property that it had discovered after foreclosure that the groundwater was contaminated, was not liable to indemnify the purchaser as the lender never became an "owner" and so Section 9601(35)(C) of CERCLA did not apply; and *U.S. v. McLamb*, 5 F.3d 69 (4th Cir. 1993)—which involved a suit by purchaser that purchased property from a lender after it had foreclosed on it, which was determined to be contaminated after the purchase; the court held that lenders who take "prompt action" to sell the property and who do not develop or manage the property in the interim are not liable for cleanup costs due to the security interest exemption).

For other pre-1996 cases dealing with a lender's potential liability for remediation costs, see *Ashland Oil v. Sonford Prods. Corp.*, 810 F. Supp. 10557 (D. Minn. 1993)(concerning the definition of "owner"); *Cuyahoga Equip. Corp.*, 980 F.2d 110 (2nd Cir. 1992); Grantors to the *Silresium Trust v. State Bank & Trust Co.*, 23 ER 2222, Docket No. 88-1324 (D. Mass. 1992); *Kelley v. Tiscornia and Manufacturers Nat'l Bank of Detroit*, 810 F.Supp. 901 (M.D. Mich. 1993) (concerning the definition of participation in management); *McGuire v. Sigma Coatings, Inc.*,

1993 WL 329982 (D. D. La. 1993); and *Reading Co. v. City of Philadelphia*, 155 B.R. 890 (E.D. Pa. 1993).

A conservative approach for a secured lender is to try to avoid CERCLA liability even under the *Fleet* Factors "capacity to influence" standard. To do so a lender must not only avoid participating in the day-to-day operational management of the borrower, it must also avoid conduct that could evidence significant participation in the financial management of the borrower. If the mortgaged property is significantly contaminated, then the lender may choose not to foreclose so as to avoid being an "owner".

Federal "Innocent Purchaser" Protection and "The Federal Brownfields Law"

As to commercial property, CERCLA provides a defense to liability to a potentially responsible party if it can establish that at the time of acquisition it had undertaken "all appropriate inquiries" into the "previous ownership and uses of the property in accordance with generally accepted good commercial and customary standards and practices; and the defendant took reasonable steps to – (1) stop any continuing release; (2) prevent any threatened future release; and (3) prevent or limit any human, environmental, or natural resource exposure to any previously released hazardous substance. 42 U.S.C.A. § 9601(35)(B) (West Supp. 2004); see also 42 U.S.C.A. § 9607(b)(3) (West 1995); *Fina, Inc. v. ARCO*, 200 F.3D 266 (5th Cir. 2000). For nonresidential properties purchased after May 31, 1997, CERCLA requires the use of procedures developed by the American Society for Testing and Materials ("ASTM"), including ASTM's Standard E1527-97, entitled "Standard Practice for Environmental Site Assessment: Phase I Environmental Site Assessments Process." 42 U.S.C.A. § 9601(35)(B)(iv)(II) (West Supp. 2004). Since adoption of this section of CERCLA ASTM has updated its standard by issuance of E1527-00, resulting in EPA's issuance of a "Clarification to Interim Standards and Practices for All Appropriate Inquiry Under CERCLA and Notice of Future Rulemaking Action," Volume 68, Fed. Reg., No. 9, p. 24888 (May 9, 2003) and an article titled "Overview of Additions and Modification to ASTM 1527-2000 Standard from ASTM Standard 15276-97." As to residential property, "all appropriate inquiries" means conducting an

inspection and title search that reveal no basis for further investigation. See 42 U.S.C.A. § 9601(35)(B)(v) (West Supp. 2004).

The 2002 Small Business Liability and Revitalization Act, Pub. No. 107—118 (January 11, 2002), and the portion thereof titled, the "Brownfields Revitalization and Environmental Restoration Act" or "BRERA" aka "The Federal Brownfields Law," was adopted with the goal of encouraging the redevelopment of "Brownfield sites" and creating clarity with respect to the level of due diligence required to qualify for CERCLA's "innocent purchaser" defense. This law directed EPA to promulgate regulations to address the required due diligence. Further regulations defining "all appropriate inquiry" are currently pending with EPA. The Federal Brownfields Law has also extended the concept of potentially protected owners to "contiguous property owners" (defined at 42 U.S.C.A. § 9607(q) (West Supp. 2004)) and "bona fide prospective purchasers" (defined at 42 U.S.C.A. §§ 9601(40), 9607(r) (West Supp. 2004). A "bona fide prospective purchaser" is a person or the tenant of a person who acquires a site after January 11, 2002, is not the party or affiliate of a party that did the release of the pollution on the site, does an investigation which makes "all appropriate inquiries" and if something is found tells the EPA about it, and cooperates with the clean up of the property by an agency. The owner who fulfills the statutory requirements of this program and its tenants are exempted from liability for the known pollutants, but a lien is imposed on the property for the amount which the clean up adds to the fair market value of the property, to be paid at sale or until the cost of the cleanup is recovered. See 42 U.S.C.A §§ 9601(40), 9607(r) (West Supp. 2004).

Asbestos

The U.S. Occupational Health and Safety Administration ("OSHA") published its final rule on Occupational Exposure to Asbestos in 1994 (the "*Final Rule*"). 59 Fed. Reg. 40963 (August 10, 1994). OSHA has published an Interpretative Regulation at 60 Fed. Reg. 33974 (June 29, 1995). In Texas, asbestos regulation is under the Department of State Health Services (formerly the Texas Department of Health). See 25 Tex. Admin Code § 295.31. Texas' regulations apply to all buildings which

are subject to public occupancy and to all individuals and organizations involved in removing or encapsulating asbestos. An asbestos survey is required before a municipality may issue a permit to renovate or demolish a "commercial" or "public" building. 25 Tex. Admin. Code § 295.32.

All buildings constructed before January 1, 1981 must, be presumed to have asbestos containing building materials in all resilient flooring, thermal insulation material and spray-on or troweled-on wall and ceiling surfaces ("*presumed asbestos*"). An owner of a pre-1981 building must manage the building and its employees as if the building contains asbestos until it is certified not to contain asbestos by a certified an asbestos expert as not containing asbestos under the Final Rules' more stringent testing standards. Under the Final Rule the seller of a pre-1981 building must notify the buyer of the presence of and location of any asbestos containing materials ("*ACMs*") known to the seller, based on "available" information. The Final Rule requires that the seller maintain and transfer to the buyer records of work performed at the site, the location and quantity of asbestos or assumed asbestos remaining at the completion of work, and data supporting any rebuttal of the presumption that ACM exists in the building.

For further information, contact Texas Department of State Health Services, Asbestos Programs Branch, 1100 W. 49th St., Austin, Texas 78756 800-572-5548 or see <http://www.tdh.state.tx.us.beh/asbestos.htm>. [will need to verify this web address]

Lead-Based Paint

Beginning in 1995, there took effect a broad range of disclosure and abatement requirements as to lead-based paint in "*target housing*," residential housing built before 1978. See Residential Lead-Based Paint Hazard Reduction Act of 1992, codified at 42 U.S.C.A. § 4851 *et seq.* (West 2003). Any tenant or purchaser of target housing must be provided with a copy of a lead paint pamphlet prepared by EPA and HUD and must also receive a written lead warning statement reciting the statutory warning. Any historical reports or studies done of the property relating to the presence of lead-based paint must be disclosed to the tenant or purchaser. The tenant or purchaser must be given an opportunity to conduct their own risk

assessment before being bound to purchase the property. Contact the Government Printing Office, Superintendent of Documents, Mail Stop XXX, Washington, D.C. 20402-9328. EPA TSCA hotline at 202-554-1404.

The Regulations exclude informal rental agreements, such as oral tenancies, and commercial lodging facilities such as hotels, motels and inns. These Rules provide that foreclosure sales will be exempt from the disclosure requirements due to the typical lack of information possessed by lenders about mortgaged property as of foreclosure. It is recommended that a foreclosing lender attempt to make such disclosures due to the acknowledged health hazards involved with lead-based paint.

State Regulations

Nuisance

A foreclosing lender may find itself the new owner of a common law or statutory nuisance. Tex. Civ. Prac. & Rem. Code Ann. §§ 125.0001-.002 (Vernon 1997).

Texas Superfund and the Secured Creditor Exemption

In 1985 the Texas Solid Waste Disposal Act ("*TSWDA*") was amended to create the Texas Superfund Program. See Tex. Health & Safety Code Ann. § 361.343 (Vernon 2001). In 1997 the Texas legislature enacted certain protections for secured creditors from state Superfund liability. See Tex. Health & Safety Code Ann. §§ 361.271(f), 361.701—703 (Vernon 2001). Although these protections were patterned after the 1996 federal statutory changes to CERCLA, there are important differences. Under the Texas rule, a secured lender is required to sell, re-lease the foreclosed upon property, or undertake a government-approved cleanup plan within "*a commercially reasonable time*." A lender is presumed to have divested itself of the property "*within a commercially reasonable time*" if it advertises the property for sale within 12 months after foreclosure. Tex. Health & Safety Code Ann. § 361.702(a)-(c) (Vernon 2001).

Texas UST Regulated Lender Exemption

In 1995, pursuant to H.B. 2587, Section 26.3514 of the Texas Water Code was amended to

provide that certain regulated lenders, such as banks, savings and loans and credit unions but not individuals, insurance companies, REITs, pension funds and other lenders not within the statutory definition, are exempted from clean-up liability for leaky underground storage tanks on the mortgaged property, if the regulated lender did not participate in the management of the site, and if they establish that their ownership after foreclosure continues to be consistent with holding the property primarily to protect their security interest. See Tex. Water Code Ann. § 26.3514 (Vernon 2000).

In order to qualify for this exemption, the regulated lender who forecloses on property must be sure to list the property for sale within 12 months of foreclosure, and accept or consider *bona fide* offers made for the property which would permit the lender to recover its debt. If a lender refuses to sell the foreclosed upon property to a purchaser who offers the full amount of the lender's debt, the lender will lose the protections of the exemption and will be considered to be holding the property primarily for investment purposes, not primarily for purposes of protecting its security interest.

"Brownfields," Innocent Owners, and State Approved Voluntary Cleanup Program

In 1997, Subchapter V, Immunity from Liability of Innocent Owner or Operator, was added to the Texas Solid Waste Disposal Act ("TWSDA"). See Tex. Health & Safety Code Ann. §§ 361.751--754 (Vernon 2001). The TWSDA authorizes the Texas Commission on Environmental Quality ("TCEQ") to issue an IOP Certificate that declares that a person is an innocent owner or operator, and not responsible for an environmental problem described in the Certificate. An applicant must establish that their property has become contaminated as a result of a release or migration of contaminants from a source not located on the applicant's property, and that they did not cause or contribute to the source of the problem. This protection is available "if after appropriate inquiry consistent with good commercial or customary practice, the person did not know or have reason to know of the contamination at the time the person acquired the property." See Tex. Health & Safety Code Ann. § 361.752(b) (Vernon 2001). IOP Certificates are not transferable. See TCEQ's website for program requirements at

www.tnrcc.state.tx.us/permitting/remed/vcp/iop.html.

In 1995, Subchapter S, Voluntary Cleanup Program, was added to the Health and Safety Code. The VCP enables private property owners, including foreclosing lenders, to negotiate a voluntary clean-up of contaminated sites in order to achieve a release from liability for subsequent owners or lenders of a contaminated site. See Tex. Health & Safety Code Ann §§ 361.601—613 (Vernon 2001) This legislation is referred to as "brownfields" legislation. It helps to make formerly-contaminated property more marketable. Upon satisfaction of a cleanup plan approved by TCEQ, it issues a Final Certificate of Completion, which results in TCEQ being bound to the legal conclusion that the site clean up is finished (at least to the extent of the contamination identified in the plan). While in the VCP, the current owner of the property is free from VCP enforcement actions. There is a Memorandum of Understanding between TCEQ and EPA – Region 6 providing that the EPA will generally not pursue enforcement actions on properties in the VCP. Note that purchasers must be placed on the VCP application prior to purchase of the contaminated property or they will need to wait until a Certificate of Completion or Conditional Certificate of Completion is issued in order to be eligible for liability waiver. Future owners or lenders will not be subject to cleanup liability for prior contamination, the subject of the Certificate, should it later be determined that the contamination was not properly remediated. However, Subchapter S does not address potential tort liability of the property owner to third parties. See TCEQ's website for program requirements and the form of the Final Certificate of Completion.

www.tnrcc.state.tx.us/permitting/remed/vcp.

Contact Jay Carsten, Head of TCEQ VCP/IOP, 512/239-5873 jcarsten@tceq.state.tx.us or Mike Frew, VCP Brownfields Coordinator, 512/239-5837 mfrew@tceq.state.tx.us.

Dry Cleaner Program

In 2003 the legislature enacted the Dry Cleaner Environmental Response Act to facilitate the clean up of property contaminated by the operation of dry cleaners See Tex. Health & Safety Code Ann §§ 374.001--253 (Vernon Supp. 2004). The law establishes a TCEQ-

administered fund available for TCEQ conducted corrective actions. Applicants must have been the owner of the contaminated site for not less than 5 years. See TCEQ's website for Dry Cleaner Remediation Program requirements at www.tnrcc.state.tx.us/permitting/rem/dry_cleaners/index.

Oil and Gas

In addition to TCEQ's VCP Program, the Railroad Commission has a VCP Program applicable to voluntary clean up of contamination arising from oil and gas exploration, production and transportation, including pipelines. There is a Memorandum of Understanding between TCEQ and RRC regarding the division of authority between these agencies. Unlike TCEQ's VCP, a person who is responsible for the contamination is not eligible to enter contaminated property into the RRC VCP Program.

See

http://www.rrc.state.tx.us/divisions/og/site_rem/VoluntaryCleanupProgram.html

or contact Aimee Beveridge 512/463-7995
aimee.beveridge@rrc.state.tx.us

or Byron Ellington 512/463-5983
byron.ellington@rrc.state.tx.us

Foreclosure Strategies

Given the current state of environmental laws, the following are strategies that might be followed by a mortgagee.

1. Inspection. If possible, the mortgagee should conduct a Phase I ESA of the mortgaged property. In order to inspect the property, the lender will have to obtain the cooperation of the owner of the property in gaining peaceable entry to the property. If the mortgagor refuses to cooperate, the lender may be able to obtain an injunction permitting entry for the purpose of having an ESA conducted. *RTC v. Polmar Realty, Inc.*, 780 F.Supp. 177 (S.D.N.Y. 1991)—granting an injunction so as to permit the mortgagee entry to conduct an ESA where the mortgage contained a clause permitting the lender the right to inspect the property upon the occurrence of a default on the loan; and *First Capital Life Ins. Co. v. Schneider, Inc.*, ___ A.2d ___ 1992 WL 101304 (Pa. Super. Ct. 1992)—holding that the inspection clause did

not allow for Phase II ESA since it would involve digging of holes in the property, conducting subsurface tests and leaving a groundwater monitoring well, but found that the "reentry to protect the security after default" clause was sufficient. Standards for such environmental site assessments are in an evolutionary process as to the standards for inquiry.

Unless the costs of the Phase I and II ESAs are listed in the deed of trust as being a cost of sale or as a secured debt if incurred by the mortgagee, there is authority that such costs are not covered by the deed of trust. *Norwest Bank Indiana v. Friedline*, 591 N.E.2d 599 (Ind. App. 3 Dist. 1992). The State Bar's form for deed of trust does not refer to the cost of an ESA as being either a cost of sale or a secured debt.

2. Sale of Loan. If the mortgaged property is contaminated and the mortgagee has an interested buyer, it might negotiate the sale of the loan to the buyer.

3. Partial Foreclosure. If the loan documents permit, the mortgagee might elect to foreclose on the portion of the mortgaged property which is not contaminated.

4. Notice to Governmental Agencies. The mortgagee might contact the governmental agencies responsible for enforcing clean up actions and report the contamination. It is possible that these agencies will undertake their own clean up actions that result in the mortgaged property being cleaned up prior to the mortgagee's foreclosure or can pressure the mortgagor into clean up actions. The mortgagee may also be able to structure a clean up plan with the agencies under one of the "Brownfield" type initiatives that minimize owner or operator liability to the lender.

5. Receivership or Injunction. The lender might seek a receiver to be appointed for the property to undertake actions to reduce waste to the mortgaged property or injunctive relief in support of the loan document covenants.

6. **Foreclosure.** The mortgagee might elect to foreclose its lien and try to avoid becoming an "owner", "operator" or "generator" as defined under the various environmental laws by complying with the statutory exemptions for qualifying foreclosing lenders.

The foreclosing lender and the trustee conducting the sale, which have knowledge of apparent contamination is faced with the dilemma of whether to disclose their knowledge, to prospective bidders at the sale. In *Karoutas v. HomeFed Bank*, 232 Cal. App. 3d 767, 283 Cal. Rptr. 809 (Cal. 1991), the court permitted the successful bidder at a foreclosure sale to recover damages from the lender by finding that the lender had violated a common law duty to disclose known defects.

A lender's attempts to set aside or rescind its foreclosure sale due to its discovery after the sale of pre-foreclosure contamination probably will not be successful. *Horicon State Bank v. Kant Lumber, Inc.*, 478 N.W.2d 26 (Wis. Ct. App. 1991).

4. Trustees, Substitute Trustees, and Agents

4.1 Appointment of the Trustee

The designation of the trustee, with powers and the authority to delegate duties or to operate through agents, is governed by the provisions of the deed of trust. As the party granting the power of sale, the mortgagor designates the initial trustee and defines the trust reposed in the trustee as well as the trustee's powers and duties. The contract with the trustee, contained in the deed of trust, defines which, if any, of the trustee's powers and duties may be delegated to another person and the standard of care the trustee shall exercise in carrying out those powers and duties.

The mortgagee is referred to in most deeds of trust as the beneficiary of the trust. Because the mortgagee generally has greater bargaining power, the deed of trust is drafted by the mortgagee's lawyer, and a person of the mortgagee's choosing, usually the lawyer or an officer of the lender or the lender itself, is appointed the trustee.

Texas courts have consistently held that the conflict of interest thus created is not significant enough to bar the mortgagee or its officer or

attorney from acting as the trustee. *Valley v. Patterson*, 614 S.W.2d 867 (Tex. Civ. App.—Corpus Christi 1981, no writ); *Donaldson v. Mansel*, 615 S.W.2d 799 (Tex. Civ. App.—Houston [1st Dist.] 1980, writ ref'd n.r.e.); *Heiner v. Homeland Realty Co.*, 100 S.W.2d 793 (Tex. Civ. App.—Waco 1936, no writ). Even though the deed of trust provides that the trustee is to be paid a commission for acting as the trustee in conducting the foreclosure on the deed of trust, the mortgagor has not purchased "foreclosure services" and is not therefore a consumer under the DTPA. *First State Bank v. Keilman*, 851 S.W.2d 914 (Tex. App.—Austin 1993, writ denied).

The trustee can enter bids at the foreclosure sale as agent for the mortgagee. *Valley International Properties v. Ray*, 586 S.W.2d 898, 902 (Tex. Civ. App.—Corpus Christi 1979, no writ).

4.2 Powers and Duties of the Trustee

The powers and duties of the trustee are stated in the deed of trust. The *Texas Real Estate Forms Manual's* form for deed of trust sets forth the trustee's role as follows:

If directed by Lender to foreclose this lien, Trustee will—

1. either personally or by agent give notice of the foreclosure sale as required by the Texas Property Code as then in effect;
2. sell and convey all or part of the Property "AS IS" to the highest bidder for cash with a general warranty binding Grantor, subject to the Prior Lien and to the Other Exceptions to Conveyance and Warranty and without representation or warranty, express or implied, by Trustee;
3. from the proceeds of the sale, pay, in this order—
 - a. expenses of foreclosure, including a reasonable commission to Trustee;
 - b. to Lender, the full amount of principal, interest, attorney's fees, and other charges due and unpaid;
 - c. any amounts required by law to be paid before payment to Grantor; and

d. to Grantor, any balance; and

4. be indemnified, held harmless, and defended by Lender against all costs, expenses, and liabilities incurred by Trustee for acting in the execution or enforcement of the trust created by this deed of trust, which includes all court and other costs, including attorney's fees, incurred by Trustee in defense of any action or proceeding taken against Trustee in that capacity.

Texas Real Estate Forms Manual, State Bar of Texas, ch. 15, form 15-1 (1999).

This form for deed of trust places three duties on the trustee: (1) to give notice of the foreclosure sale as required by the Texas Property Code, (2) to sell and convey the property pursuant to the foreclosure sale, and (3) to pay from the proceeds of the sale certain expenses, commissions, principal and interest secured by the deed of trust, fees, and any amounts required by law to be paid before payment to the grantor with any balance to the grantor.

The *Texas Real Estate Forms Manual's* form for deed of trust specifies only that the duty of giving notice of the foreclosure sale may be carried out by an agent.

The trustee assumes a separate legal capacity from those of the mortgagor and the mortgagee, with duties to both. The trustee is the special agent of both parties to the deed of trust, subsequent purchasers of the mortgaged property, and subsequent holders of the secured debt. See *Hampshire v. Greeves*, 143 S.W. 147 (Tex. 1912).

The trustee must act for both parties in "the utmost good faith and the strictest impartiality." *Hampshire*, 143 S.W. at 151; see also *Jinkins v. Chambers*, 622 S.W.2d 614 (Tex. App.—Tyler 1981, no writ).

The mortgagor should be able to expect more care, effort, and impartiality from the trustee at the present than the mortgagor could in the past in light of the trustee's fee now provided in most deeds of trust. The trustee is not personally liable for the return of foreclosure sale proceeds that the trustee has distributed in accordance with the deed of trust. *Graham v. Pazos De La Torre*, 821 S.W.2d 162 (Tex. App.—Corpus Christi 1991, no writ)—foreclosure sale set aside due to bankruptcy of mortgagor unknown to

trustee and mortgagee at time of sale; also resale by foreclosure sale purchaser to third party set aside and resale price ordered returned. However, the trustee has also been characterized as the general agent of the mortgagee. In *Matthews v. AmWest Savings Association*, 825 S.W.2d 522 (Tex. App.—Beaumont 1991, no writ) the court found that a fact question as to the apparent authority of the trustee to act for the mortgagee in inducing a bidder to withdraw its bid based on the trustee's promise that the mortgagee would sell the property to the bidder after the sale. The court characterized the trustee, also a lawyer representing the mortgagee, as the general agent of the mortgagee clothed with the apparent authority to make such promises. The court rejected characterizing the trustee as a special agent without such apparent authority.

4.3 Sale by Person Other Than Designated Trustee or Substitute Trustee

A foreclosure sale conducted by anyone other than the person designated in the deed of trust as the trustee or the duly appointed substitute trustee is void. *Sullivan v. Hardin*, 102 S.W.2d 1110 (Tex. Civ. App.—Amarillo 1937, no writ). The power of sale, unless authorized by the deed of trust, cannot be delegated to another. *Hazleton v. Holt*, 285 S.W. 115 (Tex. Civ. App.—Amarillo 1926, writ dismissed w.o.j.). Most forms of deed of trust do not place on the trustee or the substitute trustee a duty to act before a formal request to act from the beneficiary. The deed of trust may require that the request to act be in writing; in most cases the better practice is to have the request to act reduced to writing.

4.3:1 Original Holder Versus Subsequent Holder

Most deed of trust forms provide that the holder of the debt secured by the lien is authorized to request the trustee to hold the foreclosure sale. However, if the deed of trust provides that only the original mortgagee is so authorized, then he must do so even if he is no longer a holder of the secured debt. *Davis v. Volunteer State Life Insurance Co.*, 135 S.W.2d 588 (Tex. Civ. App.—Texarkana 1939, writ refused); *Rawlings v. Lewis*, 191 S.W. 784 (Tex. Civ. App.—Amarillo 1917, writ refused).

4.3:2 Multiple Holders of the Note and Multiple Notes Held by Multiple Holders

All holders of an interest in the indebtedness at the time of the default are required to join in the request to the trustee to act, unless the deed of trust provides to the contrary. See *Rogers v. Boykin*, 298 S.W.2d 199 (Tex. Civ. App.—Eastland 1956, writ ref'd n.r.e.). A good practice is to employ some objective method, rather than unanimous approval, to determine if the trustee is to be requested to act.

A conflict of interest or difference in judgment may arise between multiple noteholders. The lawyer for one of the noteholders may also be placed in a conflict of interest in being the trustee as well as the lawyer for one but not all of the noteholders.

4.3:3 Collateral Assignee of Note

A collateral assignee holding a collaterally assigned and duly endorsed note is deemed the proper party to request the trustee to act. *Lawson v. Gibbs*, 591 S.W.2d 292 (Tex. Civ. App.—Houston [14th Dist.] 1979, writ ref'd n.r.e.). In determining who had the authority to appoint a substitute trustee, courts have held that the failure to have the payee endorse the note to the collateral assignee resulted in the payee (and not the collateral assignee) being the person required to appoint the substitute trustee. *Merit Homes, Inc. v. Alltex Mortgage Co.*, 402 S.W.2d 943 (Tex. Civ. App.—Texarkana 1966, writ ref'd n.r.e.); *Busbice v. Hunt*, 430 S.W.2d 291 (Tex. Civ. App.—Tyler 1968, writ ref'd n.r.e.). The *Texas Real Estate Forms Manual* contains a form for collateral transfer of note and lien. See *Texas Real Estate Forms Manual*, ch, 16, form 16-8 and sections 16.19 and 21.11.

4.3:4 Corporate Holders

Corporate beneficiaries should exercise their powers in the same manner as they do in any other corporate action concerning real estate. *Chandler v. Guaranty Mortgage Co.*, 89 S.W.2d 250 (Tex. Civ. App.—San Antonio 1935, no writ); *Thomason v. Pacific Mutual Life Insurance Co. of California*, 74 S.W.2d 162 (Tex. Civ. App.—El Paso 1934, writ ref'd).

4.4 Appointment of Substitute Trustee

The power to appoint a substitute trustee in place of the trustee designated by the mortgagor in the deed of trust must be expressly stated in the deed of trust and is strictly construed. Any attempt to appoint a substitute trustee contrary to the provisions of the deed of trust is invalid. *Johnson v. Koenig*, 353 S.W.2d 478 (Tex. Civ. App.—Austin 1962, writ ref'd n.r.e.).

4.4:1 Proper Person To Appoint Substitute Trustee

Only the person designated in the deed of trust may appoint a substitute trustee.

4.4:2 Original Holder or Subsequent Holder

Most deed of trust forms designate the beneficiary as the person who may appoint a substitute trustee and define the term *beneficiary* as the current holder of the secured debt. The power of sale granted by the deed of trust to any subsequent holder of the secured indebtedness has been upheld. *Lawson v. Gibbs*, 591 S.W.2d 292 (Tex. Civ. App.—Houston [14th Dist.] 1979, writ ref'd n.r.e.). However, if the deed of trust does not provide for this power to be exercised by a subsequent holder of the debt, the original mortgagee must join in the appointment. See *Davis v. Volunteer State Life Insurance Co.*, 135 S.W.2d 588 (Tex. Civ. App.—Texarkana 1939, writ ref'd); *Rawlings v. Lewis*, 191 S.W. 784 (Tex. Civ. App.—Amarillo 1917, writ ref'd).

The *Texas Real Estate Forms Manual's* deed of trust provides under the beneficiary's rights that the beneficiary "may appoint in writing a substitute trustee, succeeding to all rights and responsibilities of Trustee." *Texas Real Estate Forms Manual*, ch, 15, form 15-1. Under the general provisions, the form states: "This deed of trust binds, benefits, and may be enforced by successors in interest of all parties." *Texas Real Estate Forms Manual*, ch, 15, form 15-1

Presumably a subsequent holder of the secured debt is a "successor in interest" of the person named in the deed of trust as the beneficiary.

The prior versions of the *Texas Real Estate Forms Manual's* deed of trust provided that the beneficiary is the holder (whether one or more)

of the secured indebtedness and contained the following lengthier power of appointment:

Beneficiary in any event is hereby authorized to appoint a substitute trustee, or a successor trustee, to act instead of the Trustee named herein without other formality than the designation in writing of a substitute or successor trustee; and the authority hereby conferred shall extend to the appointment of other successor and substitute trustees successively until the indebtedness hereby secured has been paid in full, or until said property is sold hereunder, and each substitute and successor trustee shall succeed to all of the rights and powers of the original trustee named herein.

Texas Real Estate Forms Manual, at 7C (1976 & Supp. 1982).

These earlier versions define the beneficiary as the holder of the indebtedness secured by the deed of trust.

4.4:3 Collateral Assignee of Note

Assuming that the deed of trust provides that the current holder of the secured debt may appoint a substitute trustee, the collateral assignee of a duly endorsed note is deemed to be the holder with the authority to appoint the substitute trustee. *Lawson v. Gibbs*, 591 S.W.2d 292 (Tex. Civ. App.—Houston [14th Dist.] 1979, writ ref'd n.r.e.). However, cases have held that the failure to have the payee endorse the note to the collateral assignee resulted in the payee (and not the collateral assignee) being the person required to appoint the substitute trustee. *Busbice v. Hunt*, 430 S.W.2d 291 (Tex. Civ. App.—Tyler 1968, writ ref'd n.r.e.); *Merit Homes, Inc. v. Alltex Mortgage Co.*, 402 S.W.2d 943 (Tex. Civ. App.—Texarkana 1966, writ ref'd n.r.e.).

4.4:4 Conditions Precedent to Appointment

The express contractual provisions of the deed of trust must be strictly followed in appointing the substitute trustee. *Springwoods Shopping Center v. University Savings Association*, 635 S.W.2d 440 (Tex. App.—Houston [1st Dist.],

rev'd on other grounds, 644 S.W.2d 705 (Tex. 1982). The court stated:

Texas courts have consistently viewed the appointment of a substitute trustee as one involving a great deal of care, discretion and good faith; as such, strict adherence to the provisions of the deed of trust have been mandated.

Springwoods Shopping Center, 635 S.W.2d at 443.

Some deed of trust forms restrict the power of the beneficiary to appoint a substitute trustee based on the existence of certain conditions. Examples of such restrictions are (1) limitations to times when a default exists and (2) requirements that the appointment be by an instrument in writing and be recorded and that the appointment power only be exercised in the absence, death, inability, refusal, or failure of the trustee to act.

4.4:5 Recordation of Resignation and Appointment

Unless the deed of trust expressly provides that the resignation or appointment be written or publicly recorded, there is no such requirement. *Stone v. Watt*, 81 S.W.2d 552, 555 (Tex. Civ. App.—Eastland 1935, writ ref'd). If the deed of trust requires the appointment to be recorded, the appointment must be recorded before the twenty-one-day public notice-of-sale period has lapsed. *Fame v. Wilson*, 192 S.W.2d 456, 459 (Tex. Civ. App.—Galveston 1946, no writ); *Chandler v. Guaranty Mortgage Co.*, 89 S.W.2d 250, 254 (Tex. Civ. App.—San Antonio 1935, no writ).

4.4:6 Appointment of Substitute Trustee After Trustee Has Posted Property

A substitute trustee may be appointed at any time during the foreclosure process. There is no necessity to repost and send new notices after the substitute trustee has been appointed for the sale to be valid. *Tarrant Savings Association v. Lucky Homes, Inc.*, 390 S.W.2d 473 (Tex. 1965); *Loomis Land & Cattle Co. v. Diversified Mortgage Investors*, 533 S.W.2d 420 (Tex. Civ. App.—Tyler 1976, writ ref'd n.r.e.); *Koehler v. Pioneer American Insurance Co.*, 425 S.W.2d 889, 891 (Tex. Civ. App.—Fort Worth 1968, no writ).

4.4:7 No Notice to Mortgagor Required

It is good practice to notify the mortgagor of the appointment of a substitute trustee if the appointment is made after the posting of the property for foreclosure by the trustee. Otherwise, the mortgagor may argue that he could not locate the trustee at the foreclosure sale. The mortgagee must comply with a requirement in the deed of trust imposing an obligation to notify the mortgagor of the appointment of a substitute trustee. *Wilson v. Armstrong*, 236 S.W. 755 (Tex. Civ. App.—Beaumont 1921, no writ).

5. Notice of Sale

5.1 Posting of Public Notice

Section 51.002 of the Property Code requires (1) written notice of the auction to be posted at least twenty-one days before the date of sale at the courthouse door of each county in which the property is located and (2) a copy to be filed in the office of the county clerk of each county in which the property is located. Tex. Prop. Code Ann. § 51.002(b)(1),(2) (Vernon Supp. 2004). The phrase “advertising the time, place and terms of sale” in a deed of trust that did not specify the means of giving notice to the public of the sale has been held to have been satisfied by complying with the posting requirements of §51.002 without further requirement of advertising the sale in the local newspaper. *First State Bank v. Keilman*, 851 S.W.2d 14 (Tex. App.—Austin 1993, writ denied). Immediately before posting the notice of foreclosure sale, the trustee must verify with the mortgagee that the loan has not been brought current; that late payments have not been accepted, reinstatement has not been granted, or other forbearance promises have not been made by the lender; or that all or a part of the mortgaged property has not been released from the lien of the deed of trust. Publicly posting the mortgagor’s property in error will expose the lender to liability. See *Texas Real Estate Forms Manual*, State Bar of Texas, ch. 21, forms 21-12, 21-13 (1999) for other forms for notice of trustee’s sale. Provision in a deed of trust requiring that the notice of foreclosure sale be filed of record “in the deed records in the county in which the mortgaged property is located as required by law” may be disregarded as imposing no duty to take any action beyond that required by section 51.002. *Thompson v.*

Chrysler First Business Credit Corp., 840 S.W.2d 25 (Tex. App.—Dallas 1992, no writ).

5.1:1 Place of Posting

If the deed of trust requires that the notice be posted in 3 public places, then the notice must satisfy both the current requirements of the Texas Property Code and be posted in 3 public places as required by the deed of trust. *Harwath v. Hudson*, 654 S.W.2d 851 (Tex. App.—Dallas 1983, writ ref’d n.r.e.). If the deed of trust requires that the notice be published in a newspaper, then the notice must be so published in addition to being posted as required by the Texas Property Code. See *Rudolph v. Hively*, 188 S.W. 721, 723 (Tex. Civ. App.—Amarillo 1916, writ ref’d) (sheriff’s sale voided; if mortgage required notice by publication in a county newspaper, it was no excuse that the county had no newspaper, and the mortgagee’s only resort was to a court of equity).

The term “**courthouse door**” is defined in Tex. R. Civ. P. 648 as meaning “either of the principal entrances to the house provided by the proper authority for the holding of the district court.” The customary bulletin boards, located near the courthouse door for posting notices of sheriff’s execution sales, have been approved for posting. *Howard v. Fulton*, 14 S.W. 1061 (Tex. 1891); *Matson v. Federal Farm Mortgage Corp.*, 151 S.W.2d 636 (Tex. Civ. App.—Waco 1941, no writ). The accepted front door of the courthouse is not required. *Micrea, Inc. v. Eureka Life Insurance Co. of America*, 534 S.W.2d 348 (Tex. Civ. App.—Fort Worth 1976, writ ref’d n.r.e.); *Heiner v. Homeland Realty Co.*, 100 S.W.2d 793 (Tex. Civ. App.—Waco 1936, no writ). The clerks of some counties (e.g., San Patricio County) require that a deputy county clerk post the bulletin board notice as a condition to accepting the notice for filing in the county clerk’s records. The bulletin board in some counties is not located near the courthouse door.

5.1:2 Duration of Posting of Notice

The public notice posted at the courthouse door does not have to remain intact and visible during every one of the days of the posting period. The trustee is not required to ensure that the notices are kept posted or are visible on the posting board. *First State Bank v. Keilman*, 851 S.W.2d

