St. Mary's Law Journal

Volume 12 | Number 4 Article 2

12-1-1981

New Developments in Real Estate Financing Symposium - Real Estate Finance - An Emphasis on Texas Law.

Jesse B. Heath Jr.

NEW DEVELOPMENTS IN REAL ESTATE FINANCING

JESSE B. HEATH, Jr.*

* B.B.A., Southern Methodist University; LL.B., Southern Methodist University. Partner, Heath & Knippa, Houston, Texas.

This article discusses new developments involving real estate financing. The first part includes a summary of some of the more significant Texas court decisions which recently have been published[1] and a few decisions rendered by federal courts and by courts in other states. The second part deals with some of the recent federal legislative and regulatory developments, such as the Depository Institutions Deregulation and Monetary Control Act of 1980, including the October 8, 1980, amendments, tax-exempt mortgage bonds, and new real estate financing techniques. The third part discusses the marketplace; that is, the new developments in real estate financing which the sellers and developers of real estate are facing today and are likely to face in the near future.

I. Case Law Developments

A. *Validity of the Mortgage*

1. *Authority of a Trustee to Mortgage Trust Property.* The trust agreement before the court in *Lawler v. Lomas & Nettleton Financial Corp.*[2] authorized the trustee to borrow money and to secure the obligation by a mortgage on trust property, but it apparently did not expressly authorize the trustee to secure a guarantee obligation by a mortgage on trust property. The trust agreement, however, did contain the following provision in paragraph 16(i):

> No purchaser from or other person dealing with the Trustee shall be responsible for the application of any purchase money or other things of value paid or delivered to the Trustee, but the receipt of the Trustee shall be a full discharge; and *no purchaser from or other person dealing with the Trustee* and no issuer or transfer agent or other agent of any issuer, of any securities to which any

1. These cases were published in volumes 583 (with the exception of usury decisions, which begin in volume 579) through the December 30, 1980, advance sheet (volume 607 through page 322) of the Southwestern Reporter and the January 31, 1981, issue of the Texas Supreme Court Journal.
2. 583 S.W.2d 810 (Tex. Civ. App.—Dallas 1979, no writ).

> transaction with and Trustee shall relate, *shall be under any obligation to ascertain or inquire into the power of the Trustee* to purchase, sell, exchange, transfer, *mortgage,* pledge, lease, distribute, or otherwise in any manner dispose of or deal with *any securities or other property held by any trustee or comprising part of the trust estate.*[3]

The trustee had given a mortgage on trust property to secure a loan made by Lomas & Nettleton Financial Corp. to a corporation, the stock of which was all, or to a great extent, owned by persons who either were beneficiaries of the trust or relatives of beneficiaries. The successor trustee of the trust filed this suit to enjoin a foreclosure under the deed of trust, on grounds which included the absence of authority for the trustee to execute the deed of trust.

The court stated the rule in Texas is that the power given to a trustee to sell trust property does not include the power to mortgage the trust property, unless the trust agreement expressly so provides or unless that power can be implied from the terms of the trust.[4] The court then extended this rule to allow the lender to rely upon the provisions in section 16(i) of the trust agreement by stating: "We hold, however, that the terms of the Lawler Family Trusts relieve a reasonably prudent lender from the duty of further inquiry as to the power of the trustee to execute this deed of trust."[5] This holding may answer the question which was left unanswered in *Spiritas v. Robinowitz,*[6] as to the extent of the inquiry

3. *Id.* at 812.

4. *See id.* at 812.

5. *Id.* at 812.

6. 544 S.W.2d 710 (Tex. Civ. App.—Dallas 1976, writ ref'd n.r.e.). The controversy in *Spiritas* involved a joint venture agreement entered into for the purpose of acquiring a tract of land. The agreement was between "Spiritas, Trustee," and "Robinowitz, Trustee;" and stated it should be governed by the Texas Uniform Partnership Act (TUPA), TEX. REV. CIV. STAT. ANN. art. 6132b (Vernon 1970). The joint venture's property was taken in the name of "Robinowitz, Trustee." Subsequently, Robinowitz, acting for himself, purchased a second, adjacent tract of land in the name of "Robinowitz, Trustee." In order to secure financing for this property, Robinowitz placed a second lien on the joint venture's tract of land. Affirming the validity of the second lien, the Dallas Court of Civil Appeals held that the joint venture agreement did not meet the "Requisites of a Trust" as set out in the Texas Blind Trust Act, *id.* art. 7425b-7 (Vernon 1960), merely because one of the partners takes title to the partnership property in his name as "trustee" and that article 6132b, section (10)3 of the Texas Uniform Partnership Act, *id.* art. 6132b, § (10)3 (Vernon 1970), governed. Consequently, Spiritas, seeking to declare the lien invalid and to recover the partnership property from a third party (the bank), had the burden of proving "that the act of Robinowitz in placing the lien on the partnership property was not apparently carrying on in the usual way the busi-

into the trustee's authority that a lender, title company, or other person must make if the provisions of the Texas Blind Trust Act[7] are inapplicable.

2. *Authority of a Partner to Mortgage Partnership Property.* Section 10(1) of the Texas Uniform Partnership Act (TUPA)[8] permits any partner to convey or mortgage title to real property held in the partnership name. The partnership, however, can recover the property unless the partner's act binds the partnership under section 9(1) of TUPA[9] or the grantee has already reconveyed the property to a holder for value without knowledge of the partner's lack of authority.[10] It would be logical to assume that in many instances, the act of mortgaging partnership property does not meet the requirement in section 9(1) of "apparently carrying on in the usual way the business of the partnership," especially in light of section 9(3) of TUPA, which requires the authorization of all partners to "[a]ssign the partnership property in trust for creditors. . . ."[11] Nevertheless, there still remains the additional requirement in section 9(1) that the mortgagee have knowledge that this authority is lacking.[12]

The court in *Spring Woods Bank v. Lanier*[13] dealt with the question of one partner's authority to mortgage partnership property. Holding that the partner's authority was lacking, the court curiously focused on sections 9(3)(a) and 25(2)(b) of TUPA, pertaining to the right of a partner to assign his interest in specific partnership property,[14] rather than upon section 9(1) and 10(1) of

ness of the partnership." Spiritas v. Robinowitz, 544 S.W.2d 710, 717 (Tex. Civ. App.—Dallas 1976, writ ref'd n.r.e.).

7. Tex. Rev. Civ. Stat. Ann. arts. 7425a, 7425b-7 (Vernon 1960).

8. *Id.* art. 6132b, § 10(1) (Vernon 1970).

9. Section 9(1) of TUPA provides that the act of every partner, including the execution of instruments in the partnership's name "for apparently carrying on in the usual way the business of the partnership" binds the partnership, unless the partner has no such authority and the other party to the transaction has knowledge of that fact. *Id.* art. 6132b, § 9(1) (Vernon 1970).

10. *Id.* art. 6132b, § 10(1) (Vernon 1970).

11. *Id.* art. 6132b, § 9(3)(a) (Vernon 1970).

12. *Id.* art. 6132b, § 9(1) (Vernon 1970).

13. 601 S.W.2d 425 (Tex. Civ. App.—Waco 1980, no writ).

14. Tex. Rev. Civ. Stat. Ann. art. 6132b, §§ 9(3)(a), 25(2)(b) (Vernon 1970). Section 25(2)(b) states that "[a] partner's right in specific partnership property is not assignable except in connection with the assignment of rights of all the partners in the same property." *Id.* § 25(2)(b).

TUPA.[15] The court further held that the mortgagee did not acquire a lien against the individual partner's interest in the partnership property when the partnership was dissolved, because the dissolution was made pursuant to an agreement under which the partner's interest in the property was transferred to the other partner.[16]

3. *Mortgage Based on Altered Deed.* In *National Bank of Commerce v. May*,[17] the grantee of a deed made an unauthorized alteration of the description of the land in the deed to provide for a larger conveyance, and then gave the bank a deed of trust lien on the land described in the altered deed. Unaware of the alteration, the bank subsequently foreclosed under the deed of trust.[18] The grantor of the deed brought suit to have the deed declared void to the extent of the alteration. The court held that since the alteration was made after the deed was executed, the deed was void with respect to the conveyance of any land in addition to the land described in the original deed, even though the bank was, in effect, an innocent purchaser. Consequently, the bank's foreclosure was effective only against the land described in the original deed.[19]

4. *Mortgage or Conveyance.* Texas law does not permit the owner of a homestead to refinance the homestead for the purpose of increasing the purchase money mortgage to include the owner's equity. One device which homeowners may be tempted to employ to circumvent this law is to contrive a sale to a third party who then places a larger mortgage on the homestead. If, however, the third party later denies the seller's claim that the sale was only a mortgage device, the seller may be in for an unfortunate surprise. Several recent decisions illustrate that Texas courts are reluctant

15. *Id.* §§ 9(1), 10(1).

16. *See* Spring Woods Bank v. Lanier, 601 S.W.2d 425, 435 (Tex. Civ. App.—Waco 1980, no writ) (doctrine of after-acquired title did not apply because title to specific partnership property did not vest in either partner individually).

17. 583 S.W.2d 685 (Tex. Civ. App.—Eastland 1979, writ ref'd n.r.e.).

18. *See id.* at 687. That the bank was innocent of any wrong doing would have been "a significant factor if plaintiffs were asserting an equitable right to reform or set aside a voidable instrument; however, the plaintiffs here were seeking a declaration that the altered deed was void, not merely voidable, as to the additional property rights purportedly conveyed by the alterations." *Id.* at 689.

19. "The rule regarding alterations of conveyances, . . ., is that a material alteration *after* the execution and delivery of said instrument is of no effect and the instrument stands as originally drawn." *Id.* at 689 (citing Stockton v. Lake Tanglewood & Skybolt, Inc., 441 S.W.2d 575, 577-78 (Tex. Civ. App.—Amarillo 1969, no writ)).

to set the conveyance aside when the homeowners later challenge the conveyance as being an invalid mortgage on their homestead.

In *Eckard v. Citizens National Bank*,[20] the homeowners conveyed their homestead to a corporation solely owned by the homeowners. The corporation then executed a note secured by a deed of trust on the home and by a guaranty signed by the sellers. The corporation authorized the purchase and loan and made several payments on the note before defaulting. The home, in the meantime, was reconveyed to the sellers. When the bank moved to foreclose, the homeowners sought to enjoin the foreclosure sale on the basis that the sale to the corporation was a "pretended sale" which was void under the Texas Constitution.[21] The court held that under the facts of this case, the homeowners failed to show that this was a "pretended sale" made only for the purpose of placing a lien on the homestead.[22]

Another case in which the sellers of a homestead argued the conveyance was a mortgage is *Rinyu v. Teal*.[23] Although the sellers were successful at trial, the appellate court reversed. The evidence showed the land was sold for a price which the court found to be a fair one, the sellers leased the land from the purchaser, and an oral option allowed the sellers to repurchase the land within six months at a $1,500 premium. The sellers not only signed an affidavit disclaiming any interest after the sale in the land other than as tenants, but also offered no objection when one of the attorneys stated that if this was an effort to mortgage their homestead he wanted no part of it.

a. *Was there a loan?* The court stated that "[w]hether a given transaction is classified as a sale or a loan depends upon the intention of the parties as 'disclosed by the contract or the attending circumstances.' "[24] In *Rinyu v. Teal*, the court held that the attending circumstances did not indicate a loan. The court was particularly impressed by the facts that the purchase price was a fair

20. 588 S.W.2d 861 (Tex. Civ. App.—Eastland 1979, writ ref'd n.r.e.).

21. Tex. Const. art. XVI, § 50.

22. Eckard v. Citizens Nat'l Bank, 588 S.W.2d 861, 862 (Tex. Civ. App.—Eastland 1979, writ ref'd n.r.e.) ("as a mater of law" the conveyance was not shown to be a "pretended sale").

23. 593 S.W.2d 759 (Tex. Civ. App.—Houston [14th Dist.] 1979, writ ref'd n.r.e.).

24. *Id.* at 761. *See generally* Marcus, *Real Estate Purchase-Leasebacks as Secured Loans*, 2 Real Est. L.J. 664 (1974); Annot., 94 A.L.R.3d 640 (1979).

one and the sellers had disclaimed at the time of the conveyance that the sale was an attempt to mortgage their homestead.

b. *If there was a loan, was it usurious?* In finding the transaction was a loan, the trial court held that the $1,500 repurchase premium made the loan usurious. The appellate court, citing *Pansy Oil Co. v. Federal Oil Co.*,[25] set forth the following elements which must be present for a loan to be usurious: (1) there must be a loan of money; (2) there must be an absolute obligation to repay the principal of the loan; and (3) there must be usurious interest. The court found one of these elements to be missing. There was no absolute obligation to repay the principal amount of the loan, because the purchaser could not require the seller to repurchase. The court further stated that although in a proper case a sale with a repurchase option may be a mortgage if "the economic compulsion of the unrealistic price compared to real market value" virtually compel the seller to repurchase, this was not true in this case.[26]

The Fifth Circuit decision in *Woods-Tucker Leasing Corp. v. Hutcheson-Ingram Development Co.*[27] involved the sale and leaseback of equipment. An issue before the court was whether the sale and leaseback was a loan transaction. The court held that since the lease agreement did not include an integration clause[28] parol evidence could be introduced to show that the lessee had an option to purchase the equipment at the end of the lease term.[29] The court

25. 91 S.W.2d 453, 455 (Tex. Civ. App.—Texarkana 1936, writ ref'd).

26. *See* Rinyu v. Teal, 593 S.W.2d 759, 762 (Tex. Civ. App.—Houston [14th Dist.] 1979, writ ref'd n.r.e.). *See also* Castillo v. Eurest, 579 S.W.2d 581, 584 (Tex. Civ. App.—Corpus Christi 1979, no writ) (to prevail against third party purchaser grantee must show deed was a mortgage and not an absolute conveyance, and that third party was not a good faith purchaser without notice that the contested deed was a mortgage); H.D. Snow Housemoving, Inc. v. Moyers, 581 S.W.2d 809, 811 (Tex. Civ. App.—Fort Worth 1979, no writ) (whether transaction is a mortgage is determined by reference to the instruments executed and "such extrinsic matters as show what the parties intended to accomplish").

27. 626 F.2d 401 (5th Cir. 1980).

28. A typical integration clause states: "This lease 'constitutes the sole agreement of the parties with respect to the subject matter thereof.' " *Id.* at 410 n.9 (citing Transamerican Leasing Co. v. Three Bears, Inc., 586 S.W.2d 472, 478 (Tex. 1979)).

29. *Compare* Woods-Tucker Leasing Corp. v. Hutcheson-Ingram Dev. Co., 626 F.2d 401, 410-11 (5th Cir. 1980) (lease did not include integration clause, therefore, oral option was collateral to lease agreement), *vacated on other grounds*, No. 79-1651 (5th Cir. April 3, 1981) *with* Transamerican Leasing Co. v. Three Bears, Inc., 586 S.W.2d 472, 477-78 (Tex. 1979) (parole evidence rule excluded evidence of oral option where leasing agreement contained integration clause) *and* Hobbs Trailers v. J.T. Arnett Grain Co., 560 S.W.2d 85, 87 (Tex. 1977) (oral evidence of purchase option excluded when leasing agreement contained

agreed with the bankruptcy and district courts' determination that the sale-leaseback transaction was, in fact, a loan subject to the Texas usury laws[30] after applying the following test:

> If there is an option and the option price is nominal in relation to the fair market value of the equipment subject to it, then the lease is, conclusively, a secured loan. If the option is not nominal the court must look to all the facts surrounding the transaction to determine whether there is a lease or a loan.[31]

Specifically, the court was persuaded by the following five facts: (1) there was a substantial difference between the fair market value of the property and the option price; (2) the "rent" was based upon the amount advanced by the lessor rather than the value of the equipment; (3) the lessee asked for a loan rather than for a sale-leaseback; (4) the lessor maintained no inventory of the equipment; and (5) the lease required the lessee to pay all taxes, insurance, and expenses for repairs.[32]

B. *Nonrecourse Mortgages*

Nonrecourse or "no personal liability" provisions can take several forms. One form merely states that the maker of the note has no personal liability for the failure to make payments on the note. A more complete form states that the maker has no personal liability for the failure to make payments on the note or for any other default under the note, deed of trust, or other security instruments, and that in the event of any such default the payee and mortgagee agree to look only to the security for the payment of the note and will not sue the maker of the note for any deficiency remaining after foreclosure. The distinction between these two forms is important because the deed of trust usually contains a number of covenants in addition to the obligation to pay the note, such as the covenant of title, to insure the property, to pay ad valorem taxes, not to commit waste, to assign the rentals from the property as security, and the like. It would be logical to assume that a note provision stating the maker would have no liability for failure to

---

integration clause and statement that the transaction was a lease and not a sale).

30. TEX. REV. CIV. STAT. ANN. art. 5069-1.01 to .09 (Vernon 1971 & Supp. 1971-1980).

31. Woods-Tucker Leasing Corp. v. Hutcheson-Ingram Dev. Co., 626 F.2d 401, 412 (5th Cir. 1980).

32. *See id.* at 413.

pay the note would not limit liability on the other covenants in the deed of trust. At least in a limited context, three recent Texas Supreme Court decisions considered this issue.

1. *Mortgagee's Liability for Taxes and Other Obligations Arising Under the Deed of Trust.*

a. *Smart v. Tower Land & Investment Co.*[33] Tower Land and Investment Co. sued for reimbursement of $18,736.53 in ad valorem taxes which the mortgagor had failed to pay as required in the deed of trust. Smart counter-claimed for usury.[34] The trial court entered judgment for Tower, and the appellate court affirmed.[35] The Texas Supreme Court granted writ of error only on the nonrecourse issue.

(1) *Nonrecourse.* The promissory note stated that "[t]he maker hereof is not now or shall ever be personally liable on this note. . . ."[36] The deed of trust obligated the mortgagor (maker) to pay taxes and assessments on the property.[37] Tower argued that the covenant to pay taxes was independent of the note. The Texas Supreme Court disagreed.

> The tax payment provision in the deed of trust provides that Smart's liability to Tower for tax reimbursement was to be secured and payable in "like manner" as his note. Under these provisions, Tower was entitled to pursue his right to reimbursement for taxes at foreclosure, when he pursued his right to receive the balance due on Smart's note. Both the purchase money debt and the tax debt comprised a single mortgage debt to be enforced at foreclosure without personal liability.[38]

The court also stated that whether Tower paid taxes before or after foreclosure, Tower did not acquire the right to a personal judgment against Smart.[39]

---

33. 597 S.W.2d 333 (Tex. 1980).

34. *See id.* at 335.

35. *See* Smart v. Tower Land & Inv. Co., 582 S.W.2d 543, 546 (Tex. Civ. App.—Dallas), *rev'd*, 597 S.W.2d 333 (Tex. 1980).

36. *See* Smart v. Tower Land & Inv. Co., 597 S.W.2d 333, 336 (Tex. 1980).

37. *See id.* at 336.

38. *Id.* at 337.

39. *See id.* at 337. The court addressed the provision in the deed of trust which allowed the holder of the indebtedness, upon default by the mortgagor, to perform "for account and at the expense of [Smart], and any and all expenses incurred and paid in so doing shall be payable by [Smart] to [Tower] with interest . . . ." *Id.* at 336. Recognizing that standing alone this provision may support an interpretation that the mortgagor's promise to reim-

It seems logical to conclude that when nonrecourse is limited to nonpayment of the note, the mortgagor's liability for the failure to perform other obligations under the deed of trust or other security instruments should not be limited. Specifically, on the issue of the mortgagor's liability for unpaid taxes, the Texas Supreme Court seems to have recognized, as indeed it should, the deed of trust or note could have stated the mortgagor is liable for unpaid ad valorem taxes or a proratable portion after foreclosure. To avoid the result of the *Smart* case, a mortgagee should expressly except from the nonrecourse provision the mortgagor's liability for ad valorem taxes, as well as liability for defaults such as the failure to carry insurance, to maintain the property, or to use rentals from the property properly.

(2) *Equitable Subrogation.* The Texas Supreme Court observed that the question as to whether one who pays ad valorem taxes on property owned by another is entitled to be subrogated to the taxing authority's lien has been the source of much litigation in Texas.[40] The court agreed that under the usual deed of trust the mortgagee who pays the mortgagor's property taxes will be subrogated to the security of the tax debt, and upon foreclosure, the sale proceeds can be applied to the payment of those taxes. Neither the mortgagee nor any other purchaser at the foreclosure sale, however, will be subrogated to the taxing authority's right to maintain a personal action against the former owner.[41] The court endorsed the holding in *The Praetorians v. State,*[42] which held that a mortgagee who pays ad valorem taxes before a foreclosure sale is limited to a foreclosure of the taxing authority's lien or, of course, a

burse the holder for taxes is a personal debt, independent of the mortgage debt, the court did not accept this interpretation. Specifically, the court stated that the installment note and the deed of trust limited the debt to a nonpersonal liability; and under the deed of trust, the mortgagee's "liability for tax reimbursement is made part of the mortgage debt." *Id.* at 337.

40. *See id.* at 338.

41. *See id.* at 338. The contractual relationship between the mortgagor and mortgagee should set out:

> the extent to which the mortgagee is subrogated to the taxing authority's rights. . . . Unless provided otherwise, the mortgagee is subrogated to the security of the tax debt. . . . The parties having fixed their rights by contract, additional rights, such as are incidental to the sovereign's taxing power, will not be created by judicial intervention.

Id. at 338.

42. 53 S.W.2d 334 (Tex. Civ. App.—Waco 1932, writ ref'd).

foreclosure of the deed of trust lien based upon the mortgagor's default.[43]

b. *Wood v. Henry S. Miller Co.*[44] *Wood* involved a suit for reimbursement for ad valorem taxes paid after foreclosure. The deed of trust contained the following provision: "Anything herein to the contrary notwithstanding, the undersigned shall have no personal liability for the payment of the note secured hereby, and in the event of default, the holder of said note shall have the mortgaged property alone as security for the payment of said note. . . ."[45]

The deed of trust obligated the mortgagor to pay ad valorem taxes and provided that, if the noteholder paid such taxes, the amount would be added to the debt.

The Texas Supreme Court held:

> The contract between Miller and the Woods did not create personal liability for taxes. To the contrary, the deeds of trust provide that Miller's tax liability shall "become part of the debt hereby secured," and that debt was a nonpersonal obligation. In light of this language and in the absence of a clear promise by Miller to personally reimburse the Woods for taxes paid by them, we hold that the Woods' remedy for recovery of delinquent taxes was foreclosure against the property.[46]

c. *R&P Enterprises v. LaGuarta, Gavrel & Kirk, Inc.*[47] In *R&P Enterprises* the mortgagee foreclosed under the deed of trust and then filed suit to recover a deficiency on the note, attorney's fees, and ad valorem taxes. The mortgagor, LaGuarta, Gavrel & Kirk, Inc., defended on the ground that under the following provision in the promissory note, if a default occurred during the first two years the payee could either sue the maker or foreclose, but the payee was precluded from foreclosing and then suing the maker.

> Notwithstanding any contrary terms expressed or implied by the provisions of this note, it is expressly stipulated and agreed that the maker shall have personal liability for payment of this promissory

43. *See id.* at 335.

44. 597 S.W.2d 332 (Tex. 1980). This is the companion case to Smart v. Tower Land & Inv. Co., 597 S.W.2d 333 (Tex. 1980). The facts of the two cases are indistinguishable. *Compare* Wood v. Henry S. Miller Co., 597 S.W.2d 332, 332-33 (Tex. 1980) *with* Smart v. Tower Land & Inv. Co., 597 S.W.2d 333, 335-39 (Tex. 1980).

45. Wood v. Henry S. Miller Co., 597 S.W.2d 332, 332 (Tex. 1980).

46. *Id.* at 333.

47. 596 S.W.2d 517 (Tex. 1980).

> note for and during the period ending with the second anniversary of the date of said note, after which time, all obligatory payments having been made prior to said date, the maker shall have no personal liability for the payment of any balance owing upon this note, and the payee, or other owner and holder or holders of said note shall thereafter look solely to the enforcement of the liens securing the payment hereof for satisfaction of the balance owing hereon, it being expressly agreed that *upon any enforcement of the liens securing payment hereof, the maker shall have no liability for any deficiency remaining unpaid or unsatisfied thereafter*, should same fail to fully satisfy and pay the unpaid balance then owing.[48]

The mortgagor defaulted on the first payment of the note. The trial court entered summary judgment for the payee. The appellate court found the note provision to be ambiguous, because it was not clear that the words "upon any enforcement of the liens" referred only to liability for payments after the first two years.[49] The Texas Supreme Court, however, found the note to be unambiguous.

> The parties intended that the note would provide for personal liability of the maker if default occurred within the first two years of the note's anniversary. The relief of personal liability of the maker by "any enforcement of the liens" follows the phrase "after which time" and relates to events occurring after the second anniversary of the note. Since it is uncontradicted there was default within the two-year period, the maker was personally liable for the deficiency as prayed for by the payee.[50]

2. *Mortgagor's Liability Under a Collateral Assignment of Leases and Rents.* The Houston Court of Civil Appeals took a different course in *Taylor v. Brennan.*[51] The promissory note executed by the mortgagor was a nonrecourse note. After the mortgagee foreclosed under the second lien deed of trust, he filed suit to recover (1) for waste of security under the collateral assignment of rentals, (2) tenant security deposits under the assignment of leases, and (3) attorney's fees under the assignments. The alleged waste was the amount of rentals collected by the mortgagor after default, which he failed to apply to the first lien note, as required in the

48. *Id.* at 518 (emphasis added).
49. *See id.* at 519.
50. *Id.* at 519.
51. 605 S.W.2d 657 (Tex. Civ. App.—Houston [1st Dist.] 1980, no writ).

assignment of rents. The mortgagor defended on the basis that the second lien promissory note was a nonrecourse note.

a. *Liability for Waste Under the Collateral Assignment of Rents.* The Texas courts have followed the general rule that an assignment of rents creates a security interest in the rents requiring some further action by the mortgagee in order to enforce that security interest.[52] Therefore, the provisions of an assignment of leases and rents do not become effective as an absolute assignment until the mortgagee actually obtains possession, or until the mortgagee asserts its rights by securing the appointment of a receiver, by impounding the rents pending foreclosure, or by taking some equivalent action.[53] The *Taylor* opinion stated that the critical question is whether the assignment was an absolute assignment of rentals or a mere pledge for security purposes. The collateral assignment provided, in part, that "the Mortgagor does hereby presently sell, assign, transfer, set over and grant to the Mortgagee during the life of these presents . . . [t]he right to the use and possession of the premises and all the rents. . . ."[54] The court construed this language to be a present and absolute assignment in favor of the mortgagee, which became effective upon the occurrence of a default. The holding sets forth that the rentals were separate and distinct security, to which the mortgagee became entitled upon the default in the payment of the first lien note, and that the measure of damages was the amount of rentals collected after default which were not applied toward the payment of the first lien note. If the collateral assignment of rentals had not been separate security, then the mortgagee could not have recovered damages if the value of the land were sufficient to discharge the

52. *See, e.g.,* Simon v. State Mut. Life Assur. Co., 126 S.W.2d 682, 686 (Tex. Civ. App.—Dallas 1939, writ ref'd) (assignment of rents provisions do not become effective until acted upon by the parties); McGeorge v. Henrie, 94 S.W.2d 761, 762 (Tex. Civ. App.—Texarkana 1936, no writ) (mortgagee is not entitled to rents and profits of mortgaged premises until he takes possession or possession is taken by a receiver); F. Groos & Co. v. Chittim, 100 S.W. 1006, 1010 (Tex. Civ. App.—San Antonio 1907, no writ) ("the right of possession is the criterion of the right to take the rents and profits; and, . . ., the one who has the right of possession at the time the rents fall due has the right, . . ., to receive them").

53. *See* G. Osborne, G. Nelson & D. Whitman, Real Estate Finance Law § 4.26, at 175-76 (1979); G. Osborne, Mortgages § 150, at 249-54 (2d ed. 1970).

54. Taylor v. Brennan, 605 S.W.2d 657, 659 (Tex. Civ. App.—Houston [1st Dist.] 1980, no writ).

security.[55] Further, if the mortgagor had collected no rentals or less than the amount required to pay the first lien note, there would have been no liability for a deficiency. In addition, the court seems to say, as other Texas courts have said, that if the collateral assignment had required the mortgagee to take some affirmative action after default in order to become entitled to the rentals, then the mortgagor would not have been liable for waste until that action had been taken.[56]

b. *Liability for Tenant Security Deposits and Attorney's Fees.* The mortgagor argued that since article 5236e[57] provides that a mortgagee who forecloses is not liable to tenants for the return of their security deposits, he should not be required to pay the mortgagee the amount of the missing tenant security deposits. *Taylor v. Brennan,* however, held that this statute does not preclude a contractual obligation between the parties; and that under this collateral assignment of leases, the mortgagee had assumed the mortgagor's responsibilities to tenants, including the responsibility for the return of security deposits.[58] The court also upheld the award for attorney's fees to the mortgagee as provided for in the two assignments.[59]

c. *Nonrecourse.* The court's opinion does not indicate how the court circumvented the nonrecourse provision in the promissory note. In fact, the opinion makes no mention of the nonrecourse provision other than to observe that this was the mortgagor's defense.[60] None of the nonrecourse cases discussed in this section are cited by the court, and the author understands that the *Smart* and *Wood* cases were not raised by the mortgagor. If the court did consider the nonrecourse provision in light of *Smart* and *Wood,* then

55. *See id.* at 660 (citing Carroll v. Edmondson, 41 S.W.2d 64, 65 (Tex. Comm'n App. 1931, judgmt adopted) (mortgagee suffers no injury when damaged property has sufficient value to secure the debt).

56. *See* Taylor v. Brennan, 605 S.W.2d 657, 659 (Tex. Civ. App.—Houston [1st Dist.] 1980, no writ) (citing Simon v. State Mut. Life Assur. Co., 126 S.W.2d 682, 686 (Tex. Civ. App.—Dallas 1939, writ ref'd); McGeorge v. Henrie, 94 S.W.2d 761, 762 (Tex. Civ. App.—Texarkana 1936, no writ)).

57. TEX. REV. CIV. STAT. ANN. art. 5236e, § 5(a) (Vernon Supp. 1980-1981).

58. *See* Taylor v. Brennan, 605 S.W.2d 657, 661 (Tex. Civ. App.—Houston [1st Dist.] 1980, no writ).

59. *See id.* at 661. Mortgagor's argument that a demand prior to filing suit was necessary to collect attorney's fees was not accepted by the court because the agreement between the parties set out no such requirement. *See id.* at 661.

60. *See id.* at 658.

the *Taylor* decision would have to be read as saying that the rights and obligations under the assignment of rents and assignment of leases were independent of the note and deed of trust and were unaffected by the nonrecourse provision in the note.[61]

3. *Negotiability of a Nonrecourse Note.* The basic issue before the court in *Hinckley v. Eggers*[62] was whether a nonrecourse promissory note is negotiable. The note provided that the makers were to have no personal liability and, in the event of default, the mortgagee's only remedy was to foreclose under the deed of trust. The holding set forth that this provision made the note payable out of a particular fund—the proceeds from a foreclosure of the security. Thus, an unconditional promise or order to pay, which is one of the requirements for negotiability under the Uniform Commercial Code,[63] was missing because the note was to be paid out of a particular fund or source within the meaning of section 3.105(b) of the code.[64]

The court stated that even though the note imposed personal liability for any accrued ad valorem taxes and interest, the note was not negotiable because such amounts were not a "sum certain," and because the court could find no authority that a note can be negotiable as to interest and not as to principal.[65] This result was not affected by the fact that the deed of trust security was

61. *See* Davidson v. Baier Corp., 259 S.E.2d 707 (Ga. App. 1979). In *Davidson,* the appellant had purchased from the appellee's assignor a tract of land for which he executed a note and deed to secure debt for the balance of the purchase price. There were four prior deeds to secure debt against the property. The appellant's note and the loan deed contained an exculpatory clause limiting recourse against the appellant for any deficiency after foreclosure; that is, the holder of the note agreed to rely solely upon the security for payment. The appellant defaulted on the payment of one or more of the prior secured debts and the holder of the senior loan deed foreclosed on it, thus wiping out the appellee and all other lienholders. The appellee filed suit on the note seeking the balance owing and was granted summary judgment. The Georgia Court of Appeals reversed the summary judgment on the basis that the parties to the note, by their diverse affidavits, created a jury issue as to the parties' intent concerning the appellant's liability on the note if a prior default resulted in foreclosure by a third party before the appellee foreclosed. The court further stated that should the trial court determine there was no intent either expressed or implied to cover this situation, then the exculpatory clause, being construed as entire and indivisible, must necessarily fail. *See id.* at 708-09.

62. 587 S.W.2d 448 (Tex. Civ. App.—Dallas 1979, writ ref'd n.r.e.).

63. *See* TEX. BUS. & COM. CODE ANN. § 3.104(a)(2) (Tex. UCC) (Vernon 1968).

64. *See id.* § 3.105(b)(2).

65. *See* Hinckley v. Eggers, 587 S.W.2d 448, 450-51 (Tex. Civ. App.—Dallas 1979, writ ref'd n.r.e.).

the entire assets of the partnership. The court read section 3.105(a)(8) of the Uniform Commercial Code[66] to mean all of the partnership's assets, present and future, must be subject to execution for the debt.[67] Thus, if the partnership owned or later acquired assets other than the security, including income or proceeds from the sale of the security, those assets would not have been subject to execution for the debt because of the nonrecourse provision in the note.

The court's holding in *Hinckley* is sound.[68] The importance of nonnegotiability was that it allowed the introduction of parol evidence to show the principal's liability on a note signed by his agent. Another consequence is that an assignee of a nonrecourse, nonnegotiable note is not a holder in due course and, therefore, takes subject to the defenses which the maker has against the payee.[69] The fact that a note is nonnegotiable does not affect its assignability. The assignee can sue the maker on the note, subject to defenses which could be raised against the assignor,[70] and can enforce the mortgage to the same extent that it can enforce the debt.[71] If the payee wants to assign a nonrecourse note, however, the payee should be given the right under the loan documents to compel the maker of the note and any persons who assume or take subject to the mortgage to provide an estoppel letter disclaiming or identifying the existence of any defenses against the payee.[72] The

66. TEX. BUS. & COM. CODE ANN. § 3.105(1)(8) (Tex. UCC) (Vernon 1968).

67. *See* Hinckley v. Eggers, 587 S.W.2d 448, 451 (Tex. Civ. App.—Dallas 1979, writ ref'd n.r.e.).

68. *See also* Busby v. Jones, 134 Tex. 241, 249, 133 S.W.2d 566, 571 (1939) (note creating no personal liability is not a negotiable instrument).

69. *See* TEX. BUS. & COM. CODE ANN. § 3.306 (Tex. UCC) (Vernon 1968).

70. *See* Nelson v. Powell, 434 S.W.2d 165, 167 (Tex. Civ. App.—Beaumont 1968, no writ)(assignee of nonnegotiable note could recover against the maker subject to same defenses which the maker could urge against the payee-assignor).

71. *See* G. OSBORNE, MORTGAGES § 227, at 448-50 (2d ed. 1970).

> [T]he general rule is uniformly followed that all defenses to the obligation, legal or equitable, that the mortgagor may have had against the assignor at the time of the assignment are available to the mortgagor when the assignee of the mortgage, even though he bought for value and took without notice, attempts to enforce it, unless the mortgagor by the form of the instrument intrusted to the assignor or otherwise has estopped himself from setting up a defense.

Id. § 227, at 449. *See also* TEX. BUS. & COM. CODE ANN. § 3.201 (Tex. UCC) (Vernon 1968) ("[t]ransfer of an instrument vests in the transferee such rights as the transferor has therein").

72. *See also* G. OSBORNE, G. NELSON & D. WHITMAN, REAL ESTATE FINANCE LAW § 5.32,

estoppel letter should soothe some of the note assignee's concerns.

C. *Foreclosures and Deeds in Lieu of Foreclosure*

1. *Appointment of Substitute Trustee.*

a. *Appointment by Collateral Assignee.* Most deeds of trust provide that the noteholder has the right to appoint a substitute trustee. But who has the right to appoint a substitute trustee after the noteholder assigns the note as collateral for a debt owed by the noteholder? The question was answered in *Lawson v. Gibbs*[73] where the court held that the collateral assignee can appoint the substitute trustee, if the note has been endorsed and delivered to the collateral assignee, because those acts make the assignee a "holder" of the note and a beneficiary under the deed of trust. If there has been no endorsement, however, the collateral assignee will have to foreclose upon the note before it will have the authority to appoint the substitute trustee.[74]

The substitute trustee must be properly appointed in order to have a valid foreclosure sale. If the collateral assignee does not have the authority to make the appointment, if the assignor cannot or will not make the appointment, and if the existing trustee cannot be persuaded to post notice of foreclosure, then the collateral assignee will face the delay of having to conduct the foreclosure of the note before it can even begin other foreclosure proceedings. In light of *Lawson,* a collateral assignee of a note secured by a deed of trust should require an endorsement and delivery. Of course, the collateral assignee in *Lawson* could have required the assignor to appoint a substitute trustee of its choice as a part of the assignment, or could have asked the assignor to appoint the substitute

---

at 338-43 (1979). Before accepting the assignment, the assignee of a nonnegotiable note should:

> request that the maker sign an "estoppel certificate," averring that the note is valid and that the maker has no defenses. Such a certificate is generally effective, and if broadly drafted provides even better protection for the assignee than would the [holder in due course] doctrine, since it insulates him from both real and personal defenses.

Id. § 5.32, at 338-39.

73. 591 S.W.2d 292 (Tex. Civ. App.—Houston [14th Dist.] 1979, writ ref'd n.r.e.).

74. *See id.* at 295 (absent indorsement, the only rights of collateral assignee in the collateral are those defined in article 9 of the UCC); TEX. BUS. & COM. CODE ANN. § 9.501 (Tex. UCC) (Vernon Supp. 1980-1981) (judicial foreclosure of assigned note is only remedy upon default for collateral assignee of a note).

trustee at a later time. For a number of reasons, the collateral assignee normally should not rely upon the assignor's cooperation in making the appointment after the assignment.

b. *Appointment by Servicing Agent.* In *Burnett v. Manufacturer's Hanover Trust Co.,*[75] the mortgagors sued for wrongful foreclosure under a deed of trust on several grounds, including defects in the appointment of the substitute trustee. The court acknowledged that the distinction between a wrongful foreclosure and an irregular exercise of a right to foreclose has never been established clearly in Texas. The court said that an irregular exercise of the right to foreclose usually arises when the mortgagor is in default, but there is some defect in the manner in which the sale was conducted. A "wrongful foreclosure" was defined as a sale that is unauthorized or without right, such as a sale when the mortgagor is not in default or after the mortgagee has agreed to an extension of time. The court stated that in the event of a wrongful foreclosure, the mortgagor has an action in tort for the difference between the market value of the property and the amount of the debt, on the theory that the foreclosure was a conversion of the mortgagor's property, especially if the property was sold to a third party.[76] Following this rationale, the court held that a sale by a substitute trustee who has not been properly appointed is more than an irregularity in the exercise of the right to foreclose and renders the sale void; therefore, damages are available to the mortgagor, especially if the property has been sold to a third party.[77] The deed of trust before the court in *Burnett* contained a typical provision requiring the appointment be made in writing by the holder of the note. The court held that the noteholder's servicing agent was not authorized to appoint the substitute trustee.[78] The court was not persuaded by the provision in the deed of trust reciting the trustee's deed was prima facie evidence that the sale had been properly conducted, since this provision only created a rebuttable presumption.[79] The holding in *Burnett* suggests that mortgagees should revise their deeds of trust to permit their agents, in-

75. 593 S.W.2d 755 (Tex. Civ. App.—Dallas 1979, writ ref'd n.r.e.).
76. *See id.* at 756-57.
77. *See id.* at 757.
78. *See id.* at 758.
79. *See id.* at 758 (citing Slaughter v. Qualls, 139 Tex. 340, 347-48, 162 S.W.2d 671, 676 (1942)).

cluding their attorneys, to give notices under the deed of trust.

2. *Notice of Foreclosure Sale.*

a. *Notice to Debtor Against Whom No Deficiency Is Sought.* Another issue before the court in *Burnett v. Manufacturer's Hanover Trust,*[80] was whether the noteholder was required to give notice of the foreclosure to the former husband, who was a maker of the note but who had conveyed his interest to the ex-wife. The mortgagors argued that the former husband was entitled to notice of the sale. The court stated that even if proper notice was not given to the former husband, there was no injury to him in the absence of a deficiency judgment. The court concluded: "[T]hat the purpose of the notice requirement is to give each debtor an opportunity to protect his own interest. The statute does not provide a remedy for damages if another debtor, no longer an owner of the property, was not given notice according to the statute."[81] The former wife could not complain, because she received notice. The court's holding that the failure to give notice to the ex-husband will not affect the validity of the sale if no deficiency judgment is sought against the debtor might be extended to any failure to give notice to other debtors or to a former owner who is secondarily liable for the debt.

b. *Notice to Those Who Purchase "Subject to" the Mortgage.* In *Hausmann v. Texas Savings & Loan Association,*[82] the court held that a person who purchases property subject to, rather than in assumption of, the mortgage is not a "debtor obligated to pay such debt" within the meaning of article 3810,[83] and accordingly, is not entitled to receive notice of foreclosure by mail under the statute.[84] In addition, the court stated the requirement for the twenty-one days notice by mail is calculated by including the date the notice is mailed.[85]

80. 593 S.W.2d 755 (Tex. Civ. App.—Dallas 1979, writ ref'd n.r.e.).

81. *Id.* at 758.

82. 585 S.W.2d 796 (Tex. Civ. App.—El Paso 1979, writ ref'd n.r.e.).

83. TEX. REV. CIV. STAT. ANN. art. 3810 (Vernon Supp. 1980-1981).

84. *See* Hausemann v. Texas Sav. & Loan Ass'n, 585 S.W.2d 796, 800 (Tex. Civ. App.—El Paso 1979, writ ref'd n.r.e.) ("debtors obligated to pay the debt were served in compliance with the statute").

85. *See id.* at 801 (citing Hutson v. Sadler, 501 S.W.2d 728, 730 (Tex. Civ. App.—Tyler 1973, no writ) (notice of sale of real estate under deed of trust posted for 21 days inclusive of day of posting, but exclusive of day of sale, met requirements of posting notice for 21 days prior to date of sale)).

c. *Notice to Address Specified in Deed of Trust.* Article 3810 was amended effective January 1, 1976, to require that the holder of a note give twenty-one days notice of foreclosure to "each debtor obligated to pay such debt according to the records of such holder" by mailing it to the debtor "at the most recent address as shown by the records of the holder. . . ."[86] The question before the Dallas Court of Civil Appeals in *Lido International, Inc. v. Lambeth,*[87] was whether a typed-in statement in the deed of trust providing that notices required under the deed of trust and article 3810 would be satisfied by a notice to a specified address for the mortgagor was controlling, even though the mortgagor had given the noteholder a temporary change of address[88] and the printed form of the deed of trust stated that notice would be given " 'at the most recent address as shown on the records of the holder of the debt.' "[89] The deed of trust made no provision for a change of address. With regard to the conflict between the printed and typed notice provision, the appellate court held that the typed provision controlled. Regarding the requirement in article 3810 that notice be sent to the last known address, the appellate court said: "Article 3810 merely establishes a minimum level of protection for the debtor and the parties here contracted within such statutory minimum."[90] The appellate court held, therefore, that the noteholder satisfied the requirements of the deed of trust and article 3810 by sending the notice to the address stated in the deed of trust. The Texas Supreme Court reversed[91] and held as follows: "If Lambeth's records showed a more recent address, then this notice did not comply with the statutory requirement of addressing the notice to the most recent address as shown by the records of the holder of the debt. It would defeat the legislative purpose of the amended statute if the debtor could not change his address after the execution of the deed of trust."[92] Thus, the Texas Supreme Court con-

86. TEX. REV. CIV. STAT. ANN. art. 3810 (Vernon Supp. 1980-1981).

87. 601 S.W.2d 112 (Tex. Civ. App.—Dallas), *rev'd,* 24 Tex. Sup. Ct. J. 203 (Jan. 31, 1981).

88. Specifically, the mortgagor informed the noteholder "that he was returning to Iran and gave an address and telephone number in Iran where he could be reached." *Id.* at 114.

89. *Id.* at 114.

90. *Id.* at 115.

91. 24 Tex. Sup. Ct. J. 203 (Jan. 31, 1981).

92. *Id.* at 204.

cluded that the evidence raised a fact question as to whether the temporary address was the most recent address as shown on Lambeth's records. Since notice was not sent to that address the requirements of article 3810 probably were not met.[93]

d. *When Noteholder's Records Contain No Address.* Compliance with article 3810 "most recent address" requirement generates another question. Is the noteholder required to mail the notice if its records contain no address for the debtor? The Tyler Court of Civil Appeals replied negatively in *Krueger v. Swann.*[94] The court, reciting the settled premise that the general purpose of article 3810 is to provide only a minimum level of protection for the debtor, held that "[t]he statute does not create a duty on the holder of the debt to search for the address of the debtor if none is shown in the records of the debt holder."[95]

e. *Partner's Remedy Against Managing Partner for Lack of Notice of Default and Foreclosure Against Partnership Land.* In *Newton v. Mallory,*[96] following the foreclosure of the partnership's property, several partners sued to recover the amount of the contributions they had made over the years to the partnership.[97] Affirming the trial court's "instructed verdict that the appellants take nothing," the court stated that the correct remedy in a suit such as this should be the same remedy available to a mortgagor whose land has been wrongfully foreclosed. Therefore, the proper measure of damage to each partner for the failure of the partnership's trustee or manager to give notice that the mortgage was in default,[98] and was going to be foreclosed, is the value of each partner's percentage interest in "what was lost" (the land), measured by the fair market value of the land at the time of the foreclosure sale less the mortgage indebtedness.[99] The conclusion which can be

93. *See id.* at 204. Since the court of civil appeals had affirmed a summary judgment by the trial court, the Texas Supreme Court in reaching its decision viewed "all evidence and every reasonable inference therefrom" in the light most favorable to the non-movant (appellant). *See id.* at 203.

94. 604 S.W.2d 454 (Tex. Civ. App.—Tyler 1980, writ ref'd n.r.e.).

95. *Id.* at 457. "This does not leave the debtor without notice, as the statute still requires the traditional method of notice of foreclosure at the courthouse door." *Id.* at 457.

96. 601 S.W.2d 181 (Tex. Civ. App.—Dallas 1980, no writ).

97. *See id.* at 181-82.

98. The mortgage was in default because "some of the partners failed to make their agreed contributions." *Id.* at 182.

99. *See id.* at 182-83.

drawn from the holding in *Newton* is that the manager of a partnership or venture has a duty to notify the partners or venturers that the mortgage is in default, in order to allow them the opportunity to cure the default with their own funds or to bid at the foreclosure sale.

f. *Misdescription of Property in Notice of Foreclosure Sale.* Inadequacy of the bid price at foreclosure is not, by itself, enough to set aside the sale;[100] thus, mortgagors will attempt to show some irregularity in the sale which contributed to the inadequate price. In *Diversified Developers, Inc. v. Texas First Mortgage REIT*,[101] the mortgagor challenged the sale on the ground that the description of the land in the trustee's notice of sale included land released from the mortgage after the notice was posted. The court could find no other Texas case on point, but found authority in other states' holding that normally the advertisement and sale of unsecured property attracts rather than deters bidders at a foreclosure sale.[102] In this case, the court stated, the mortgagor knew the released property would not be sold, the sole bidder had no intention of purchasing the released property, and there was no evidence that any prospective bidder was deterred from bidding at the sale.[103]

3. *Rights of Purchaser at Void Foreclosure Sale.* At a time when loan defaults and foreclosures are increasing, it is worthwhile to repeat the warning to purchasers at foreclosure sales restated in *Henke v. First Southern Properties, Inc.*:[104]

> One who bids upon property at a foreclosure sale does so at his peril. If the trustee conducting the sale has no power or authority to offer the property for sale, or if there is other defect or irregularity which would render the foreclosure sale void, then the purchaser

100. *See* Tarrant Sav. Ass'n v. Lucky Homes, Inc., 390 S.W.2d 473, 475 (Tex. 1965).

101. 592 S.W.2d 43 (Tex. Civ. App.—Beaumont 1979, writ ref'd n.r.e.).

102. *See id.* at 45. " 'Therefore, the [trial court] could have inferred that the effect of its actual inclusion in the advertised sale would more normally have been to attract rather than deter bidders, and that the [foreclosure sale purchaser] was the only one who was likely to suffer prejudice thereby.' " *Id.* at 45 (citing Crist v. House & Osmonson, Inc., 7 Cal.2d 556, 61 P.2d 758, 759-60 (1936)).

103. *See id.* at 45. The fact that there was "no evidence of any prejudice or harm to the mortgagor resulting from the inclusion of the previously released property" influenced the court in affirming the validity of the foreclosure. *See id.* at 45.

104. 586 S.W.2d 617, 620 (Tex. Civ. App.—Waco 1979, writ ref'd n.r.e.).

cannot acquire title to the property.[105]

Although First Southern Properties, Inc. argued that this rule should not be applied because it was a bona fide purchaser, the court stated that the rule protecting bona fide purchasers applies only to a purchaser from a holder of legal title who has the power to convey.[106] The court, however, acknowledged that if the purchaser discharges the mortgage, it is entitled to be subrogated to the lien of the creditor to the extent of the payment made by the purchaser.[107]

4. *Extension of Credit by Mortgagee to Purchaser at "Cash" Foreclosure Sale.* The typical deed of trust provides that the trustee will sell the property at foreclosure sale "for cash." If the mortgagee agrees before the sale to extend credit to the purchaser, has the requirement of a sale for cash been met? In *Valley International Properties, Inc. v. Ray,*[108] the court held that the requirement had been met. "[W]e find no evidence of any wrongful acts or fraud in connection with allowing Los Campeones to use credit extended by the mortgagee at the sale while all others were asked to pay cash."[109] The court said that it would have been an "idle gesture" for the mortgagee to have given the purchaser the cash to give to the mortgagor, who would have been required to give it back to the mortgagee.[110] Irrespective of the court's holding, mortgagees should be careful about discussing terms of sale with prospective purchasers at foreclosure sales. If the extension of credit by the mortgagee exceeded the balance due on the note or were on more favorable terms, the mortgagor might be able to show harm because (1) the extension of credit left the mortgagor liable on the note, rather than discharging the debt to the extent of the bid price, or (2) the mortgagor would have been entitled to receive any

105. *Id.* at 620.

106. *See id.* at 620.

107. *See id.* at 621.

108. 586 S.W.2d 898 (Tex. Civ. App.—Corpus Christi 1979, no writ).

109. *Id.* at 901.

110. *See id.* at 901. The court relied upon the holding in Chase v. First Nat'l Bank, 20 S.W. 1027, 1029 (Tex. Civ. App. 1892, no writ). *See also* French v. May, 484 S.W.2d 420, 425 (Tex. Civ. App.—Corpus Christi 1972, writ ref'd n.r.e.). The court found that the mortgagor had not been damaged, harmed, hindered, or impaired by the extension of credit, permitting an assumption of the note balance, to a person who purchased at the foreclosure sale for the full amount of the debt. *See id.* at 425.

excess above the note balance.

5. *Effect of Deed in Lieu of Foreclosure Upon Junior Lienholders; Application of Article 5520.*[111] A nonjudicial foreclosure under the typical deed of trust extinguishes junior liens. For a variety of reasons, including possible tax benefits to the debtor, the mortgagee may accept a deed in lieu of foreclosure.[112] *Jones v. Ford,*[113] involved the correlative rights of a mortgagee who accepted a deed in lieu of foreclosure and those of a person who held title under a sheriff's deed issued as a result of an execution on a personal judgment against the mortgagor. Unable to pay the indebtedness, the mortgagor executed a quitclaim deed conveying the contested land to the mortgagee. The deed of trust was executed in February of 1969 and recorded in February of 1970; the sheriff's deed was executed in June of 1970 and recorded in May of 1971; and the quitclaim was executed in 1972 and recorded in 1975. The debt secured by the deed of trust was due in 1969 and was not extended. Jones, who held title under the sheriff's deed, contended that the mortgagee's lien rights were no longer effective because of the provisions in article 5520.[114] Article 5520 provides, in part, as follows:

> At the expiration of such four (4) year periods [after the cause of action accrues] payment of any such lien debt shall be conclusively presumed to have been made, and the lien for the security of same and any power of sale for the enforcement thereof shall be void and cease to exist, unless said lien is extended by written agreement of the party or parties primarily liable for the payment of the indebtedness, as provided by law;. . . .[115]

The court held that while the quitclaim did not operate to extend the deed of trust lien, it was effective to convey title to the mortgagee since it was delivered during the four year limitation period.[116] The quitclaim, however, conveyed title subject to the rights of the junior lienholder and for that reason, despite the broader language used in the court's opinion, did not have the

111. TEX. REV. CIV. STAT. ANN. art. 5520 (Vernon 1958).

112. *See* P. ANDERSON, TAX PLANNING OF REAL ESTATE 149-57 (1977).

113. 583 S.W.2d 821 (Tex. Civ. App.—El Paso 1979, writ ref'd n.r.e.).

114. TEX. REV. CIV. STAT. ANN. art. 5520 (Vernon 1958).

115. *Id.*

116. *See* Jones v. Ford, 583 S.W.2d 821, 822-23 (Tex. Civ. App.—El Paso 1979, writ ref'd n.r.e.).

same effect as a foreclosure sale. The essence of the court's opinion is that the delivery of the quitclaim within the four year limitation period had the effect of "perfecting" the mortgagee's superior deed of trust lien and, since the quitclaim did not result in a merger of the deed of trust lien, the mortgagee could thereafter foreclose the deed of trust lien, even though the foreclosure occurred after the four year limitation period had run.[117] In summary, the quitclaim took the deed of trust lien out of article 5520.

Although the quitclaim may have been effective to transfer the mortgagor's rights to the mortgagee without causing a merger of the deed of trust lien, article 5520 does not seem to except this situation from the requirement that the deed of trust lien be foreclosed within the four year limitation period. Thus, the court's opinion endorsing the trial court's judgment foreclosing the deed of trust lien after this four year period had run is questionable. On the other hand, the junior lienholder had very little right after the deed in lieu of foreclosure was delivered. In *North Texas Building & Loan Association v. Overton*,[118] the court stated that after a deed in lieu of foreclosure the junior lienholder has an "equity of redemption" but is not elevated to a first lien.[119] Texas courts have held that the junior lienholder will lose this "equity of redemption" unless a tender of the prior indebtedness is made.[120] The equity of redemption may be found to be worthless, however, if the amount of the prior indebtedness exceeds the property's value.[121] Of course, whether there is a foreclosure or a deed in lieu of foreclosure, mechanics' and materialmen's lien claimants have some rights to remove the materials they furnished.[122]

---

117. *See id.* at 123.

118. 126 Tex. 104, 86 S.W.2d 738 (1935).

119. *See id.* at 109, 86 S.W.2d at 741.

120. *See* Baker v. Marable, 396 S.W.2d 222, 227 (Tex. Civ. App.—El Paso 1965, writ ref'd n.r.e.) (failure to offer to pay indebtedness owed for unpaid purchase price was sufficient to show junior lienholder lost his right of redemption); North Texas Bldg. & Loan Ass'n v. Overton, 91 S.W.2d 429, 431 (Tex. Civ. App.—Amarillo 1936, no writ)(failure to insist upon right of redemption and make tender of prior indebtedness sufficient to show abandonment of such right).

121. *See* R.B. Spencer & Co. v. May, 78 S.W.2d 665, 667 (Tex. Civ. App.—Waco 1935, writ ref'd)(deed of reconveyance did not destroy equity of redemption but right was worthless when indebtedness which had to be paid far exceeded value of the property). *See also* Jackson & Martin, *Deed in Lieu of Foreclosure*, 13 STATE BAR SECTION REPORT OF REAL ESTATE, PROBATE AND TRUST LAW 12 (Mar. 1975).

122. *See* First Nat'l Bank v. Whirlpool Corp., 517 S.W.2d 262, 269 (Tex. 1974), *dis-*

A cautious mortgagee who is willing to accept a deed in lieu of foreclosure should (1) require a deed rather than a quitclaim, (2) have the deed state the deed of trust lien is not merged and the rights of the mortgagee to foreclose under it are extended, (3) foreclose under the deed of trust, if necessary, before the four year limitation period expires, and (4) promptly record all documents.

6. *Requirement of a Fair and Impartial Foreclosure Sale.* The Houston Court of Civil Appeals reached the following decisions in *Dodson v. McCoy*[123] in upholding the trial court's judgment cancelling the trustee's deed and discharging the lien and indebtedness on the condition that the mortgagor pay into the registry of the court the amount of the foreclosure sale price.

a. *Public Auction.* A sale conducted in the corner of the lobby of the Harris County Courthouse when fifty to one hundred people were present was a "public auction,"[124] as the term is used in deed of trust clauses and in article 3810.[125] A question which arises is whether it would really matter how many, or if anyone, were present at the sale?

b. *Fair and Impartial Sale.* The following testimony of the mortgagor was evidence upon which the jury concluded, that the substitute trustee had not acted fairly or impartially in conducting the sale:

> Mrs. McCoy testified that she was standing about 3 feet away from the substitute trustee at the time of the sale and that there were about 12 to 15 people around him at the time. She did not hear him say anything about the property and did not hear him read the legal description of the property or say "this property is for sale." She did not hear him offer the property up for public bidding, although there were other people who wished to bid on the property. She saw him hold up some papers and mumble something, then turn and walk away.[126]

c. *Inadequate Bid Price.* The mortgagor's testimony that the property was sold for approximately one-sixth its value was evi-

---

cussed in Heath & Bentley, *Real Property, Annual Survey of Texas Law,* 32 Sw. L.J. 27, 84-85 (1978).

123. 601 S.W.2d 128 (Tex. Civ. App.—Houston [1st Dist.] 1980, no writ).

124. *See id.* at 130.

125. TEX. REV. CIV. STAT. ANN. art. 3810 (Vernon Supp. 1980-1981).

126. Dodson v. McCoy, 601 S.W.2d 128, 131 (Tex. Civ. App.—Houston [1st Dist.] 1980, no writ).

dence upon which the jury concluded that the manner in which the sale was held caused or contributed to a sale at a grossly inadequate sale price.[127]

This decision is a warning to trustees who conduct foreclosure sales to provide the essential information about the property and the sale in a clear and audible manner, preferably with a witness who can testify on the trustee's behalf. It is also interesting to note that the remedy provided by the trial court was not to reinstate the loan, which had been accelerated for nonpayment of taxes, but to require the mortgagor to pay the foreclosure sale price.[128] While most foreclosure bids made by the mortgagee are in the amount of the balance due on the loan, the trial court's remedy illustrates that a bid below the amount of the loan balance may leave the mortgagee short if the trustee's deed is cancelled and the mortgagor is only required to match the foreclosure sale price.

7. *Inadequate Bid Price as Basis for Setting Aside Sale in Bankruptcy.* A significant decision regarding non-judicial foreclosure was rendered in *Durrett v. Washington National Insurance Co.*[129] A third party, bidding the balance due on the indebtedness secured by the deed of trust, was the high bidder at the 1977 foreclosure sale. Nine days after the foreclosure sale, the debtor filed a petition for an arrangement under Chapter XI of the Bankruptcy Act and sought to set aside the foreclosure sale as a transfer in violation of section 67(d) of the Bankruptcy Act.[130] The Fifth Circuit determined that while the bid price was equal to the balance of the indebtedness, it was only 57.7% of the then fair market value of the property. Finding no authority in a district or appellate decision dealing only with the transfer of real property, the Fifth Circuit held that a non-judicial foreclosure sale for 57.7% of the market value of the property was not a "fair equivalent" for the transfer of the property; therefore, the sale was voidable under

127. *See id.* at 131. It has long been the law in Texas that a grossly inadequate sale price alone will not justify setting the sale aside, *see* Tarrant Sav. Ass'n v. Lucky Homes, Inc., 390 S.W.2d 473, 475 (Tex. 1965); however, a grossly inadequate sale price coupled with an irregularity in the manner in which the sale was held justifies that result. *See* American Sav. & Loan Ass'n v. Musick, 531 S.W.2d 581, 587 (Tex. 1975).

128. *See* Dodson v. McCoy, 601 S.W.2d 128, 130 (Tex. Civ. App.—Houston [1st Dist.] 1980, no writ).

129. 621 F.2d 201 (5th Cir. 1980).

130. *See* 11 U.S.C. § 548 (Supp. III 1979).

section 67(d).[131] The court did not accept the noteholder's argument that the foreclosure sale was not a transfer made by the debtor but one made by the trustee under the deed of trust.[132]

This obviously is a significant decision, especially for states such as Texas, with speedy non-judicial foreclosure procedures.[133] Few lenders or third parties are willing to bid fair market value if it exceeds the mortgage indebtedness at a non-judicial foreclosure sale. Further, for states such as Texas which have no redemption rights, the decision offers an alternative to a mortgagor who files a bankruptcy proceeding and challenges the foreclosure bid price. The decision runs contrary to the general Texas rule that an inadequate bid price alone is not grounds for setting aside a foreclosure sale. It also could discourage or "chill" third party bidders. If the decision is correct and is applied in the case of a mortgagee who purchases property at a foreclosure sale and then resells it to a bona fide purchaser, then the mortgagee could be liable for damages to the mortgagor.

8. *Failure to Give Notice of Payment of Prior Lien as a Default Supporting Foreclosure.* Although Texas courts tend not to favor technical or non-monetary defaults under deed of trust liens, the court in *Slaughter Investment Co. v. Cooper*[134] allowed the mortgagee to proceed with a foreclosure sale based upon a default of the mortgagor in failing to give notice that monthly installments on three prior lien notes had been paid. The court's opinion does not indicate that the prior lien notes had not been paid, but other evidence recited in the opinion suggests such a conclusion. Of course, if there had been evidence that the prior lien notes had not

---

131. *See* Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201, 204 (5th Cir. 1980). In reaching this decision the court noted that in one instance the sale of real property for approximately 50% of its fair market value was found to be void for lack of fair consideration. *See id.* at 203 (citing Schafer v. Hammond, 456 F.2d 15, 17-18 (10th Cir. 1972)).

132. *See* Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201, 204 (5th Cir. 1980). While the actual transfer of title was made when the deed of trust was executed to secure an existing indebtedness, the court stated that the "transfer" within the purview of section 67(d) of the Bankruptcy Act did not occur until the day of the foreclosure sale. Thus, the conveyance took place within the one-year period required in order to set the sale aside. *See* Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201, 204 (5th Cir. 1980) (construing 11 U.S.C. § 548 (Supp. III 1979)).

133. The United States Court of Appeals for the Fifth Circuit currently is considering a case similar to *Durrett. See* Abramson v. Lakewood Bank & Trust Co., Docket No. 79-1592 (5th Cir., filed Mar. 12, 1979).

134. 597 S.W.2d 455 (Tex. Civ. App.—Dallas 1980, no writ).

been paid and were in default, this case would fall into the monetary default category. Without that evidence, however, the failure to give notice of payment was a non-monetary default. This is not to suggest that a non-monetary default cannot be as serious as a monetary default, since a default on a prior lien can certainly produce serious consequences for the inferior lienholder.

D. *Usury.*

1. *Intent to Charge Usury.* A typical deed of trust savings clause disclaims any intent to charge usury. The only mention of intent in this context is found in chapter one of the Texas usury statutes, which provides the following: "[T]here shall be no penalty for any usurious interest which results from an accidental and bona fide error."[135] This provision, however, cannot be relied upon to save a mortgage that is expressly usurious. The Texas Supreme Court in *Cochran v. American Savings & Loan Association,*[136] stated the rule on intent as follows:

> Intent in usury cases does not mean intent to charge a usurious rate of interest. Rather, it means intent to make the bargain made. [Citations omitted.] The subjective intent of the lender is irrelevant if, in fact, the lender has contracted for, charged or received interest on a loan in excess of the maximum permitted by law. To avoid the penalties imposed by article 5069-1.06, the lender is required to plead, prove, and obtain a finding that his contract for, charge or receipt of usury was a result of accidental and bona fide error.[137]

2. *Time-Price Differential.* The sales contract before the court in *Mid States Homes, Inc. v. Sullivan,*[138] quoted a cash price for the land and house and a credit-sale price, based upon a small down payment and an interest rate of 11.4% per annum. The court held that this was a time-price differential under article 5069,[139] therefore, the amount of the finance charge was not interest. "If the negotiations between a buyer and a seller involve a bona fide quotation of both a cash price and a credit price, the transaction

135. TEX. REV. CIV. STAT. ANN. art. 5069-1.06 (Vernon Supp. 1971-1980).
136. 586 S.W.2d 849 (Tex. 1979).
137. *Id.* at 850.
138. 592 S.W.2d 29 (Tex. Civ. App.—Beaumont 1979, writ ref'd n.r.e.).
139. TEX. REV. CIV. STAT. ANN. art. 5069-1.01(a) (Vernon 1971) (interest "shall not include any time-price differential however denominated arising out of a credit sale").

does not involve usury, even though the quoted credit price is such as to exceed the cash price plus lawful interest thereon."[140] This is the only reported case applying the time-price differential exception to a real estate mortgage. It should not be relied upon as authority until the Texas Supreme Court addresses the question.

3. *Compensating Balances, Payment of Unearned Attorney's Fees, and Other Requirements Imposed by Lender.*

a. *Compensating Balances; Unearned Attorney's Fees; Purchase of Other Indebtedness.* The court in *Bradley v. Houston State Bank,*[141] faced several interesting issues. The borrowers alleged that the bank's requirement that a $20,000 compensating balance be deposited with the bank made the loan usurious. The court distinguished *First State Bank v. Miller,*[142] where $14,000 of the loan was "frozen" in a non-interest bearing account at the bank. Finding that First State Bank had general use of the funds, the court held the loan to be usurious.[143] In *Bradley,* the $20,000 was not a part of the loan proceeds; in fact, the $20,000 deposit was made by a corporation of which one of the borrowers was the president. Thus, the court in *Bradley* unlike *Miller,* held the borrower had full use of the loaned funds; therefore, the $20,000 compensating balance made by a third party should not reduce the true principal amount of the loan.

The borrowers also argued the requirement that unearned attorney's fees be paid made the loan usurious.[144] The court, however,

---

140. Mid State Homes, Inc. v. Sullivan, 592 S.W.2d 29, 30 (Tex. Civ. App.—Beaumont 1979, writ ref'd n.r.e.).

141. 588 S.W.2d 618 (Tex. Civ. App.—Houston [14th Dist.] 1979, writ ref'd n.r.e.).

142. 563 S.W.2d 572 (Tex. 1978).

143. *See id.* at 574-75. The *Miller* case is discussed and distinguished from Tanner Development Co. v. Ferguson, 561 S.W.2d 777 (Tex. 1977), where the court applied the "doctrine of spreading all interest over the whole term of loans secured by real property," *id.* at 786, in Heath & Bentley, *Real Property, Annual Survey of Texas Law,* 32 Sw. L.J. 27, 78-79 (1978). *Cf.* Texas Int'l Mortgage Co. v. M.P. Crum Co., 564 S.W.2d 421, 422 (Tex. Civ. App.—Dallas 1978, writ ref'd n.r.e.) (lender's requirement that part of loan be deposited with independent bank to secure payment of debt did not make loan usurious; although borrowers did not have full use of amount deposited, interest was properly charged on total obligation because borrowers received interest payments on required amount deposited and usage restrictions were mere consequence of loan agreement); Moss v. Metropolitan Nat'l Bank, 533 S.W.2d 397, 399 (Tex. Civ. App.—Houston [1st Dist.] 1976, no writ) (fee paid to third parties to provide compensating balance was not usurious). *See also* Wolf, *The Mortgage Escrow Debate Revisited,* 9 REAL EST. REV. 85 (1979); Annot., 92 A.L.R.3d 769 (1979).

144. *See* Bradley v. Houston State Bank, 588 S.W.2d 618, 623 (Tex. Civ. App.—Houston [14th Dist.] 1979, writ ref'd n.r.e.). The court points out that a note contain-

found that these fees were paid as a condition to the sale of the note to another bank and not as a condition to the payment of the note. "Houston State Bank was free to place any price upon these notes as a condition of sale, and to require the payment of any sums it felt necessary to protect itself, including the payment of amounts it felt would be required as attorney's fees in the future."[145] The borrowers further alleged the loan was made usurious by the bank's requirement that the bank to which the borrower's note was sold also purchase one of the borrower's individual notes. The court refuted this allegation on the same basis as the second allegation.[146]

b. *Purchase of Lender's Royalty Interest.* There were two issues before the court in *Franklin Offices, Inc. v. Harding.*[147] The plaintiffs contended that the loan to the corporation should be treated as a loan to the individual principals of the corporation. Finding no evidence that the loan to the corporation was a subterfuge to cloak a loan to the individuals at an excessive interest rate, the court rejected this argument.[148] The plaintiffs also argued that the price paid for a royalty interest should be treated as interest, thus making the loan usurious. The lender denied that he required Dr. Franklin, one of the principals of the corporation, to purchase the overriding royalty interest, but admitted that he suggested the purchase and that Dr. Franklin was willing to make the purchase in order to induce the lender to make the loan. Dr. Franklin testified that he considered the royalty interest to have no value, while the lender, an experienced oil operator, testified that the royalty interest was worth the $12,500 purchase price. The court distin-

---

ing a provision which stipulates that if placed in the hands of an attorney for collection an additional 10% for attorney fees shall be paid by the debtor is valid and does not render a transaction usurious at its inception. *See id.* at 623. "Appellants argue however that the collection of attorney's fees, which have not actually been incurred, does constitute the collection of usurious interests." *Id.* at 623.

145. *Id.* at 623.

146. "Because the transaction was a purchase from the Bank, it was free to impose any condition, including the purchase of an individual note of one of the debtors, . . . without rendering the transaction usurious." *Id.* at 623.

147. 579 S.W.2d 254 (Tex. Civ. App.—Dallas 1979, no writ).

148. Allowing a corporation to be the borrower in order to charge a higher rate of interest indicates compliance with usury laws, not evasion, therefore, the transaction is not usurious. *See id.* at 256 (citing American Century Mortgage Investors v. Regional Center, Ltd., 529 S.W.2d 578, 582 (Tex. Civ. App.—Dallas 1975, writ ref'd n.r.e.)).

guished *Glover v. Buchman*,[149] where the lender's requirement that each borrower purchase a coupon was held to be a subterfuge to charge additional interest. In *Franklin Offices, Inc.*, the court stated that the plaintiff had failed to establish that the parties did not intend the assignment of the royalty interest to be a benefit to Dr. Franklin, or that the royalty interest had no value.[150]

c. *Purchase of Lender's Stock.* A similar result was reached in *Loomis v. Blacklands Production Credit Association.*[151] In *Loomis* the court held that the lender's requirement that the borrower purchase class B stock in the lender's institution was not a "front-end charge" thereby making the loan usurious. The lender was chartered under the Farm Credit Act of 1971,[152] which requires that borrowers own stock in chartered institutions. The court held that this fact, coupled with the fact that the borrower was not required to pay for the stock out of the loan, the stock had value which was later repaid to the borrower, and ownership of the stock gave the borrower voting privileges, kept the stock price from being a charge made on the loan.[153]

d. *Commitment Fees.* When is "interest" not interest? When is a commitment fee not interest? These two questions were before the Texas Supreme Court in *Stedman v. Georgetown Savings & Loan Association.*[154] The court defined the issue before it as follows: "[W]hether an accruing charge of 10 percent per annum on the principal amount of a loan commitment (which was exacted during the 8 month existence of the commitment) was a bona fide commitment fee or a cloak to conceal usurious interest on the permanent loan."[155] The court referred to its earlier holding in *Gonza-*

149. 104 S.W.2d 66 (Tex. Civ. App.—Galveston 1937, writ dism'd).

150. *See* Franklin Offices, Inc. v. Harding, 579 S.W.2d 254, 256 (Tex. Civ. App.—Dallas 1979, no writ). The good faith purchase of merchandise saves a transaction from being designated usurious. *See id.* at 256 (construing Glover v. Buchman, 104 S.W.2d 66, 68 (Tex. Civ. App.—Galveston 1937, writ dism'd)).

151. 579 S.W.2d 560 (Tex. Civ. App.—Waco 1979, writ ref'd n.r.e.).

152. 12 U.S.C. § 2001 (Supp. IV 1980).

153. *See* Loomis v. Blacklands Prod. Credit Ass'n, 579 S.W.2d 560, 563 (Tex. Civ. App.—Waco 1979, writ ref'd n.r.e.). The purchase of class B stock in the lender's institution was found not to be a front-end charge which must be deducted from the amount of indebtedness in order to determine "the true principal of the loan in testing for usury." *Id.* at 563 (construing First State Bank v. Miller, 563 S.W.2d 572, 575 (Tex. 1978); Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 787 (Tex. 1977)).

154. 595 S.W.2d 486 (Tex. 1979).

155. *Id.* at 487. *See generally* 12 ST. MARY'S L.J. 259 (1980).

les County Savings & Loan Association v. Freeman,[156] that a fee which commits the lender to make a loan at some future date does not fall within the definition of interest contained in article 5069.[157] Although the loan commitment had the characteristics of a bona fide commitment (an option, not an obligation, for Stedman to borrow funds under the commitment at a future date), Stedman argued for a different construction in light of the fact that the lender's offer referred to the charge as "interest," and it was called "interest" by the loan officer and in the monthly statements which the lender sent to Stedman. The Texas Supreme Court held that the trial court was correct in looking beyond the label given the charge by the parties and in finding that the charge was a bona fide commitment fee.[158]

4. *Interim and Permanent Loan as One Transaction.* In *Spanish Village, Ltd. v. American Mortgage Co.*,[159] the mortgagor argued that the interim loan and the permanent loan should be treated as two separate loans, and that the interim loan was usurious. Both the trial court and the appellate court disagreed. The appellate court stated:

> We have concluded that the contract documents, when construed together, clearly provide for only one 41½ year loan made by American Mortgage Company to appellant to finance the construction of the Spanish Village Apartment project; that this loan was evidenced

156. 534 S.W.2d 903 (Tex. 1976).

157. TEX. REV. CIV. STAT. ANN. art. 5069-1.01(a) (Vernon 1971).

158. *See* Stedman v. Georgetown Sav. & Loan Ass'n, 595 S.W.2d 486, 489 (Tex. 1979). The court in *Freeman* stated "whether or not a charge labeled a 'commitment fee' is merely a cloak to conceal usury may depend upon whether or not the fee is unreasonable in light of the risk to be borne by the lender." Gonzales County Sav. & Loan Ass'n v. Freeman, 534 S.W.2d 903, 906 (Tex. 1976). Justice Spears in his dissenting opinion in *Stedman* relied upon this language to conclude: "A legitimate, bona fide commitment fee must be both *reasonable* and intended only as consideration for having the future loan available." Stedman v. Georgetown Sav. & Loan Ass'n, 595 S.W.2d 486, 491 (Tex. 1979) (emphasis added). The majority, however, concluded: "In any event the reasonableness of the amount charged would not constitute usurious interest since it was consideration for a bona fide commitment fee." *Id.* at 489. It seems, therefore, that while the reasonableness of the amount may be a factor in determining whether a commitment fee is actually a devise to conceal usury, once it is determined that the fee is a legitimate commitment fee paid to secure a future loan, there is no requirement that the amount charged be reasonable. *Cf.* Gonzales County Sav. & Loan Ass'n v. Freeman, 534 S.W.2d 903, 908 (Tex. 1976) (savings and loan association had burden of establishing true nature of loan fee as either a valid commitment fee or a fee to cover " 'reasonable' expenses").

159. 586 S.W.2d 195 (Tex. Civ. App.—Tyler 1979, writ ref'd n.r.e.).

by a single mortgage note dated July 12, 1973, maturing December 1, 2014, payable to American Mortgage Company or order, in the original principal sum of $1,651,900.00, with interest at seven percent per annum and secured by a single deed of trust.[160]

. . . . .

We also hold that the total interest provided for by the note should be spread over the entire 41½ year term of the note under the rule of *Nevels v. Harris,* [129 Tex. 190, 102 S.W.2d 1046 (1937)] as adopted and applied by the Supreme Court in *Tanner Development Company v. Ferguson, 651 S.W.2d 777 (Tex. 1977),* and again recently in *First State Bank of Bedford v. Miller,* 563 S.W.2d 572 (Tex. 1978).

. . . . .

Under this test, the relevant time is not determined by whether any particular lender parts with the risk of loss before the end of the note period by selling the note to another lender; it depends solely on the period that the borrower contracts to have and does have use of the funds.[161]

5. *Choice of Law.* In periods of tight money and high interest rates, out-of-state lenders may be willing to make a real estate construction loan for a Texas project, but, at least in the absence of more liberal federal preemption laws, will be unwilling to limit the interest rate to the maximum rate allowed by Texas law. When such is the case, the lender will take steps to structure the loan so that the usury law of another state will apply. Two significant decisions were recently reported involving the lender-designated choice of law. The first case applied the traditional Texas tests.

In *Hi Fashion Wigs Profit Sharing Trust v. Hamilton Investment Trust,*[162] after restating Texas law allowing the parties to

---

160. *Id.* at 200. The court relied upon the rule set out in Nevels v. Harris, 129 Tex. 190, 102 S.W.2d 1046 (1937), "that the question of usury must be determined by a construction of all the documents constituting the loan transaction, interpreted as a whole and in the light of the attending circumstances." *Id.* at 197, 102 S.W.2d at 1048; *see* Spanish Village, Ltd. v. American Mortgage Co., 586 S.W.2d 195, 199 (Tex. Civ. App.—Tyler 1979, writ ref'd n.r.e.).

161. Spanish Village, Ltd. v. American Mortgage Co., 586 S.W.2d 195, 200 (Tex. Civ. App.—Tyler, writ ref'd n.r.e.). Furthermore, the court pointed out that the interest charged was within the maximum rate which could have been charged on the "true" principal of the loan. *See id.* at 200-01 (construing Tanner Dev. Co. v. Ferguson, 561 S.W.2d 777, 782 (Tex. 1977); Nevels v. Harris, 129 Tex. 190, 197, 102 S.W.2d 1046, 1049 (1937)) (test for usury should be applied to net amount of money received by borrower).

162. 579 S.W.2d 300 (Tex. Civ. App.—Eastland 1979, no writ).

choose the law that will govern the transaction as long as it bears a reasonable relationship to the chosen state,[163] the court upheld the parties' choice of Oklahoma law. The following factors were considered by the court in determining that the loan transaction had a reasonable relationship to Oklahoma: (1) the borrowers were Oklahoma employee benefit trusts; (2) the loan agreement was negotiated in Oklahoma and New Jersey, although closed in New Jersey; (3) the loan documents stipulated that Oklahoma law was applicable; (4) disbursements under the loan agreement were made in Oklahoma; and (5) interest statements were mailed to the borrowers in Oklahoma, although the note payments were payable in New Jersey.[164] The exception to this rule is that Texas courts will not apply the law of the designated state if it is shown that the designation was merely a contrivance to avoid Texas usury laws.[165] Some of the elements in finding a reasonable relationship with the designated state are: (1) choice of law designation in the loan documents, (2) place of payment, (3) place of performance of the loan covenants, (4) place of negotiations, (5) place of closing, (6) place of loan funding, (7) location of collateral, and (8) domicile of lender, borrower, and guarantors.[166]

The general premise that Texas courts will apply the law of the state designated in the loan documents, if there is a reasonable relationship between the loan transaction and the state,[167] was shaken by the Fifth Circuit's initial opinion in *Woods-Tucker Leasing Corp. v. Hutcheson-Ingram Development Co.*[168] *Woods-*

163. *See* Dugan v. Lewis, 79 Tex. 246, 253, 14 S.W. 1024, 1026 (1891); TEX. BUS. & COM. CODE ANN. § 1.105(a) (Tex. UCC) (Vernon Supp. 1980-1981).

164. *See* Hi Fashion Wigs Profit Sharing Trust v. Hamilton Inv. Trust, 579 S.W.2d 300, 301-02 (Tex. Civ. App.—Eastland 1979, no writ).

165. *See* Securities Inv. Co. v. Finance Acceptance Corp., 474 S.W.2d 261, 271 (Tex. Civ. App.—Houston [1st Dist.] 1971, writ ref'd n.r.e.). In *Hi Fashion Wigs* the trial court found the agreement designating Oklahoma law to be " 'free from any taint of sham, subterfuge, or coercion, and the State of Oklahoma bears a reasonable relationship to the parties and the transactions.' " Hi Fashion Wigs Profit Sharing Trust v. Hamilton Inv. Trust, 579 S.W.2d 300, 302 (Tex. Civ. App.—Eastland 1979, no writ).

166. *See generally* USURY LAWS AND MODERN BUSINESS TRANSACTIONS 1980, at 228-29 (Practicing Law Institute 1980).

167. *See, e.g.,* Dugan v. Lewis, 79 Tex. 246, 253, 14 S.W. 1024, 1026 (1891); Hi Fashion Wigs Profit Sharing Trust v. Hamilton Inv. Trust, 579 S.W.2d 300, 302 (Tex. Civ. App.—Eastland 1979, no writ); Securities Inv. Co. v. Finance Acceptance Corp., 474 S.W.2d 261, 271 (Tex. Civ. App.—Houston [1st Dist.] 1971, writ ref'd n.r.e.).

168. 626 F.2d 401 (5th Cir. 1980), *vacated*, No. 79-1651 (5th Cir. April 3, 1981).

Tucker Leasing Corp. involved a sale and leaseback of equipment, which was held to be a loan.[169] As a loan, it was found to be usurious both under Mississippi law, the law chosen by the parties in the documents, and Texas law, the law of the borrower's residence. Choice of law was important because Texas law provides more stringent penalties for usury than does Mississippi law.[170] In the first opinion the court held that notwithstanding the fact that the loan documents provide that the law of another state governs the transaction, Texas courts will apply the usury laws of the borrower's state if the borrower pleads and proves that the other state has no interest in the transaction.[171] This holding was a complete departure from established Texas law,[172] and it drew numerous amicus curiae briefs from lenders' counsel. On motion for rehearing, the Fifth Circuit withdrew its first opinion and affirmed the district court.[173] The court focused upon section 1.105(a) of the Texas Uniform Commercial Code[174] in upholding the choice of Mississippi law that was designated by the parties in the sale-leaseback documents. The Fifth Circuit stated that section 1.105 "establishes the rule that parties to a multistate transaction are free to choose the law that will govern their rights and obligations so long as the jurisdiction whose law is chosen bears a 'reasonable relation' to their transaction."[175] The court further held that if a reasonable relation exists, it is immaterial that the state law was chosen for the purpose of allowing the lender to charge a higher interest rate:

> That the intent of their choice of law provision was to avoid the usury laws of some interested jurisdiction is immaterial — they are perfectly free to do just that. What they are forbidden to do is to evade those laws *at will*, capriciously or fraudulently, by selecting

---

169. Woods-Tucker Leasing Corp. v. Hutcheson-Ingram Dev. Co., No. 79-1651 (5th Cir. April 3, 1981).

170. *See id.*

171. *See* Woods-Tucker Leasing Corp. v. Hutcheson-Ingram Dev. Co., 626 F.2d 401, 409 (5th Cir. 1980), *vacated*, No. 79-1651 (5th Cir. April 3, 1981).

172. *See* Dugan v. Lewis, 79 Tex. 246, 253, 14 S.W. 1024, 1026 (1891) (law of the state designated in loan documents will be applied).

173. *See* Woods-Tucker Leasing Corp. v. Hutcheson-Ingram Dev. Co., No. 79-1651 (5th Cir. April 3, 1981).

174. Tex. Bus. & Com. Code Ann. § 1.105(a) (Tex. UCC) (Vernon Supp. 1980-1981).

175. Woods-Tucker Leasing Corp. v. Hutcheson-Ingram Dev. Co., No. 79-1651 (5th Cir. April 3, 1981).

> the law of a jurisdiction without a normal relation to the transaction or by contriving contacts with an otherwise noninterested jurisdiction so as to validate their choice of law.[176]

The court observed in a footnote to the opinion that honoring the parties' choice of law in this case did not offend fundamental public policy of the State of Texas; although the court said that it had found no Texas case that had invalidated a choice of law on this ground.[177]

6. *Nonrefundable Pre-Paid Interest as Usury.* The court in *Smart v. Tower Land & Investment Co.*[178] did not grant writ of error on the usury issue and, the author understands, this issue was not argued before the Texas Supreme Court. Thus, the court's holding must have come as a surprise to both parties.

The mortgagor, Smart, prepaid the first three years of interest. The provision in the note that the court found to be critical stated: "The maker hereof is not now nor shall he ever be personally liable on this note, but the payees or other holders of this note shall never be obligated to refund any payment of interest or principal after such payment has been made."[179] Smart did not contend that Tower received usurious interest, but rather that the note was usurious on its face because under a hypothetical circumstance (acceleration of the note during the first two years without refund of the prepaid interest) it allowed Tower to receive usurious interest. The court stated the general Texas policy pronounced in *Walker v. Temple Trust Co.*:[180] "The contract under construction will not be found usurious on its face unless it expressly entitles the lender, upon the happening of a contingency or otherwise, to exact interest at a rate greater than that allowed by law."[181] Since this note, however, expressly provided that the prepaid interest would not be refunded if the note were accelerated during the first two years, there was in the court's view an obvious intention to exact usurious

176. *Id.*
177. *See id.*
178. 597 S.W.2d 333 (Tex. 1980).
179. *Id.* at 340.
180. 124 Tex. 575, 577-78, 80 S.W.2d 935, 937 (1935).
181. Smart v. Tower Land & Inv. Co., 597 S.W.2d 333, 341 (Tex. 1980); *see* W.E. Grace Mfg. Co. v. Levin, 506 S.W.2d 580, 584 (Tex. 1974) (contract to pay fixed charge for uncertain period based upon a reasonable contingency is "not necessarily usurious merely because there is a possibility that more than legal interest might be paid").

interest.

> Having affirmatively provided for the retention of unearned interest, Tower was obliged to make further provisions ensuring that the retention of this interest would not result in a usurious transaction. Neither the note nor the deed of trust, nor any of the other documents contains any kind of usury savings clause whatever. [Citations omitted]. In the absence of a savings clause, we find that Tower's expressed authorization to retain excess unearned interest overcomes the presumption of legality accorded to allegedly usurious contracts. Because the installment note is usurious on its face, we remand this case to the trial court for determination of the proper remedy to be imposed.[182]

The Dallas Court of Civil Appeals had applied the same general Texas policy to reach the opposite result, holding that, since the note was silent as to how unearned interest would be applied, the note should be construed as allowing any unearned interest to be credited to unpaid principal so as to make the contract legal.[183] The Texas Supreme Court, however, refused to construe the note in this manner, absent an express provision in the note. The Dallas Court of Civil Appeals also held that under *Tanner Development Co. v. Ferguson*,[184] the prepaid interest could be spread over the term of loan, despite the fact that there was no savings clause in the note.

It should be kept in mind that the Texas usury statute was amended effective September 1, 1975, to require that interest be spread over the term of the loan secured by real estate for the purpose of determining whether usurious interest was contracted for, charged, or received, and if the borrower prepaid the loan, then the interest in excess of the amount which could have been charged over the actual term of the loan has to be refunded.[185] In a footnote the Texas Supreme Court acknowledged this amendment, but said since neither party had contended that the amendment was controlling no opinion was expressed as to its application.[186] Generally, the amendment is not applicable to a contract or cause of

182. Smart v. Tower Land & Inv. Co., 597 S.W.2d 333, 341 (Tex. 1980).
183. Smart v. Tower Land & Inv. Co., 582 S.W.2d 543, 545 (Tex. Civ. App.—Dallas), *rev'd*, 597 S.W.2d 333 (Tex. 1980).
184. 561 S.W.2d 777 (Tex. 1977).
185. *See* TEX. REV. CIV. STAT. ANN. art. 5069-1.07(a) (Vernon Supp. 1971-1980).
186. Smart v. Tower Land & Inv. Co., 597 S.W.2d 333, 341 n.2 (Tex. 1980).

action which arose before September 1, 1975.

Several lessons are learned from *Smart*. First, despite the applicability of section 1.07(a) of article 5069, a savings clause in both the note and the deed of trust is recommended. In addition, despite some faint hint in the *Smart* opinion, an alternative note provision that excess interest will be credited to the principal of the note is not recommended as a means to avoid the collection of usurious interest. Further, the *Smart* decision, like *Tanner Development Co. v. Ferguson*,[187] arose in a different era. These transactions occurred before the Tax Reform Act of 1976, and in particular section 461(g),[188] which now requires that prepaid interest be capitalized and deducted ratably over the term of the loan. Taxpayers were encouraged to prepay interest in the first year in order to increase the purchaser's tax benefits. Consequently, sellers of real property who required a minimum down payment were often persuaded to convert the down payment into mostly prepaid interest. Thus, as unconventional as the "non-refundable" interest clause in the *Smart* note may appear today, in the former era it was an effort by the seller to retain the minimum down payment that was an essential part of the deal.

7. *Prepayment Charge is Not Interest*. The promissory note that was in issue in *Ware v. Traveler's Indemnity Co.*[189] permitted the maker to prepay the note on any interest payment date. The maker wanted to prepay the note prior to the next interest payment date. The noteholder agreed provided the maker paid the interest that would have been due on the next interest payment date. The maker paid the unaccrued interest and then filed suit alleging that the noteholder had charged usurious interest. The court held that since the note did not permit the maker to prepay the loan before the next interest payment date, the requirement that unaccrued interest be paid was merely a charge for the privilege of prepaying the loan and was not compensation for the use, forebearance, or detention of money within the meaning of article 5069-1.01(a).[190]

187. 561 S.W.2d 777 (Tex. 1977).

188. I.R.C. § 461(g).

189. 604 S.W.2d 400 (Tex. Civ. App.—San Antonio 1980, no writ).

190. TEX. REV. CIV. STAT. ANN. art. 5069-1.101(a) (Vernon 1971).

8. *Federal Preemption of State Usury Laws Under the Brock Bill.* The issue before the court in *Braugh v. Corpus Christi Bank & Trust*[191] was whether the Brock Bill,[192] which was enacted on October 29, 1974, preempted Texas usury law with respect to a loan made before October 29, 1974, but which was renewed and extended in December, 1974. The Brock Bill permitted national banks and certain federally insured lending institutions to charge up to 12.5% interest per annum on business and agricultural loans in the amount of $25,000.00 or more. The borrower argued that the Brock Bill did not apply to a loan made before October 24, 1974, whether or not it was renewed or extended after that date. The court could find no Texas authority on this issue. After reviewing the legislative history accompanying the Brock Bill, the court concluded that the Brock Bill did apply to "a voluntary modification of a preexisting loan which is, in fact, in default after the inception date of the Bill, particularly where, as here, the Bank was entitled to declare a default and to foreclose the liens securing the notes."[193] It does not appear that the court intended to limit its holding to renewals and extensions of pre-Brock Bill loans in default on or after October 29, 1974, because elsewhere in the opinion the court states in more general terms that an extension or renewal of a loan is generally treated in Texas as a new contract evidencing the existing debt.[194] Although the Brock Bill did not apply to loans made after June 30, 1977, the court's holding may have some continuing impact on loans made before that date.

E. *Due-on-Sale Clauses*

A due-on-sale clause permits the mortgagee to call the loan in the event the real estate covered by the deed of trust is sold, and in some clauses contracted to be sold, without the mortgagee's consent. The dramatic rise in interest rates has caused many lenders to use the clause as a means of requiring the purchaser of real property to consent to a higher interest rate, a substantial transfer fee, or other modifications in the mortgage. The courts in states

---

191. 605 S.W.2d 691 (Tex. Civ. App.—Corpus Christi 1980, no writ).

192. 12 U.S.C. § 1831a(a) (1976). The Brock Bill applied to loans made after October 29, 1974, and before July 1, 1977, unless subsequently enacted state law prohibited the charging of interest at the rate provided in the Brock Bill.

193. Braugh v. Corpus Christi Bank & Trust, 605 S.W.2d 691, 697 (Tex. Civ. App.—Corpus Christi 1980, no writ).

194. *See id.* at 696.

other than Texas have been divided in their enforcement of the clause.[195] In this section, the two reported Texas decisions involving due-on-sale clauses will be discussed, along with one pending Texas case, a Ninth Circuit personal property case in which Texas law was applied, and some recent decisions in other states.

The two reported Texas cases which have considered the enforceability of the due-on-sale clause appear to support the enforceability of the clause. One is *A.R. Clark Investment Co. v. Green,*[196] in which the Texas Supreme Court held that the lenders could accelerate the maturity of the notes, because the borrower had sold the motel without obtaining the lender's consent as was required under a chattel mortgage on the personal property. The court rejected the borrower's argument that the lender had waived the right to accelerate or was estopped to enforce that right. The borrower's argument was based primarily upon the fact that the lender did not elect to accelerate until more than four months after the sale. The court, with four justices dissenting, held that the lender did not waive the right to accelerate by accepting note payments from the new owner because the default was a nonmonetary default or by waiting to elect to accelerate because the lender's attorney gave notice of the right to accelerate within a few weeks after the sale, the lender and new owner were in continuous negotiations during that time, and the lender frequently reminded the new owner of its right to accelerate. The second case is *Ashley v. Leitch.*[197] In this case, the borrower's only argument appears to have been that the due-on-sale clause applied only in the event that the purchaser assumed the loan, and did not apply to a sale subject to the loan. The court rejected this argument and allowed acceleration. The equitable arguments which have persuaded a number of the supreme courts in other states were not discussed in *Ashley*.

There is at least one pending Texas case which may shed some light on the direction Texas courts will take regarding due-on-sale clauses in the future. The case is *Sonny Arnold, Inc. v. Sentry*

195. *See* Report of Committee on Real Estate Financing, *Enforcement of Due-on-Transfer Clauses*, 13 REAL PROP., PROB. & TR. J. 891 (1978); Comment, *The Due-on-Sale Clause As A Reasonable Restraint On Alienation—A Proposal For Texas*, 8 ST. MARY'S L.J. 514 (1976).

196. 375 S.W.2d 425 (Tex. 1964).

197. 533 S.W.2d 831 (Tex. Civ. App.—Eastland 1975, writ ref'd n.r.e.).

Savings Association, which is before the Amarillo Court of Civil Appeals.[198] In the *Sonny Arnold* case, the borrower executed a note, secured by a deed of trust covering an apartment project. The deed of trust contained the following provision:

> On sale of transfer of (i) all or any part of the Property, or any interest therein, or (ii) beneficial interests in Borrower (if Borrower is not a natural person or persons but is a corporation, partnership, trust or other legal entity), Lender may, at Lender's option, declare all of the sums secured by this Instrument to be immediately due and payable. . . . This option shall not apply in case of: . . . (b) sales or transfers when the transferee's creditworthiness and management ability are satisfactory to Lender and the transferee has executed, prior to the sale or transfer, a written assumption agreement containing such terms as Lender may require, including, if required by Lender, an increase in the rate of interest payable under the note.

In *Sonny Arnold,* the lender, after being informed of a proposed sale of the realty, indicated a satisfaction with the proposed assumption of the indebtedness if the assumption was by a corporation with a modification of the note to provide for a higher interest rate. Subsequently, the borrower sold the realty to an individual without any modification to the note. Within a month of the sale, the borrower was notified by the lender that the sale was not in compliance with the due-on-sale clause in the deed of trust, and that the lender had elected to accelerate the maturity of the indebtedness.

In *Brown v. Avemco Investment Corp.,*[199] a federal diversity case decided by the Ninth Circuit applying Texas law, the court held that section 1.208 of the Uniform Commercial Code[200] and "equitable principles" prohibit acceleration under a "due-on-lease" clause. Although the *Brown* decision dealt with a breach of a covenant prohibiting the further leasing of an airplane without lender's consent, it is the first case applying Texas law which limits the enforceability of the due-on-sale clause. The court did not cite either the *Ashley* or *A. R. Clark* cases but relied on equitable principles under Texas law in reaching its decision.

---

198. No. 9247 (Tex. Civ. App.—Amarillo, filed June 2, 1980).
199. 603 F.2d 1367 (9th Cir. 1979).
200. *See* TEX. REV. CIV. STAT. ANN. art. § 1.208 (Tex. UCC) (Vernon 1968).

> Acceleration clauses are designed to protect the creditor from actions by the debtor which jeopardize or impair the creditor's security. They are not to be used offensively, e.g., for the commercial advantage of the creditor. Acceleration is a harsh remedy with draconian consequences to the debtor. Acceleration is a matter of equity and the courts, including those of Texas, have historically been careful to evaluate the fairness of acceleration in the particular facts of a case.[201]

It should be noted that the court, in dictum, compared the differences between due-on-sale and due-on-lease clauses, noting that "[u]nlike a lease, a sale of the property transfers title of the collateral to new owners, non-signators to the security agreement and unknown to and unapproved by the creditor."[202]

The court's focus in *Brown* on the Texas law regarding acceleration of the maturity of notes takes on added significance in light of the decision of the Corpus Christi Court of Civil Appeals in *McGowan v. Pasol*,[203] where the court made the following statement:

> It has been held that the holder of a promissory note is precluded from accelerating its maturity where there are circumstances which tend to show that the holder has exercised his option to accelerate, not for the purpose of protecting his debt or preserving the security therefor, but for the purpose of coercing the maker to pay the then balance remaining unpaid on the note, or risk foreclosure of the lien on the property securing the debt.[204]

This language closely resembles recent decisions in other states, which have required the mortgagee seeking to exercise the due-on-sale clause to show some impairment of the security or likelihood of repayment of the debt because of the sale.

A few of the recent decisions in other states are discussed to show the mixed results the courts are reaching on this issue. The New York Supreme Court Appellate Division held in *Silver v. Rochester Savings Bank*,[205] that under a deed of trust due-on-sale clause which requires the mortgagee's consent to a sale of the security, which consent will not be unreasonably withheld, the mort-

201. Brown v. Avemco Inv. Corp., 603 F.2d 1367, 1376 (9th Cir. 1979).
202. *Id.* at 1380.
203. 605 S.W.2d 728 (Tex. Civ. App.—Corpus Christi 1980, no writ).
204. *Id.* at 732.
205. 424 N.Y.S.2d 945 (N.Y. App. Div. 1980).

gagee cannot condition its consent upon the purchaser's payment of a higher interest rate. The court held that the intent of the parties was for the mortgagee's approval to apply only to the approval of the character and financial ability of the purchaser; thus, the mortgagee unreasonably withheld its consent. A federal district court in Virginia, in *Williams v. First Federal Savings & Loan Association*,[206] held that the use of a land trust to transfer ownership of property will not escape the application of a due-on-sale clause contained in a deed of trust that covers the property. The owners of the property had created an unrecorded Virginia statutory land trust, conveyed the property to themselves as trustee subject to the deed of trust, and then assigned the rights and beneficial interest in the trust to the purchasers. The court held that the transfer of title to the owners as trustee violated the due-on-sale provision, and that a statutory land trust cannot be used as a means of avoiding the application of the clause.

In *Tierce v. APS Co.*,[207] the Alabama Supreme Court refused to follow the recent trend in other jurisdictions, and held that the mortgagee was entitled to accelerate the maturity of the note under a due-on-sale clause after a sale of the property, even though the mortgagee had agreed to consent to the sale if the purchaser would agree to pay a higher interest rate which the purchaser refused to do.[208] The court then made this general observation after acknowledging the contrary decisions in other states:

> We cannot, however, agree that the desire of a lender to terminate loans upon transfers, due to rising interest rates, is not a valid business purpose, thus rendering a "due on sale" clause unconscionable and unenforceable when such desire is the primary purpose for acceleration.[209]

Likewise, the Nebraska Supreme Court, in *Occidental Savings & Loan Association v. Venco Partnership*,[210] held that balancing the return on loan portfolios with the cost of money is critical to the

206. 500 F. Supp. 307 (E.D. Va. 1980).
207. 382 So. 2d 485 (Ala. 1980).
208. *See id.* at 486. In so holding, the court followed Tidwell v. Wittmeier, 43 So. 2d 782 (Ala. 1907), and found the recent decision in First S. Fed. Sav. & Loan Ass'n v. Britton, 345 So. 2d 300 (Ala. App. 1977), to be in error.
209. Tierce v. APS Co., 382 So. 2d 485, 487-88 (Ala. 1980).
210. 293 N.W.2d 843 (Neb. 1980).

survival of lending institutions, and outweighs the restrictions on transferability imposed by due-on-sale clauses. "The potential failure of savings and loan associations and the loss of their depositors' funds should be of no less a concern to the courts than the inability of a property owner to transfer its mortgage at a premium when selling its property."[211] Thus, the court held that a due-on-sale clause is enforceable absent pleading and proof that its enforcement would be inequitable in a particular case. Finally, in dictum, the Chancery Division of the Superior Court of New Jersey, in *Investors Savings & Loan Association v. Ganz,*[212] stated that due-on-sale clauses in mortgages "are enforced to protect the interest the lender has in the identity of his debtor, . . . [having] as their obvious purpose the protection of the lender's security."[213] This statement appears to reflect the current state of the law in New Jersey.

F. *Loan Commitments*

1. *Applicability of Deceptive Trade Practices Act.* In *Riverside National Bank v. Lewis,*[214] the Texas Supreme Court in a five to four decision held that a loan commitment is not a transaction covered by the Texas Deceptive Trade Practices Act,[215] because money is not "goods" or "services" within the meaning of the Act. The court, however, held that the plaintiff might have a cause of action for common law fraud, if he could prove his allegations that the bank made false promises to him concerning its intention to make the loan.

2. *Damages or Specific Performance of Loan Commitments.*

a. *Recovery of Damages for Breach of Oral Loan Commitment.* In *Coastland Corp. v. Third National Mortgage Co.,*[216] Coastland sued the mortgage company for breach of an oral commitment to

211. *Id.* at 849.

212. 416 A.2d 918 (N.J. Super. 1980).

213. *Id.* at 921.

214. 603 S.W.2d 169 (Tex. 1980).

215. TEX. BUS. & COM. CODE ANN. §§ 17.41-.63 (Tex. UCC) (Vernon Supp. 1980-1981). *See also* Begelfer v. Najarian, 409 N.E.2d 167 (Mass. 1980). The Massachusetts Supreme Court held that the lender was not engaged in a trade or business within the meaning of that state's consumer protection act, because the lender's participation in the real estate transaction out of which the loan arose was nominal. *See id.* at 176.

216. 611 F.2d 969 (4th Cir. 1979).

provide construction financing for a condominium project. The Fourth Circuit affirmed the district court's findings that a binding commitment was made by the lender and that the scope and terms of the agreement were sufficiently complete to permit Coastland to recover damages, despite the fact some of the loan terms had not been agreed upon, since this was a suit for damages and not for specific performance. The court reversed the district court's damage award of one-half of Coastland's anticipated profits, because lost profits are too speculative for a new enterprise. The court, however, affirmed the partial award of Coastland's architectural, legal, and engineering expenses against appellee's cross-appeal for full reimbursement, and sustained the district court's refusal to award interest on a fee paid by Coastland to secure the financing commitment.

b. *Specific Performance of Permanent Loan Commitment.* Although the Third Circuit in *First National State Bank v. Commonwealth Federal Savings & Loan Association,*[217] refused to find that the construction lender was a third party beneficiary to the permanent loan commitment, it did find that the facts supported the trial court's award of specific performance of the permanent loan commitment. The court noted that since the shopping center was unprofitable, it was not unreasonable for the trial court to conclude that alternative financing was not available; thus, an accurate calculation of damages was impracticable. The Third Circuit stated that although specific performance of loan commitments is not favored, this was a proper case in which to apply that remedy. The court then said:

> If the permanent lender can escape its commitment when a project seems to have failed, that party will have achieved a significant shifting of risks without a corresponding shift in the returns on successful ventures. A permanent lender's primary security on such a venture is the capitalized value of the project, and so it is the permanent lender, not the construction lender, that has the responsibility and presumably the expertise to analyze the business risks. It is therefore appropriate to place the risk of the project's nonviability on the permanent lender.[218]

This suit was brought by the interim lender, as the developer's as-

217. 610 F.2d 164 (3d Cir. 1979) (applying New Jersey law).
218. *Id.* at 173-74.

signee. The permanent lender refused to close its loan on the ground that the project had not been completed in accordance with the plans and specifications, but gave no explanation. The trial judge found that the project was substantially completed.[219]

G. *Mechanics' and Materialmen's Liens*

This article does not attempt to cover all decisions involving mechanics' and materialmen's liens, but a few significant decisions affecting real estate financing are discussed.

1. *Contractor's Right to Foreclose Against Materials Furnished by Subcontractors.* In *Richard H. Sikes, Inc. v. L & N Consultants, Inc.*,[220] the mechanic's and materialman's lien claimant was permitted to foreclose against "removable" improvements which had been made by the lien claimant, a contractor, and by the subcontractors who had provided labor or materials for the contractor, even though the contractor had not paid the subcontractors in full. The court explained its holding by comparing the relative liability of the owner and contractor.

> If the subcontractors do not perfect their liens under the statutes, they may not look to the owner for payment, but the contractor remains liable to them. . . . On the other hand, allowing the contractor's lien to extend to the improvements (including removals) furnished by his unpaid subcontractors does not expose the owner (or his successor in interest) to an unwarranted risk of double liability.[221]

Therefore, although the foreclosure of the mortgagee's superior lien extinguished the contractor's lien on the land and other improvements, it did not prevent the contractor from enforcing its lien against improvements made by the contractor and its subcontractors. The court in *Richard H. Sikes, Inc.* did not limit its holding to the fact that the contractor seeking to remove the materials was the general contractor, by, through, or under whom the materials were furnished. Subsequently, the Fifth Circuit in *Suburban*

---

219. *See id.* at 169. *See generally* Groot, *Specific Performance of Contracts to Provide Permanent Financing*, 60 CORNELL L. REV. 718 (1975); Mehr & Kilgore, *Enforcement of the Real Estate Loan Commitment: Improvement of the Borrower's Remedies*, 24 WAYNE L. REV. 1011 (1978); Annot., 82 A.L.R.3d 1116 (1978).

220. 586 S.W.2d 950 (Tex. Civ. App.—Waco 1979, writ ref'd n.r.e.).

221. *Id.* at 956.

Homes Lumber Co. v. Lomas & Nettleton Financial Corp. (In re Jamail)[222] concluded that the court in *Richard H. Sikes, Inc.* should have so limited its holding.[223]

2. *When Does "Material Injury" Result From the Removal of Materials?* The rule in Texas is that a perfected materialman's lien is superior to a prior recorded deed of trust lien to the extent the materials covered by the materialman's lien can be removed without material injury to the land, pre-existing improvements, or the materials.[224] But what does "material injury" mean? Two important holdings in *Monocrete Pty. Ltd. v. Exchange Savings & Loan Association,*[225] provide some answers. The court first held that "one standard for determining whether material injury would occur to the improvements [materials] is the economic benefit to be realized by the materialman."[226] Since concrete roof tiles worth $2,490, after allowing for breakage, could be removed from three houses, the court found that there was an economic benefit to the materialman which, under the court's test, also meant there would be no material injury to the materials. The requirement of an economic benefit would, in the court's view, prevent a "spiteful" removal by materialmen.

The court also held that the test is whether material injury to pre-existing improvements would occur during the process of removing the materials. There was no evidence that material injury would occur during the removal process. The court stated that it was not relevant that the remaining structure would be subject to damage from the elements after the roof had been removed.[227]

222. 609 F.2d 1387 (5th Cir. 1980). In *Suburban,* enforcement of a materialman's lien on removable improvements was denied on the ground that the materialman, although the major supplier of materials, "had failed to segregate and identify the materials it had supplied." *Id.* at 1388.

223. *See id.* at 1389-90. The court in *Suburban* points out that the *Sikes* decision sustaining the enforcement of a general contractor's materialman's lien "against all removable improvements regardless of whether they were constructed by the general contractor or his subcontractors" specifically applied to materials supplied pursuant to a contract between the landowner and the general contractor. *See id.* at 1389-90.

224. First Nat'l Bank v. Whirlpool Corp., 517 S.W.2d 262, 269 (Tex. 1974).

225. 601 S.W.2d 448 (Tex. Civ. App.—Dallas 1980, no writ).

226. *Id.* at 453.

227. *See id.* at 452. When removing improvements, the materialman should "use reasonable care and skill in removal, otherwise he may subject himself to damages for injury to the remaining improvements." *Id.* at 452.

3. *Extent of Lien Where There Are Multiple Original Contracts.* In *McKalip v. Smith Building & Masonry Supply, Inc.*,[228] the court held that under the Texas mechanics' and materialmen's lien statutes the maximum amount for which a subcontractor or materialman can have a lien is limited to: (a) 10% of the contract price required to be retained under article 5469,[229] plus (b) any additional amount paid out by the owner after receipt of the statutory notice.[230] The court then considered the meaning of the 10% retainage requirement of article 5469. The material supplier argued that under *Hayek v. Western Steel Co.*,[231] the owner was required to retain 10% of each original contract price for the entire project until thirty days after final completion of all improvements. The court noted that in 1973 the Texas Legislature amended article 5452[232] to provide definitions for the terms "contract price" and "work" which had the effect of overruling the *Hayek* decision. The court stated: "In our opinion the Legislature's Amendment of Article 5452 was intended to and does have the effect of limiting the retainage fund of Article 5469 to 10% of a particular original contract, in situations where there are multiple original contracts executed for the construction of a single project."[233] Accordingly, the court held that the owner was only required to retain 10% of the original contract under which the lien claimant had furnished materials. The lien, therefore, was limited to 10% of the amount of the particular original contract.

H. *Securities Compliance in Financings of Joint Ventures and Partnerships*

A recent report of the Real Estate Securities and Syndications Institute predicts that equity partners in publically registered and privately subscribed syndicates will be the chief source of $300 billion in investment and development capital for the real estate industry in the 1980s. These syndicates normally offer units in a partnership or venture for sale to fifteen or more people. If the offering of the units is not registered with the securities agencies, it

228. 559 S.W.2d 884 (Tex. Civ. App.—Waco 1980, writ ref'd n.r.e.).
229. TEX. REV. CIV. STAT. ANN. art. 5469 (Vernon Supp. 1980-1981).
230. *Id.* art. 5453.
231. 478 S.W.2d 786 (Tex. 1972).
232. TEX. REV. CIV. STAT. ANN. art. 5452 (Vernon Supp. 1980-1981).
233. McKalip v. Smith Bldg. & Masonry Supply, Inc., 599 S.W.2d 884, 889 (Tex. Civ. App.—Waco 1980, no writ).

is usually because the syndicate believes the offering is exempt from registration. Two recent Texas decisions explore the necessity of registering partnership and venture interests involving unimproved land.

The Texas Securities Act[234] provides that it is unlawful to sell or offer to sell "securities," unless the securities have been registered, the securities or the transaction is exempt, or the issuer of the securities has a permit.[235] The act defines a "security" to include: (1) stock or other "evidence" of indebtedness; (2) a "certificate in or under a profit sharing or participation agreement"; (3) "any certificate or interest representing or secured by an interest in any or all of the capital, property, assets, profits or earnings of any company"; (4) "investment contract"; or (5) "any other instrument commonly known as a security."[236]

When the term "securities" is applied to real estate or to an interest in a partnership or joint venture that owns real estate, the courts have focused upon the meaning of "investment contract." The meaning of investment contract under the federal act[237] was defined by the United States Supreme Court as:

> [A] contract, transaction or scheme whereby a person invests his money in [1] a common enterprise and is led to [2] expect profits [3] solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.[238]

All three elements must be present for the interest sold to be classified as an investment contract and, therefore a security.

1. *Sale of an Interest in a General Partnership or Joint Venture.* The sale of an interest in a true joint venture or general partnership generally does not involve the sale of a security because the venturers or partners have the power to participate in the management of the entity and, therefore, the third element of an

---

234. TEX. REV. CIV. STAT. ANN. art. 581-1 (Vernon 1964 & Supp. 1980-1981).

235. *See id.* art. 581-7(A)(1) (Vernon Supp. 1980-1981).

236. *Id.* art. 581-4(A) (Vernon 1964).

237. 15 U.S.C. § 78c(a)(10) (1976).

238. SEC v. W.J. Howey Co., 328 U.S. 293, 298-99 (1946); *accord,* Westchester Corp. v. Peat, Marwick, Mitchell & Co., 626 F.2d 1212, 1215 (5th Cir. 1980); Cameron v. Outdoor Resorts of Am., Inc., 608 F.2d 187, 192 (5th Cir. 1979); SEC v. Koscot Interplanetary, Inc., 497 F.2d 473, 477 (5th Cir. 1974).

investment contract—solely from the efforts of the promoter or a third party—is missing. If the joint venture or general partnership, however, does not permit, whether in fact or as a practical matter, the investors to participate in the management of the entity, and if the other elements are present as they normally are in a real estate investment, then an investment contract should be found to exist.[239] Professor Bromberg has suggested that "the courts would do better to abandon the implied exception of joint ventures from TSA [Texas Securities Act] and . . . focus on whether the facts point to a 'security' and 'sale' from one venturer to another."[240]

The issue before the court in *Wilson v. Lee*[241] was whether "a joint venture interest in raw land, purchased by investors whose sole expectation of profit or appreciation rests upon market inflation and not upon the managerial or entrepreneurial efforts of others" is a security.[242] The court held that it was not a security. The land was located in a remote rural area and its immediate use was limited to farming and pasturage.

In addition, each of the plaintiffs testified that they relied upon market value inflation for their expectation of profits, and that the service to be rendered by the manager of the venture was to hold title to the land. The court also observed that under the venture agreement certain action could be taken only with the consent of the owners of a majority of the venture interests, and that the owners of 60% of the venture had the right to direct the operations of the venture. The court in *Wilson* found the facts before the court in *McConathy v. Dal Mac Commercial Real Estate, Inc.*[243] to be very similar and the holding in *McConathy* to be persuasive. Thus, in the *Wilson* court's view, the third *Howey* element is missing if the investors' expectation for profits rests entirely upon market appreciation and the only efforts expected from the manager of the venture are to preserve and protect the property by

239. *See* Pawgan v. Silverstein, 265 F. Supp. 898, 900 (S.D.N.Y. 1967); *cf.* Bruner v. State, 463 S.W.2d 205, 214 (Tex. Crim. App. 1970) (whether a particular instrument is a security depends upon the substance and not the form of the transaction as determined by the surrounding circumstances).

240. Bromberg, *Civil Liability Under Texas Securities Act § 33 (1977) and Related Claims*, 32 Sw. L.J. 867, 890 n.74 (1978).

241. 601 S.W.2d 483 (Tex. Civ. App.—Dallas 1980, no writ).

242. *Id.* at 484.

243. 545 S.W.2d 871 (Tex. Civ. App.—Texarkana 1976, no writ).

paying taxes and the like.

2. *Sale of an Interest in a Limited Partnership.* If an interest in a joint venture or general partnership generally is not a security, should an interest in a limited partnership be treated any differently? Several writers on Texas law feel that there is a difference, since under the Texas Uniform Limited Partnership Act (TULPA)[244] a limited partner has very little say in the management of the partnership.[245] One Texas court of civil appeals has disagreed with this analysis.

Two issues were before the court in *Adickes v. Andreoli.*[246] Andreoli sued to rescind a purchase of a 15% interest in a limited partnership on the grounds that he was induced to make the purchase by the omissions and misrepresentations of the defendants and that the purchase of the interest involved the sale of a security which was not registered as required by the Texas Securities Act.[247] In discussing the securities issue the court, rather than limiting its inquiry to an investment contract, first struggled with the meaning of a certificate or interest in the capital, property, assets, profits, or earnings of a company and the meaning of evidence of indebtedness, as those terms are used in the Texas Securities Act. Relying upon a Michigan case[248] cited by the Texas Supreme Court in *Brown v. Cole,*[249] the court in *Adickes* distinguished between a sale of an interest before and after the limited partnership is organized. The court appears to acknowledge that the sale of an

244. TEX. REV. CIV. STAT. ANN. art. 6132a (Vernon 1970 & Supp. 1980-1981).

245. *See* Burton, *Real Estate Syndications in Texas: An Examination of Securities Problems,* 51 TEXAS L. REV. 239, 243-44 (1973); Heath, *Real Property, Part II, Annual Survey of Texas Law,* 33 SW. L.J. 31, 71 (1979); Miller, *Traditional Equity Transactions and Private Placements,* in N-33 ADVANCED REAL ESTATE COURSE (State Bar of Texas 1980); Subcommittee Report, *Regulation of Real Estate Securities, Including the Applicability of Federal Rule 146 and Its Use in State Blue Sky Laws,* 13 REAL PROP., PROB. & TR. J. 841, 842 (1978). *See also* Goodman v. Epstein, 582 F.2d 388, 406 (7th Cir. 1978) (holding that as a matter of law a partnership organized under the Illinois Uniform Limited Partnership Act has all the elements of an investment contract), *cert. denied,* 440 U.S. 939 (1979).

246. 600 S.W.2d 939 (Tex. Civ. App.—Houston [1st Dist.] 1980, no writ).

247. TEX. REV. CIV. STAT. ANN. art. 581-1 (Vernon 1964 & Supp. 1980-1981).

248. Polk v. Chandler, 268 N.W. 732 (Mich. 1936).

249. 155 Tex. 624, 291 S.W.2d 704 (Tex. 1956). The court in *Brown* held that the Texas Securities Act does not apply to joint ventures and transactions between venturers. *See id.* at 631, 291 S.W.2d at 709. "To constitute a joint [venture] there must be a community of interest and participation in the profits. It is in the nature of a partnership engaged in the joint prosecution of a particular transaction for mutual profit." *Id.* at 631, 291 S.W.2d at 709.

interest in a limited partnership after its organization is a sale of a security within the meaning of the Texas Securities Act. The court, however, held that since Andreoli agreed to purchase an interest in a limited partnership which was to be formed in the future, no sale of an interest in a company was involved. The court gave no consideration to the fact that the limited partnership was later organized and that Andreoli made further contributions to the partnership. The court also held that a receipt for purchase of an interest in a partnership which is to be organized in the future is not an "evidence of indebtedness."[250] This holding seems to be correct, but the court's reasoning is difficult to follow.

Finally, the court considered the meaning of an investment contract. The court held that the interest in the limited partnership was not an "investment contract," because there was no evidence "that it was the expectation of the parties that the success of the venture would depend upon those 'essential managerial efforts . . . which effect the failure or success of the enterprise.' "[251] This is one of the factors that the Texas Supreme Court, in *Searsy v. Commercial Trading Corp.*,[252] listed as a prerequisite to a finding that an "investment contract" (a security) is involved in a sale. In support of its holding that the limited partnership interest was not an investment contract, the court cited *Searsy*, which involved the sale of commodity options, and *McConathy*, which involved a joint venture.[253] These cases hardly support the court's decision, especially in light of the contrary decisions where limited partnerships were the issue. Perhaps the Texas Supreme Court will have the opportunity to express its view in this case.

250. The instruments relied on by Androeli were not within the Texas Supreme Court's definition of "evidence of indebtedness" defined in Searsy v. Commercial Trading Corp., 560 S.W.2d 637, 641 (Tex. 1977), as " 'all contractual obligations to pay in the future for consideration presently received.' " Adickes v. Androeli, 600 S.W.2d 939, 944 (Tex. Civ. App.—Houston [1st Dist.] 1980, no writ). Likewise, the transaction did not constitute capital, property, assets, profits, or earnings of a company as defined by the Texas Securities Act. *See id.* at 945.

251. Adickes v. Androeli, 600 S.W.2d 939, 945 (Tex. Civ. App.—Houston [1st Dist.] 1980, no writ) (quoting Searsy v. Commercial Trading Corp., 560 S.W.2d 637, 641 (Tex. 1977)).

252. 560 S.W.2d 637 (Tex. 1977).

253. *See* Adickes v. Androeli, 600 S.W.2d 939, 945 (Tex. Civ. App.—Houston [1st Dist.] 1980, no writ).

I. *Miscellaneous*

1. *Failure of Purchaser to Seek Lender's Approval.* In *McDaniel v. Kudlik,*[254] the contract required the purchaser to assume an existing mortgage or, if the purchasers "could not obtain approval to assume" the mortgage, then the parties agreed to enter into a contract for deed. The jury found that the purchasers had not even attempted to obtain the lender's approval. Being in default of the contract for failing to seek the approval, the court ruled that the purchasers were not entitled to specific performance of the alternative contract for deed, and that the seller could retain the purchaser's escrow deposit.[255]

2. *Right to Commission on Foreclosure Sale.* The question before the court in *Browder v. Hughes,*[256] was whether a credit on the promissory note of a bid at foreclosure sale was a payment on the note entitling the real estate brokers to part payment of their commission. The brokers deferred a portion of their commissions in exchange for promissory notes, which provided that the brokers were entitled to a pro rata share of any payment made on the purchaser's nonrecourse note to the seller "*if, as, and when said payments are received, but not otherwise.*" (Emphasis supplied.)[257] After the purchaser defaulted on the note, the property was sold at foreclosure to the noteholder's representatives, who bid the balance due on the note. The brokers argued that the credit on the note amounted to a "payment" which entitled them to receive a pro rata share. The court held that payment on the broker's notes was dependent upon a payment on the purchaser's note, and that a credit on the note of the foreclosure bid was not a payment.[258] The court's decision was influenced by the fact that the purchaser's note did not allow the noteholder to seek a deficiency. If the note had provided for full liability which the noteholder elected not to pursue, a different result might have been reached.[259]

254. 598 S.W.2d 350 (Tex. Civ. App.—Houston [14th Dist.] 1980, writ ref'd n.r.e.).

255. *See id.* at 351-52. The courts will imply an obligation on the purchaser to use good faith to obtain the financing; *cf.* Black Lake Pipe Line Co. v. Union Constr. Co., 538 S.W.2d 80, 88 (Tex. 1976) (judgment of party regarding adequacy of performance will be sustained if made in good faith). *See also* Annot., 78 A.L.R.3d 880 (1977).

256. 597 S.W.2d 525 (Tex. Civ. App.—Beaumont 1980, writ ref'd n.r.e.).

257. *Id.* at 527.

258. *See id.* at 528.

259. *See id.* at 528. Since there was no right to a deficiency judgment against the maker

3. *Negligent Misrepresentation and Change in Commitment Exceptions in Mortgagee's Title Insurance.* In *Great American Mortgage Investors v. Louisville Title Insurance Co.*,[260] the court held that the tort of negligent misrepresentation applies to a title insurer which issued a mortgagee's information letter or title policy binder erroneously stating that there are no restrictions of record that applied to the property.[261] The court further held that the lead lender bank, which acted under a participation agreement with an out-of-state lender, was a joint venturer with the out-of-state lender.[262] A second mortgagee's information letter, therefore, which was delivered to the bank before the loan was closed and which disclosed the restrictions was knowledge to the bank that was imputed to the other lender, precluding reliance by the lenders upon the error in the first mortgagee's information letter. The out-of-state lender first actually learned of the restriction when area residents filed suit to enjoin the construction of the three-story apartment project. The cost incurred by the borrower in reconstructing a part of the project in order to conform to the height restriction and in acquiring adjacent land in order to conform to the requisite number of square feet of land per unit caused the borrower to default on the loan. The court, however, held that since the notice of the restrictions given to the bank through the second mortgagee's information letter was imputed to the other lender, neither lender could recover its loss from the title insurer.[263]

4. *Anti-Redlining Preemption.* The United States Supreme Court in *Stein v. Conference of Federal Savings & Loan Associations*[264] affirmed the Ninth Circuit's holding that the Federal Home Loan Bank Board's exercise of its regulatory power under the Home Owners' Loan Act[265] preempts any legislation that may be passed by California making federal savings and loan associa-

of the note and the brokers lost nothing upon foreclosure, the court refused to change a contingent obligation into an unconditional liability. *See id.* at 528.

260. 597 S.W.2d 425 (Tex. Civ. App.—Fort Worth 1980, writ ref'd n.r.e.).

261. *See id.* at 430.

262. *See id.* at 431.

263. *See id.* at 432.

264. _ U.S. _, 100 S. Ct. 1304, 63 L. Ed. 2d 754 (1980). *See* Bettauer, *Federal and State Anti-Redlining Laws: Must National Banks Comply with Both?*, 97 BANKING L.J. 329 (1980).

265. 12 U.S.C. §§ 1461-1470 (1976).

tions subject to state regulations on anti-redlining practices.[266] An interesting comparison is presented in *National State Bank v. Long*.[267] This case involved a statute passed in New Jersey designed to prevent discrimination in mortgage lending based upon the location of the property.[268] The National State Bank of Elizabeth argued that the Home Mortgage Disclosure Act[269] and Community Reinvestment Act[270] preempt state legislation dealing with anti-redlining practices. The Third Circuit disagreed, holding that national banks are subject to state law unless the state law "(1) expressly conflicts with federal law, (2) frustrates the purpose for which national banks were created, or (3) impairs their efficiency to discharge the duties imposed upon them by federal law."[271] The Third Circuit found none of these exceptions applied to state anti-redlining laws.

5. *Power of Attorney to Subordinate Mortgage. Land Title Co. v. F.M. Stigler, Inc.*[272] involved the priority of liens following an allegedly unauthorized subordination of a mortgage. A written power of attorney authorized the seller's attorney to subordinate the purchase money mortgage to improvement and construction loans. A loan was obtained from H.N.C. Realty Co., with the loan proceeds being used to make the down payment on the purchase of property and to service debt installments on the loan. The attorney-in-fact executed an agreement to subordinate the mortgage to the new loan. The appellate court held that since the new loan was not for the construction of improvements on the property, the subordination agreement was invalid because the attorney had no authority to execute it.[273] The appellate court stated that H.N.C. Realty Co. had the duty to inquire into the agent's authority if it intended to rely upon that authority, that the seller's retention of the down payment did not constitute ratification of the subordina-

---

266. *See* Conference of Fed. Sav. & Loan Ass'n v. Stein, 604 F.2d 1256, 1260 (9th Cir. 1979), *aff'd*, _ U.S. _, 100 S. Ct. 1304, 63 L. Ed. 2d 754 (1980).

267. 630 F.2d 981 (3rd Cir. 1980).

268. *See id.* at 982.

269. Home Mortgage Disclosure Act of 1975, Pub. L. No. 94-200, tit. 3, 89 Stat. 1125 (codified at 12 U.S.C. §§ 2801-2809 (1976)) (expired 1980).

270. Community Reinvestment Act, 12 U.S.C. §§ 2901-2905 (Supp. III 1979).

271. National State Bank v. Long, 630 F.2d 981, 987 (3rd Cir. 1980).

272. 609 S.W.2d 754 (Tex. 1980).

273. *See* Land Title Co. v. F.M. Stigler, Inc., 595 S.W.2d 158, 161 (Tex. Civ. App.—Dallas), *rev'd*, 609 S.W.2d 754 (Tex. 1980).

tion agreement, and, therefore, that H.N.C. Realty Co. could not recover the down payment made to the seller.[274] The Texas Supreme Court reversed, holding that the seller's refusal to return the down payment after learning of the subordination agreement and the source of the money amounted to a ratification of the attorney-in-fact's unauthorized subordination.[275]

6. *Mailing Note Payment Before Due Date.* Promissory notes generally require the note payments be made on a specific date, giving the noteholder the right to declare a default and accelerate the maturity of the note if the payments are late. The main question involved in *McGowan v. Pasol*[276] was whether the maker of the note was late in making a payment which was mailed in Mexico before the date it was due, but was not received by the noteholder until after the due date. The court held that the payment had been timely made: "Where payment of an obligation by mail is authorized, the mailing of a letter including remittance which is properly addressed, and with postage prepaid on the last day of payment, is a timely payment."[277] In addition, the court held that since the noteholder had accepted numerous late payments on prior occasions, it would be inequitable to permit the noteholder to accelerate the maturity of the note when no advance notice had been given to alert the maker that late payments would not be accepted in the future.[278]

7. *Specifying Size of Insurer Does Not Violate Sherman Act.* Two savings and loan associations and the Federal National Mortgage Association (Fannie Mae) did not enter into a conspiracy in violation of the Sherman Act[279] by requiring mortgaged property be insured by insurance companies meeting specified size requirements which were established by a private rating service. In so

---

274. *See id.* at 164. The appellate court held that the sellers were not estopped to deny ratification because (1) when they first learned of the unauthorized act by way of the foreclosure proceeding they disaffirmed by bringing suit to set it aside; and (2) retention of the down payment was based upon a right within the contract of sale and not upon the source of funds. *See id.* at 164.

275. *See* Land Title Co. v. F.M. Stigler, Inc., 609 S.W.2d 754, 758 (Tex. 1980).

276. 605 S.W.2d 728 (Tex. Civ. App.—Corpus Christi 1980, no writ).

277. *Id.* at 731.

278. *See id.* at 732. Equity will not allow the enforcement of the option to accelerate a promissory note when it is evident the intent is not to preserve the security, but to coerce payment of the entire debt. *See id.* at 732.

279. 15 U.S.C. §§ 1-7 (1976).

holding, the court in *Consolidated Farmers Mutual Insurance Co. v. Anchor Savings Association,*[280] observed that the standards were set to help assure the safety of the investment, and that none of the defendants had any competitive interest in the insurance issuance business.

8. *Liability of Remote Grantees.* In *Somers v. Avant,*[281] the Supreme Court of Georgia held that a remote grantee of mortgaged property who takes by a deed in which he agrees to pay the debt is personally liable to the mortgagee even though the remote grantee's grantor took only subject to the debt and did not assume it.[282] The court noted that there is a split of authority on this question, but the majority of jurisdictions have held that the mortgagee can recover against the remote grantee on its promise to pay a debt not owed by his grantor.[283] The court focused on the intent of the remote grantee and his grantor and concluded that when a grantee accepts a deed he is bound by the covenants contained therein even though he does not sign the deed. If the covenants are supported by consideration, the courts will enforce them unless to do so would be contrary to law or public policy.[284]

9. *Appointment of Receiver Under Deed of Trust to Collect Rentals.* In *Riverside Properties v. Teachers Insurance & Annuity Association of America,*[285] the court held that while the authorization given in the deed of trust for the appointment of a receiver to take possession of the property and collect rentals is not binding on the courts, it has evidentiary weight and is one of the equities to be considered by the courts in deciding whether a receiver should be appointed.[286] Thus, the deed of trust provision was found to be adequate to permit the court to appoint a receiver under article 2293.[287]

280. 480 F. Supp. 640 (D. Kan. 1979).

281. 261 S.E.2d 334 (Ga. 1979).

282. *See id.* at 336.

283. *See id.* at 335.

284. *See id.* at 336.

285. 590 S.W.2d 736 (Tex. Civ. App.—Houston [14th Dist.] 1979, no writ).

286. *See id.* at 738.

287. Tex. Rev. Civ. Stat. Ann. art. 2293 (Vernon 1971). While there was no showing that the property was in jeopardy or insufficient to discharge the mortgage debt as required by section 2 of article 2293, the deed of trust provision was "adequate for the trial court to order the appointment of a receiver under subsection 4 of article 2293 and the usuages of equity." Riverside Properties v. Teachers Ins. & Annuity Ass'n of America, 590 S.W.2d 736,

10. *Taxation of Sales Involving Wrap-Around Mortgages.* Another knot was tied in the wrap-around package in *Goodman v. Commissioner.*[288] *Goodman* involved the sale of an apartment project to family trusts, which subsequently sold it to a third party. The sale to the trusts wrapped-around an existing mortgage, which the trusts agreed to pay by making the monthly installments to a bank, in order to pay the first mortgage and then remit the balance of the payments to the sellers. The Tax Court held that under this procedure, the trusts took the property "subject to" the first mortgage so that the excess of the mortgage over the sellers' basis was to be included in the first-year payments under the installment method of reporting. The court distinguished *Stonecrest Corp. v. Commissioner,*[289] and *Estate of Lamberth v. Commissioner,*[290] in which cases the wrap-around payments were made to the sellers (into their general funds), who retained the full responsibility for the payment of the mortgage until the date when the property was deeded to the purchaser and the mortgage balance was assumed.

II. Legislative and Regulatory Developments

A. *Federal Usury Preemption Under the Depository Institutions Deregulation and Monetary Control Act of 1980.* On March 31, 1980, President Carter signed the Depository Institutions Deregulation and Monetary Control Act of 1980.[291] This Act repeals Public Law 96-161,[292] although Public Law 96-161 continues to apply to loans made while it was in effect. Title V of the Act, which is divided into three parts, deals with state usury laws.[293] A technical amendment to title V (amendment) was signed by President Carter on October 8, 1980, as section 324 of the Housing and Com-

737-38 (Tex. Civ. App.—Houston [14th Dist.] 1979, no writ).

288. No. 12561-77 (T.C. Dec. 29, 1980).

289. 24 T.C. 659 (1955).

290. 31 T.C. 302 (1958).

291. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (amended 1980).

292. 12 U.S.C. § 1735f-7 (Supp. III 1979).

293. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, tit. V, 94 Stat. 161 (amended 1980); *see* Murray, *Usury in Texas and Federal Usury Moratorium,* in Advanced Real Estate Law Course (State Bar of Texas 1980). *See generally* Harroch & Frasch, *The New California Usury Law in Light of the Monetary Control Act of 1980,* 35 Bus. Law. 1053 (1980).

munity Development Act of 1980.[294] The amendment was effective April 1, 1980.

1. *Part A: Residential Loans.* Part A of title V, as amended, which is section 501 of the Act,[295] provides that the constitution and laws of any state which limit the rate of interest, discount points, finance charges, or other charges will not apply to loans, mortgages, credit sales, or advances which are (a) secured by a first lien on residential real property, stock allocated to a dwelling unit, or a residential manufactured home, (b) made after March 31, 1980, and (c) described in section 527(b) of the National Housing Act.[296] While this Act, as amended, is generally limited to institutional-type lenders, specific exceptions include: (1) the National Housing Act's limitation of one to four family occupancy does not apply to this Act;[297] and (2) the term "lender" is broadened to include any lender approved by HUD for participation in any mortgage insurance program under the National Housing Act.[298] This preemption does not apply to a loan, credit sale, or advance made in any state after March 31, 1980, if after this date and before April 1, 1983, the state or its voters adopts a law overriding this preemption as it applies in the state.[299] The preemption, however, will continue to apply to a loan, mortgage, credit sale, or advance (a) made pursuant to a commitment entered into after March 31, 1980, and before the state overrides the preemption, or (b) which is a rollover, as described in the regulations of the Federal Home Loan Bank Board, which is made during the same period.[300] Any state may adopt a limitation on discount points or other charges at any time.[301] Special exceptions apply to residential manufactured homes.[302] In summary, part A of the Act applies to apartment

---

294. Housing and Community Development Act of 1980, Pub. L. No. 96-399, § 324, 94 Stat. 1647 (amending Pub. L. No. 96-221, tit. V, 94 Stat. 161 (1980)).

295. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 501, 94 Stat. 161, *as amended by* Housing and Community Development Act of 1980, Pub. L. No. 96-399, § 324, 94 Stat. 1647.

296. 12 U.S.C. § 1735f-5(b) (1976).

297. *See* Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, tit. V, § 501(a)(1)(C)(i), 94 Stat. 161, *as amended by* Housing and Community Development Act of 1980, Pub. L. No. 96-399, § 324, 94 Stat. 1647.

298. *See id.* § 501(a)(1)(C)(vi).

299. *See id.* § 501(b)(2).

300. *See id.* § 501(b)(3).

301. *See id.* § 501(b)(4).

302. *See id.* § 501(c).

financing, providing no limit on the interest rate or other charges that can be charged on covered loans. Furthermore, the amendment changes the Act to make it applicable to any individual who finances the sale or exchange of a residence owned and previously occupied by the individual as a principal residence. The Federal Home Loan Bank Board has promulgated regulations under section 501 of the Act.[303]

2. *Part B: Business and Agricultural Loans.* Part B of title V, as amended, which includes sections 511 and 512 of the Act,[304] provides that *any person* can charge interest at a rate of not more than 5% in excess of the Federal Reserve discount rate on ninety-day commercial paper, including any surcharge (which as of November, 1980 is 2%), on any business or agricultural loan, secured or unsecured, renewals or other extensions, in the amount of $25,000.00 (or $1,000.00 if made after the date of the amendment) or more which is made or committed to be made after April 1, 1980.[305] If state law, however, permits the charging of a higher rate, then presumably the state law is not preempted. The penalty for knowingly exceeding this rate is a forfeiture of all interest on the loan. The person who actually pays excessive interest can recover twice the amount in a suit brought within two years after the date of the payment.[306] A state can override this preemption in a manner similar to that prescribed in part A, but in any event the part B preemption ends on April 1, 1983.[307] In summary, part B unlike part A (a) limits the amount of interest that can be charged, (b) is available to any "person" who makes the loan, and (c) has an expiration date. "Business or agricultural loan" is not defined, however, prompting some to ask whether a construction loan for an apartment project is a business loan under part B or a residential loan under part A.

Although *Briggs v. Capital Savings & Loan Association,*[308] was

303. *See* 45 Fed. Reg. 24,112 (1980).

304. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, tit. V, §§ 511-512, 94 Stat. 161, *as amended by* Housing and Community Development Act of 1980, Pub. L. No. 96-399, § 324(c), 94 Stat. 1648.

305. *See id.*

306. *See id.* § 511(b).

307. *See id.* § 512.

308. 597 S.W.2d 600 (Ark. 1980).

decided under the Brock Bill[309] before passage of the Depository Institutions Deregulation and Monetary Control Act of 1980, the holding of the court may be applied under the new Act, since the basic language in the business or agricultural loan exception remains the same. In 1977 Briggs obtained a $110,000.00 loan with interest at 10.25% per annum from Capital Savings & Loan Association (Capital), which was used to pay off another person's real estate development loan. Briggs made a few payments and then sued Capital alleging that the loan was usurious under Arkansas law, which prohibited the charging of interest in excess of 10% a year. Capital defended on the basis that the loan was a business loan within the meaning of the Brock Bill, and, therefore, the bank could charge interest at a rate five percent above the federal discount rate. Briggs argued that the loan was a personal loan. The Arkansas Supreme Court was impressed by the following facts: (1) Brigg's loan application indicated it was a commercial loan to purchase property; (2) Briggs signed an affidavit stating the purpose of the loan was to obtain operating capital and it was a business or agricultural loan within the meaning of federal law permitting the charging of interest in excess of 10% a year on business or agricultural loans over $25,000.00; (3) the loan was used to pay off the other person's development loan; and (4) there were instruments in the loan file to indicate that Briggs was purchasing the real estate development (such purchase was abandoned without Capital's knowledge, apparently before the loan was made).[310] The court found this evidence sufficient to show that a business loan within the meaning of the federal preemption statute was made.[311] With regard to the weight which might be given to a "loan purpose" affidavit, the court said: "A lender should be able to rely on the sworn statement of a borrower as to his intended use of the loan proceeds in determining the applicability of the Brock Bill."[312] On the other hand, the court observed that not all real estate transactions are "business" ventures, citing a residential loan as an example.[313] Of course, many residential loans are cov-

309. 12 U.S.C. § 1730e (1976).
310. Briggs v. Capital Sav. & Loan Ass'n, 597 S.W.2d 600, 602-03 (Ark. 1980).
311. *See id.* at 603.
312. *Id.* at 603.
313. *See id.* at 602.

ered by the new Act.[314]

3. *Part C: Other Loans.* Part C of title V, which includes sections 521 through 525 of the Act,[315] amends the Federal Deposit Insurance Corporation Act,[316] National Housing Act,[317] and Federal Credit Union Act[318] to permit certain lenders which are covered by those acts to charge interest at the greater of (a) the rate allowed by state law, or (b) 1% in excess of the Federal Reserve discount rate on ninety-day commercial paper. These lenders, therefore, can make any loan within their lending powers at the rate permitted under part C. Of course, the part A and part B preemptions also would be available to some of the same lenders. A penalty essentially identical to the one provided under part B is imposed upon a lender who knowingly takes, receives, reserves, or charges an excessive rate. The part C preemption applies to loans made or committed to be made in a state after March 31, 1980, and before the state or its voters overrides the preemption.[319] The Small Business Investment Act of 1958[320] also is amended in part C.

4. *Effective Date Generally.* The amendment to title V of the Depository Institutions Deregulation and Monetary Control Act of 1980 makes clear that a loan is deemed to have been made after April 1, 1980, and during the period the Act remains in effect if the loan (a) is funded or made in whole or in part during the period, even if made pursuant to a commitment or other agreement made before April 1, 1980, (b) made prior to April 1, 1980, and provides for interest during the period at a variable or fluctuating rate, or (c) is a renewal, extension, or modification made during that period of a loan with the written consent of any person who is obligated

---

314. In a case of first impression, the Illinois Court of Appeals held in Huss v. Mara, 396 N.E.2d 92 (Ill. App. 1979), that an installment contract for the sale of an apartment building involved "money loaned" under the business loan exception in the Illinois usury statute. *See id.* at 94 (construing ILL. REV. STAT. ch. 74, § 4 (1975)).

315. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, §§ 521-525, 94 Stat. 164-67, *as amended by* Housing and Community Development Act of 1980, Pub. L. No. 96-399, § 324, 94 Stat. 1647.

316. 12 U.S.C. §§ 1811-1832 (1976 & Supp. III 1979).

317. *Id.* §§ 1701-1750.

318. *Id.* §§ 1751-1790.

319. *See* Depository Institutions Deregulations and Monetary Control Act of 1980, Pub. L. No. 96-221, § 525, 94 Stat. 167, *as amended by* Housing and Community Development Act of 1980, Pub. L. No. 96-399, § 324, 94 Stat. 1647.

320. 15 U.S.C. § 687 (1976).

to repay the loan.[321]

5. *Regulations.* The Federal Home Loan Bank Board has published regulations under the Depository Institutions Deregulation and Monetary Control Act of 1980 which provide major changes for real estate loans by federal savings and loan associations.[322] Some of the changes are: (1) elimination of all dollar limits (mortgage insurance will be required for loans above 90% of value); (2) elimination of the requirement that loans be secured by a first lien on real estate; (3) elimination of geographical restrictions, which will allow out-of-state as well as distant in state loans (also applicable to state-chartered federally insured associations); (4) restricting loans above 80% of value of condominium or cooperative conversions to units that will be occupied as the principal residence of the borrower; (5) limiting the term of loans for combination land acquisition and construction loans to seven years, with a three year extension; (6) lengthening the maximum term for a home loan to forty years; (7) raising to 75% the loan-to-value ratio on nonamortized multi-family loans.[323]

The Federal Home Loan Bank Board also has proposed certain amendments to the regulations it had promulgated under section 501 of the Act.[324] The proposed regulations are intended to (i) conform the existing regulations to the amendments to the Act under the Housing and Community Development Act of 1980 and (ii) provide that certain wrap-around mortgage loans will be treated as if they were first lien loans for purposes of section 501 of the Act. The proposed regulations provide that purchase money loans secured by liens on property subject to liens securing prior indebtedness will be considered as being secured by first liens, when the wrap-around loan: (a) matures no earlier than the latest maturity date of the prior indebtedness; (b) equals in principal amount the aggregate of the outstanding prior indebtedness plus the additional funds advanced; (c) requires periodic payments by the borrowers sufficient to meet required current payments on prior indebtedness; (d) requires the lender to make payments due on prior in-

321. *See* Housing and Community Development Act of 1980, Pub. L. No. 96-399, § 324(c), 94 Stat. 1648 (amending Pub. L. No. 96-221, tit. V, 94 Stat. 161 (1980)).

322. 45 Fed. Reg. 76,095 (1980).

323. *See id.* at 76,096-98.

324. *See id.* at 24,112.

debtedness as long as payments are received from the borrower; (e) gives the lender the right to cure defaults with respect to any prior indebtedness or to satisfy such indebtedness; and (f) obligates the borrower to reimburse the lender for sums advanced in order to secure or protect the lender's lien. In addition, the lender must at all times have sufficient funds available to satisfy the prior indebtedness. For this purpose, lenders who are regularly examined and supervised by a state or federal authority are considered to have sufficient funds available if the amount of prior indebtedness is recorded as a liability on the lender's books. The introduction to the regulations indicates that other lenders may be required to maintain escrows in the amount of the prior indebtedness in order to have satisfied this requirement.[325]

The Federal Reserve Board will adhere to some of the regulations promulgated under the previous preemption law.[326] In the first regulation issued, the Federal Home Loan Bank Board interpreted the state-law usury preemption statute, Public Law 96-161, to permit a lender under a "prevailing-rate" commitment which was outstanding when the law became effective to make loans at the lower of the prevailing rate at the time of the closing or the maximum rate permitted under the state's usury law.[327]

B. *Tax-Exempt Mortgage Bonds*

Anxious to spur residential construction in their communities during a period of high interest rates, municipalities have been selling tax-exempt bonds to raise funds to provide low-interest home financing to low and moderate income families. The Internal Revenue Service, concerned about a loss of tax revenue, strongly opposed these bonds. The result has been a lengthy debate in Con-

325. *Id.* at 86,500.

326. *Id.* at 24,112.

327. *Id.* at 2,840. Other interpretations of this preemption law can be found in 45 Fed. Reg. 6165 (1980), including an interpretation that the preemption applies: (1) to a new borrower who assumes an existing residential first lien mortgage at an increased rate (but does not apply if there is no change other than a substitution of obligors), if the transaction takes place during the preemption period; (2) to a refinancing during the preemption period of an existing first lien on covered residential property; and (3) to a commitment to a home builder to provide permanent mortgage financing to qualified purchasers of his homes, if closed pursuant to the commitment within the two year period provided for in the statute. *Id.* at 6165.

gress over legislation designed to curb the issuance of the bonds. The new law, H.R. 5741, was signed by President Carter on December 5, 1980. It applies to mortgage bonds issued by states and municipalities after December 31, 1980. Some of its provisions are: (1) each state can issue the greater of $200,000,000 a year or 9% of its average volume of bonds issued during the previous three years, which will be divided equally between states and municipalities (except in the case of states with special home rule legislation); (2) the bonds can only be used to make loans on one to four family units, one of which must be occupied by an owner who did not own a home during the prior three years (except for rehabilitation or home improvement loans and loans in certain lower income or economic distressed areas); (3) there are no limits on the amount of income a borrower can have to qualify for a loan; and (4) the home price cannot exceed 90% of the average purchase price during the prior year in that Standard Metropolitan Statistical Area. All single-family tax-exempt programs, however, are prohibited after December 31, 1983. In a related development, the Internal Revenue Service has ruled that the simultaneous issuance of tax-exempt notes and tax-exempt bonds to finance the same housing project violates the arbitrage regulations and causes the interest on notes to be taxable.[328]

C. *New Mortgage Documents*

1. *Shared-Appreciation Mortgages.* The Federal Home Loan Bank Board has given its preliminary approval to a shared-appreciation mortgage.[329] This new mortgage device would allow lenders who are under the board's jurisdiction to make home loans at a fixed interest rate below market for a ten-year term, although the loan could be amortized over a term of up to forty years. In order to obtain a shared-appreciation mortgage, the borrower would have to make a lump sum payment of "contingent interest" equal to a portion of the appreciation in the value of the home, if the home were sold or transferred within ten years. If the home were not sold or transferred within ten years, then (1) an appraisal would be

---

328. *Compare* Mortgage Subsidy Bond Tax Act of 1980, Pub. L. No. 9499, 94 Stat. 2599 *with* [1980] 8 Hous. & Dev. Rep. (BNA) 518.

329. 45 Fed. Reg. 66,801 (1980). The proposed rules are discussed in [1980] 8 Hous. & Dev. Rep. (BNA) 518.

made to determine the value of the home at the end of the ten-year period, and the resulting lender's share, and (2) the lender would be obligated to refinance the principal loan balance and the contingent interest for a thirty-year term, at current market rates, without charging any fees other than appraisal costs, without any prepayment penalties, and by using any mortgage program other than a shared-appreciation mortgage. The lender's share of the appreciation would be negotiable, but could not exceed forty percent.

Although the shared-appreciation mortgage offers the advantage of lower fixed interest rates, it also has some disadvantages. First, the lender's share of appreciation could cause the total interest charges to greatly exceed interest charged on more conventional loans. Second, the payment of the lump sum contingent interest could cause the borrower's interest deductions in the year paid to exceed taxable income, without any right under current law to carry the excess over to future years. A third possibility is that the borrower might be subject to a capital gains tax on the full amount of the appreciation, including the lender's share. Lenders would be restricted by anti-redlining requirements from making loans only in neighborhoods that have experienced price appreciation.

2. *Adjustible-Rate, Renegotiable-Rate, and Graduated-Payment Mortgages.* The Comptroller of the Currency has published proposed rules that would establish a framework within which national banks could make residential mortgage loans at rates of interest that could be adjusted periodically (but not more frequently than a six-month period) with certain limitations on the amount of the adjustment (not more than 0.5% every six months, with a limit of 5% in any one rate change, but with no ceiling); prepayment penalties could not be charged after the first scheduled rate-adjustment notification date; the loans would be assumable at the bank's discretion; and state laws establishing adjustible-rate guidelines would be preempted.[330] The Federal Reserve Board has published final regulations regarding disclosures for renegotiable-rate mortgages under Truth in Lending.[331]

The Federal Home Loan Bank Board has approved the renegotiable-rate mortgage, which will allow interest rates to be adjusted every three, four, or five years, depending upon the change in mar-

330. *See* 45 Fed. Reg. 64,196 (1980).
331. *See id.* at 62,976.

ket rates, by up to .05% a year, with a maximum increase or decrease of 5% over the life of the mortgage.[332] Consumer protection features in the new regulations include: (1) lenders can foreclose because of a late payment, but cannot refuse to renew the loan for this reason; (2) no fee can be charged for the renewal; (3) the lender must give ninety (but no more than 120) days notice in advance of a renewal or adjustment date if there will be a change in the interest rate; and (4) the loan can be prepaid in whole or part at any time after the borrower receives the first renewal notice. This program will allow savings and loan associations to abandon completely fixed-rate mortgages. This new form of loan is expected to have a significant long-term effect on new mortgage financing. The Federal Reserve System has published a staff interpretation of Regulation Z requirements regarding disclosures for renegotiable-rate mortgages.[333]

The Federal Home Loan Bank Board also has proposed rules for a new mortgage document that would combine some of the features of a graduated payment and renegotiable-rate mortgage.[334] This mortgage would begin with a stated interest rate and a payment schedule, but the amount of the monthly payments would increase by fixed percentages over a five to ten year period. The interest rate could be increased or decreased by up to .05% a year at three-to-five year intervals.

The Savings and Loan Section of the Finance Commission of Texas and the Texas Savings and Loan Commissioner have issued regulations, effective June 1, 1980, which permit certain forms of adjustible-rate mortgages.[335]

D. *Installment Sales*

H.R. 6883, which liberalizes and simplifies installment sales under section 453 of the Internal Revenue Code, has been enacted into law.[336] The new law eliminates the requirement that no more

---

332. *See id.* at 24,108. Some technical changes in these regulations were later made. *See* [1980] 8 Hous. & Dev. Rep. (BNA) 518.

333. 45 Fed. Reg. 41,437 (1980).

334. *See* [1980] 8 Hous. & Dev. Rep. (BNA) 405.

335. *See generally* Comment, *Variable Rate Mortgages: Texas Savings & Loan Associations Authorized To Offer Flexible Financing Alternatives*, 12 St. Mary's L.J. 1144 (1980).

336. Installment Sales Revision Act of 1980, Pub. L. No. 96-471, 94 Stat. 2247.

than 30% of the sale price be received in the year of sale and that there be at least two payments, thereby allowing a sale where one lump sum is received in a subsequent year to be taxed in the year of receipt rather than in the year of the sale. The application of the new law is automatic and does not require the taxpayer to file an election to receive the benefits of an installment sale. This law places some restrictions on sales between related parties (taxpayer-spouse, taxpayer-corporation or partnership owned 80% by the taxpayer and spouse, and corporation-partnership owned 80% by the taxpayer or spouse), unless the taxpayer can show that a principal purpose of the sale was not tax avoidance. The restriction means that the taxpayer-seller will have to include the deferred payment in income for the year of the sale, which will prevent the purchaser from receiving the benefit of higher depreciation resulting from the stepped-up basis before the seller has to report the income from the sale. Some of the other provisions in the new law are: if an installment obligation is cancelled or otherwise becomes unenforceable, a "disposition" of the installment obligation occurs and gain to the holder of the installment obligation is accelerated; any previously unrecognized gain from an installment sale will be recognized by the estate of a seller who dies after October 19, 1980, if the obligation is transferred by bequest, devise, or inheritance; an installment sale is available on sales occurring after October 19, 1980, even though a portion of the price is subject to some contingency; when like-kind property is received as a part of an installment sale, the like-kind property will not be treated as "payment" in the year of sale or as a part of the "contract price"; and standby letters of credit and third-party guarantees used as security for deferred payment sales will not be included as a "payment" received on the installment obligation. The new law was signed by President Carter on October 19, 1980; most of its provisions apply to all sales made in taxable years after October 2, 1980, the date the law was enacted by Congress. Thus, the new law applies to all sales made during 1980 by calendar-year taxpayers.

In a related development, the Internal Revenue Service has proposed that, effective September 29, 1980, (except for written contracts entered into prior to that date), the minimum interest that can be charged on deferred payments in installment sales be raised to 9% from 6% a year, and that the imputed interest on loans that fail to meet this requirement be raised to 10% (compounded semiannually) from 7% a year.[337]

E. *Real Estate Settlement Procedures Act*

A twenty-five page report, prepared by Peat, Marwick, Mitchell & Co. and recently released by HUD,[338] concludes that the Real Estate Settlement Procedures Act (RESPA)[339] has had a favorable impact on the settlement service market and should be retained, but certain changes in RESPA or practices under RESPA could improve competition and reduce costs for consumers. Some of the recommended changes are: (1) having information booklets distributed by real estate brokers rather than by lenders; (2) testing the use of information booklets tailored to the customs in specific areas; (3) requiring the information booklets be distributed to borrowers at an earlier stage; (4) testing the use of the lender-pay concept, where the lender decides which settlement services will be provided and either provides them or purchases the services from others, but the lender-pay concept was not recommended for implementation at this time; (5) considering a uniform state title insurance regulatory act to cover premium charges, charges for other services provided by title or escrow companies, reserve requirements, and other aspects of title insurance business; (6) implementing a single title insurance policy for lender and owner; (7) discounting premiums charged for policies issued on individual units in condominiums or subdivisions that are already covered by title insurance; and (8) publicizing the fact that real estate brokerage commissions are negotiable.[340]

F. *Some Other Regulations Regarding Savings and Loan Associations*

1. *Investment by Savings and Loan Associations in Commercial First Liens.* Regulations have been published by the Federal Home Loan Bank Board that will permit federal savings and loan associations to invest in commercial real estate loans on the security of a first lien; provided the loans are guaranteed by the Eco-

337. 45 Fed. Reg. 57,739, 80,837 (1980).
338. *See* [1980] 8 Hous. & Dev. Rep. (BNA) 438.
339. 12 U.S.C. §§ 2601-2617 (1976).
340. *See* [1980] 8 Hous. & Dev. Rep. (BNA) 438.

nomic Development Administration, the Farmers Home Administration, or the Small Business Administration.[341]

2. *Proposed Changes in Mortgage Loans Made by Savings and Loan Associations.* Proposed regulations by the Federal Home Loan Bank Board would permit federal savings and loan associations to make 90% multi-family and single-family loans (without private mortgage insurance) and to make second mortgages; and would extend the maximum term on home loans to forty years, remove dollar limits on the loans, and remove geographical restrictions on investments.[342]

3. *Capital Certificates.* Rules have been issued by the Federal Home Loan Bank Board that will allow federally insured savings and loan associations and mutual savings banks to raise capital, and as a result increase mortgage lending, through the sale of capital certificates. The certificates could be used to satisfy up to 20% of the institutions statutory reserve and net worth requirements.[343]

G. *Federal Preemption of Due-on-Sale Enforcement*

Effective June 8, 1976, the Federal Home Loan Bank Board promulgated regulations[344] permitting federal savings associations to use due-on-sale clauses in mortgages. Several federal courts have held that these regulations preempt state laws that impose restrictions on the enforceability of the due-on-sale clause. In *Great Western Union Federal Savings & Loan Association v. Walters,*[345] the court held that the federal regulations preempted state law, even though the federal home loan uniform mortgage instrument provides that it is governed by state law.[346]

After deferring earlier announced plans, the Federal National Mortgage Association (Fannie Mae) has stated that it will begin enforcing the due-on-sale clause in conventional loans purchased under commitments issued by Fannie Mae on or after November 10, 1980. Under this policy, Fannie Mae will conduct a credit re-

341. 45 Fed. Reg. 31050 (1980).

342. *See* [1980] 8 Hous. & Dev. Rep. (BNA) 193.

343. 45 Fed. Reg. 55750 (1980).

344. 12 C.F.R. § 545.6-11(f) to -11(g) (1976).

345. No. C79-906V (W.D. Wash. June 18, 1980).

346. *See also* Conference of Fed. Sav. & Loan Ass'n v. Stein, 604 F.2d 1256 (9th Cir. 1979), *aff'd*, _ U.S. _, 100 S. Ct. 1304, 63 L. Ed. 2d 754 (1980); Glendale Fed. Sav. & Loan Ass'n v. Fox, 481 F. Supp. 616 (C.D. Cal. 1979).

view of the purchaser and, if interest rates have risen since the time the loan was made, the interest rate charged on the loan will be increased if the loan is assumed by the purchaser. The reason Fannie Mae postponed earlier implementation of this policy was to study alternatives for the eleven states[347] in which restrictions have been imposed upon the enforcement of due-on-sale clauses. In these eleven states, Fannie Mae will only purchase loans that contain a right to call the loan at the end of a seven year period.

III. NEW DEVELOPMENTS IN THE MARKETPLACE

Inflation, coupled with high and frequently fluctuating interest rates, is having a profound and probably long-term impact on lending practices. An unfortunate borrowers' philosophy that the cost of borrowing funds is relatively cheap as long as the cost of funds tomorrow will be higher, and in any event lower than inflation, must be disproven if we ever are to see long-term, fixed-rate financing again.[348] If and until this change occurs, lenders are not likely to be willing to forego their demands for a participation in the "hedge" against inflation. Obviously, the lesson lenders have learned over the recent years will not be easily forgotten. In the meanwhile, what are borrowers likely to face over the near term?

The recent legislative and regulatory developments discussed in the preceding section of this article already answer a part of this question. Lenders have demanded and are receiving new mortgage techniques, such as the right to pre-determined adjustments in the interest rate charged on loans,[349] the right to renegotiate the interest rate at specified intervals, a relaxation or removal of limitations imposed by usury statutes, more inflexible due-on-sale or due-on-mortgage clauses, and a right to share in the appreciation of the mortgaged property.[350] One form of a shared-appreciation mortgage is discussed in the preceding section of this article. Others, such as equity participations, through joint ventures with the borrower, contingent interests such as percentages of gross rentals,

347. These states are identified by Fannie Mae as Arizona, California, Colorado, Georgia, Illinois, Iowa, Michigan, Minnesota, New Mexico, South Carolina, and Washington.

348. Ginsberg, *The Death of Fixed Rates*, FORBES MAGAZINE, Oct. 13, 1980, at 43.

349. Barnes, *A Proposal for "Indexed" Mortgage Financing*, MORTGAGE BANKER, Oct. 1980, at 32.

350. THE NATIONAL REAL ESTATE INVESTOR, Oct. 1980, at 45.

lenders' options to purchase, sale and leasebacks, and similar techniques have been in existence for some time. Other forms of equity participation or ownership will continue to develop.

The impact inflation and high interest rates have had on lenders is perhaps best illustrated in the life insurance industry. Life insurance companies have long been the primary source of permanent real estate financing. In recent years, however, the inflation-conscious consumer has become increasingly resistant to the purchase of ordinary life insurance policies. This development has seriously restricted the funds many life insurance companies have available to loan. In addition, existing policyholders have been taking advantage of their privilege to borrow on their life insurance policies at low rates of interest, which has further depleted the life insurance companies' loan reserves. It is anticipated that life insurance companies will devise new approaches to make the ordinary life insurance policy more attractive to the consumer and, of course, the cost of these new approaches will be passed along to borrowers. Today many life insurance companies' participation in the real estate market has been through the investment of pension funds they administer. These investments, however, are generally in outright purchases of real estate rather than in real estate mortgages.

This is not to say that other lenders have not been just as severely impacted by inflation and high interest rates. Savings institutions, which also have placed and brokered substantial amounts of real estate mortgages in the housing market, have found it increasingly difficult to attract savings deposits from consumers who are offered a number of alternatives to invest their funds at higher rates of return than the savings institutions have been authorized to offer.

Savings institutions are not the only entities affected by inflation. Developers can still find financing for their projects, but to the extent permanent financing is available today, it is too costly for developers who are operating under traditional formulas to evaluate the viability of their developments. Many developers have been forced to accept construction loans without having any permanent or "take-out" financing. These developers continue to hope for a break in the market conditions, which will allow them to find acceptable permanent financing before the term of the construction loan ends. In most cases, however, these developers have been disappointed and have been required to extend the construction loan, find short-term, take-out financing, or sell to investors at a price below their expectations.

The next step may be to full equity investments. Pension funds are becoming an important source of real estate capital. How developers will adjust to this source of capital remains to be seen. Another important source of capital has been and will continue to be real estate ventures and syndications, also discussed in this article. Venture and syndication capital traditionally involved some financing, even if short-term, construction financing, but the future may see these ventures or syndications paying the full price in cash. A similar source of funds can be provided by a condominium project. Apartment condominiums have been traditional, but the market may make office building, and perhaps hotel and shopping center condominiums attractive. Joint ventures, syndications, and condominium purchasers will be willing to accept a lesser rate of return on their investments than would a lender, because they can receive the tax benefits of depreciation and operating expenses. Another source of financing in the future will be the seller or developer, who in order to realize the best available price for their projects will be forced to finance a part of the sale price, and often at below-market rates of interest. Finally, at least in some markets such as Texas, the foreign investor who is willing and able to buy real estate for cash or for a large cash down payment will continue to be a significant source of funds for sellers and developers of real estate.

It is customary for no one to want to be the last one to pay the bill. Consequently, the higher cost of financing eventually will be passed along to the consumer. For example, tenants can expect shorter-term leases and/or rental adjustments which reflect the increase in the consumer price index or increases in the cost of real estate financing, including rental adjustments based upon increases in financing charges as well as other operating expenses. Are consumers ready for these changes? The answer lies in the future, but the most probable answer is that they will have to accept such changes or accept and demand changes in the nation's economy and life style that may, just may, someday return them to the ways of the past.