REAL ESTATE CENTER

A Homeowner's Rights Under Foreclosure

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Real Estate Center

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Advisory Committee

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Summary

Many homeowners facing foreclosure are unaware of their rights. Knowledge of the rules, regulations and laws governing Texas home foreclosures can help homeowners protect their interests from an improper or irregular foreclosure process. This report explains the foreclosure process from default on a payment through sale of the property and targets areas that a homeowner may wish to examine during or after foreclosure.

This report is limited to foreclosures under deeds of trust. It does not cover foreclosures under executory contracts, sometimes referred to as *contracts for deed*.

Three Elements of Foreclosure

A proper foreclosure has three elements: (1) the real estate lien note executed by the mortgagor (borrower) at closing for the balance of the purchase price, (2) the deed of trust signed by the buyer at closing giving the mortgagee (lender) a security interest in the land being purchased and (3) the pertinent Texas statutory and case law. Generally, a foreclosure is proper as long as it complies with the procedure outlined in the deed of trust. Texas law is relevant only where the deed of trust is silent on an issue or where the deed of trust conflicts with Texas law.

There is no mandatory (or promulgated) Texas deed of trust. The forms may vary from lender to lender. The deed of trust prepared by the State Bar of Texas serves as the basic guideline for this report. Other deeds of trust may contain different provisions.

Copies of executed deeds of trust may be secured from the county clerk's office in the county where the land is located. The lender records the deed of trust to secure an interest in the financed property.

To trigger a foreclosure, the borrower must, among other things, default on a periodic payment required by the real estate lien note as described in the deed of trust. The lender then has the option of accelerating the collection of the remaining balance of the note. The entire amount of remaining indebtedness, not just the periodic payment in arrears, becomes due and payable.

This provision is known as the *acceleration clause*. Without it, the lender would be forced into a series of foreclosures, foreclosing only on the amount of the installment in default and not the entire unpaid balance of the note.

If the collateral securing the note is the debtor's residence, the lender may not accelerate the note immediately following a default. Instead, the lender must give the debtor at least a 20-day written notice to cure the payments in arrears. The notice must be sent by certified mail. The notice cannot be waived and is required in all instances.

If the debtor does not make the payments in default during the 20-day period, the lender may accelerate the debt by sending notice of the acceleration to the debtor.

If the collateral does not serve as the debtor's residence, the lender must give the following three notices unless they are waived in the deed of trust:

- A demand notice for the installment in arrears and thereafter affording the debtor an opportunity to remedy the default
- A clear and unequivocal notice of the lender's intent to accelerate the debt after the debtor has been given a reasonable time to cure the installment in arrears

- A final notice that acceleration has in fact occurred.

The first notice regarding the demand for the payment in arrears generally is not required by the deed of trust. However, the Texas Supreme Court has suggested that the lender "bring home to the borrower that failure to cure will result in acceleration of the note and foreclosure under the power of sale." It has been held proper to combine the first notice concerning the default with the second one involving the intent to accelerate.

Waivers of Notice

If the collateral is not the debtor's residence, it is possible for the debtor to waive the described notices in the deed of trust. Texas courts disagree somewhat on the proper language for an effective waiver. Some courts have held that certain language waives the notice of acceleration but not the notice of intent to accelerate. The majority of courts, however, have upheld the effectiveness of most waivers. In cases of doubt, the courts tend to prevent acceleration of the note without proper notices.

The lender's conduct may forfeit the right to accelerate without notice even where an effective waiver has been included in the deed of trust. The case in question involved a lender who had accepted seven consecutive late payments and then attempted to foreclose without giving notice of acceleration after the eighth default occurred. The courts held the lender's past conduct destroyed the clear and unequivocal intent to accelerate once the debtor defaulted on a payment.

If the debt has been properly accelerated, the mortgagee (lender) may proceed to foreclose on the property by a nonjudicial sale. No lawsuit is required. If the foreclosure sale is conducted in accordance with the deed of trust and Texas law, the sale is effective in transferring title to the highest bidder.

The steps leading to the actual sale are described in the deed of trust and in Section 51.002 of the Texas Property Code. First, the lender requests the person designated as the trustee in the deed of trust (or the substitute trustee, as the case may be) to sell the property. Next, the trustee must give a 21-day advance notice of the sale by posting, sending and filing various notifications:

- A written or printed notice must be posted at the courthouse door of the county in counties where the property is located. If the property is located in more than one county, posting must occur in all counties where the land is located and specify the county in which the sale will occur. The day of posting counts as the first day of the required 21. It has been held that the phrase "at the courthouse door" means near any main access door to the courthouse.
- The same written or printed notice posted at the courthouse door also must be filed with the county clerk of each county in which the property is located.
- The written or printed notice likewise must be sent by certified mail, postage prepaid, to each debtor obligated on the indebtedness. The notices must be forwarded to the debtor's most recent address as shown by the lender's records. (The day the notice is postmarked counts as the first day of the required 21.)

Contents of Notice

There is little Texas statutory law regarding the contents of the notice. Because the purpose of the notice is to alert the borrower and prospective purchasers of the sale, the notice should contain the date of the deed of trust along with the volume and page where it is recorded; the name of mortgagor, mortgagee and trustee; a statement of default and a request for the trustee to sell property; and the time, date, terms and place of sale.

Effective January 1, 1988, the notices must state the earliest time the sale will occur. Furthermore, the sale must begin within three hours of the designated time.

The sale, according to Section 51.002(a) of the Texas Property Code, may be conducted on the first Tuesday of any month between 10 a.m. and 4 p.m. (but within

three hours of the time specified in the notices) following the 21st day after proper notices have been posted, filed and sent. Effective January 1, 1988, the sale must take place at the county courthouse in the county where the land is located in the area designated by the commissioners court. The customary practice of conducting the sale on the courthouse steps no longer applies. If the Tuesday occurs on a legal holiday, the sale is still valid.

These notices are the minimum requirements necessary for a valid foreclosure sale. However, if the deed of trust requires more, the additional requirements must be strictly followed. For example, many pre-1976 deeds of trust require posting at three public places, not just at the courthouse door.

Only the debtors and guarantors must receive personal notices at their last known addresses. Junior lienholders on the property are not required to receive notice unless a contractual agreement mandates it. As a matter of policy, all lienholders and other interested partners should be contacted to ensure spirited bidding.

The trustee is the central character in the foreclosure process. The trustee has the sole authority to sell the collateral and to convey title. The debtor grants this authority to the trustee in the deed of trust.

There are few restrictions on who can serve as trustee. Practically any competent person may qualify. The debtor may select the trustee, but in practice, the lender designates. The trustee may be the mortgagee or the mortgagee's agent but probably not the mortgagor.

Regardless of who serves as trustee, the trustee owes a fiduciary duty to both the mortgagee and mortgagor. The trustee must act in good faith and fairness to both parties in conducting a fair, impartial foreclosure sale after posting, filing and sending proper advance notices.

If the designated trustee is unavailable, a substitute trustee may be appointed in strict compliance with the deed of trust; otherwise the resulting sale is invalid. Only the party or parties designated in the deed of trust may appoint the substitute trustee. This is generally the lender or any subsequent holder of the indebtedness.

The conditions contained in the deed of trust for the appointment of a substitute trustee, if any, must be strictly followed. For instance, if the deed of trust provides that a substitute trustee can be appointed only where the original trustee fails to act, or where the original trustee resigns or dies, then these conditions must occur before a valid substitute trustee may be appointed.

The wording used in the State Bar deed of trust contains no conditions or contingencies for the appointment of a substitute trustee. It simply states that the lender may appoint a substitute trustee without any formality other than that the designation must be in writing.

Unless the deed of trust provides otherwise, one trustee need not formally resign before another is appointed. If the original trustee has posted, filed and sent the required notices, the substitute trustee need not wait 21 days after his or her appointment to conduct the sale. The sale may still occur 21 days after the notices were first properly posted, filed and sent.

Valid Sale by Trustee

The trustee is the only person who can conduct a valid sale. However, agents of the trustee may sign, post, file and send the notices. Once the notice is posted, the trustee or the agents need not check the courthouse to ensure the notice remains in place.

After the necessary notices have been posted, filed and sent and the required 21-day waiting period has elapsed, the trustee may proceed with the sale on the first Tuesday of the following month anytime between 10 a.m. and 4 p.m. but within three hours of the time designated in the notices. The trustee commences the sale in the area of the courthouse designated by the commissioners court by first reading a copy of the posted notice, second by stating the terms of the sale and then by opening the bidding.

Generally the trustee will require cash-only sales. Section 51.002 of the Texas Property Code contains no restrictions on

the type of consideration required. If the deed of trust dictates cash only, only cash bids may be received.

At the sale, all parties present may bid. Third parties, the lender and even the debtor are qualified.

The trustee may bid, but it is important to ascertain for whom the bids are entered. If the trustee also is the mortgagee, all bids must be for the mortgagee. If the trustee is not the mortgagee, the trustee cannot bid the property either on his or her behalf or on the account of a corporation the trustee controls. However, the trustee may purchase the property in the name of a disinterested third party.

If the mortgagee enters the highest bid, the mortgagee can acquire the property without any out-of-pocket costs as long as the bid price does not exceed the balance of the debt. The lender simply applies the purchase price as a credit against the mortgagor's debt.

As mentioned, the mortgagor (borrower) may bid at the foreclosure sale, but this is unlikely. If the borrower had sufficient funds, he or she would have paid off the installment in arrears to prevent the lender from ever accelerating the note. After the note is accelerated, the borrower still can prevent the foreclosure sale by redeeming the entire unpaid balance of the note anytime before the actual sale begins. This is known as an *equity of redemption.*

In addition to the equity of redemption, many states give the mortgagor a right of redemption for a certain period after the sale occurs. The right of redemption enables the foreclosed borrower to repurchase the property for the price it brought at the foreclosure sale. The right of redemption attempts to ensure that the property will generate adequate revenue at the foreclosure sale. Unfortunately for foreclosed Texas homeowners, there is no right of redemption in this state.

Division of Proceeds

Once the sale occurs, the proceeds are divided in the following manner and in the following order:

- The expenses of advertising the sale and making the conveyance, including any commission to the trustee and attorney's fees other than those provided in the real estate lien note (the State Bar deed of trust includes a 5 percent commission for the trustee)
- The full amount of the unpaid principal, interest, attorney's fees and other charges due and unpaid as provided in the real estate lien note
- The remaining balance to the mortgagor

Should the foreclosure sale not generate sufficient revenue to cover the first two categories, the borrower is still personally liable for the balance. To recover the deficiencies, the lender may institute and obtain a judgment against the borrower. This is sometimes called a *deficiency suit or deficiency judgment.*

Deficiency Judgments

In 1991, the 72nd Texas Legislature enacted new legislation altering the way deficiency judgments are handled.

In the past, mortgagors (debtors) have complained that the prices brought at foreclosure sales were below the fair market value of the collateral. When the mortgagee (lender) was the purchaser, a possible double recovery occurred. In the case of *Olney Savings and Loan Association v. Farmers Market of Odessa,* 764 S.W. 2d 869 (Tex. App. 1989), the lender purchased the property at the foreclosure sale for $150,000 and immediately sold it for $200,000. The lender then sued the debtor for a deficiency based on the foreclosure price of $150,000, even though a $50,000 profit had been realized in the interim.

Texas case law has held consistently that the debtor has no recourse. As long as the lender complies strictly with the procedural rules specified in the deed of trust and in Chapter 51 of the Texas Property Code, both the foreclosure sale and price will be upheld.

To remedy this situation, Texas legislators added Sections 51.003–51.005 to the Texas Property Code in 1991. Section

51.003, entitled "Deficiency Judgments," applies only to nonjudicial foreclosures. It provides:

- The lender has two years to recover a deficiency judgment after the foreclosure sale (formerly it was four years).
- If the lender seeks a deficiency judgment, the debtor may request the court to determine the fair market value of the collateral as of the date of sale.
- The fair market value shall be determined by the finder of fact after the introduction of competent evidence of value by the parties. Competent evidence of value may include but not be limited to: expert opinion testimony; comparable sales; anticipated marketing time and holding costs; cost of sale; and the necessity and amount of any discount to be applied to the future sales price or the cash flow generated by the property to arrive at a current fair market value as of the date of the foreclosure sale.
- If the debtor does not request the determination of value, the foreclosure price shall be used to compute the deficiency.
- If the court determines that the fair market value is greater than the sales price, the debtor is entitled to an offset against the deficiency for the amount.
- Any money received by the lender from a private mortgage guaranty insurer shall be credited to the debtor's account prior to the suit for a deficiency. However, the private mortgage guaranty insurer may then sue the debtor for the amount of the payment.

Sections 51.004 and 51.005 are entitled "Judicial Foreclosure–Deficiency" and "Judicial or Nonjudicial Foreclosure after Judgment Against Guarantor–Defeciency" respectively. The two sections were added primarily to protect both debtors and guarantors in the event of either a *judicial* or *nonjudicial* foreclosure. Either party may challenge the fair market value of the collateral within 90 days after the sale or 90 days after the guarantor receives actual notice of the sale, whichever is later. The procedure for determining fair market value and the offset against the deficiency is the same as specified in Section 51.003.

The primary differences between Section 51.003 and Sections 51.004 and 51.005 are that the latter two sections:

- apply to *both* judicial and nonjudicial foreclosure sales,
- provide for the debtor or guarantor to challenge the fair market value of the collateral even *before* a lender seeks a deficiency judgment and
- can be used offensively by plaintiffs while Section 51.003 can be used only defensively by a defendant.

Note. Although the statutes attempt to remedy an inequitable position for debtors, substantive and technical legal questions persist.

The statute may be unconstitutional. A similar law was passed in 1933. The Texas Supreme Court declared it unconstitutional because it impaired existing contract rights. *Langever v. Miller,* 76 S.W. 2d 1025 (Tex. 1934). However, similar legislation has been upheld by the U.S. Supreme Court not to be in violation of the U.S. Constitution. *Richmond Mortgage & Loan Corp. v. Wachovia Bank & Trust Co.,* 300 U.S. 124 (1937).

The lender has three choices in the event of a default: (1) to seek a judgment for the unpaid balance of the note and perhaps foreclose later on the collateral, (2) to foreclose on the collateral and then seek a deficiency judgment or (3) to seek a judgment on the note and foreclose simultaneously on the collateral. The statutes are inapplicable when the lender sues on the real estate lien note but does not foreclose on the collateral.

The phrase *fair market* value is not defined but the statutes describe five possible ways to determine it. However, the five guidelines are not inclusive.

And finally, debtors still may be losers. When the difference between the fair market value and the foreclosure price exceeds the deficiency, the debtor has no right to a refund of the excess.

Debtors' Alternatives and Remedies

Many debtors faced with the possibility of foreclosure attempt to convey the property back to the lender. If the lender accepts the deed in lieu of foreclosure, it saves time, the expense of conducting the sale and possible litigation costs associated with an irregular or improper foreclosure. Although the law is not conclusive on the issue, a deed in lieu of foreclosure will satisfy the entire debt held by the lender against the property. Deficiency suits will be eliminated.

If the original borrower resells the property before the existing note is retired, the new buyer may or may not be liable for a deficiency judgment. If the new buyer does not get independent financing, he or she must either assume or "take subject to" the existing note. If the note is assumed, the new buyer and the seller are mutually liable for the monthly installment payments. Likewise, both are jointly responsible for any deficiency judgments. However, if the new buyer takes "subject to" the note, he or she avoids personal liability both for the payment of the existing note and for any deficiency judgments. This leaves the original borrower solely responsible for both.

The borrower may complain that the reason the property did not bring sufficient revenue was because of an impropriety, two possible remedies are available: setting aside (rescinding) the sale or suing for damages.

The borrower may pursue only one of the two. An election to pursue one bars any action to pursue the other later.

An exceedingly low price generated at the foreclosure sale is not sufficient in itself to render a sale invalid. However, the greater the disparity between the sales price and the market value of the property, the more readily the courts will find any irregularity sufficient for the debtor to successfully challenge the sale. The irregularity, however, must have contributed to the inadequacy of the consideration (low price) received at the sale.

Further, the inadequacy of the consideration can be grounds to have the sale set aside under federal bankruptcy laws. If the sales price does not equal or exceed 70 percent of the property's fair market value, the sale can be voided as a fraudulent transfer if the debtor files for bankruptcy within one year of the sale.

If the debtor does attack the sale under Texas law because of an irregularity, the attack most likely will be for damages and not to rescind. To set aside the sale, the debtor first must repay or offer to redeem the property from the purchaser at the price brought at the foreclosure sale. If the debtor possessed such resources, the foreclosure probably would never have occurred.

Statute of Limitations

The statute of limitations may be a barrier. *With minor exceptions, an action to set aside a sale must be initiated within four years.* And, if the property has been resold during the interim to a purchaser unaware of the irregularities, the action to rescind the sale (but not for damages) may be lost.

For these reasons, most debtors who attack a foreclosure sale seek damages. To recover damages from a wrongful foreclosure, the debtor must prove how much the property would have brought if the irregularity had not occurred. In any event, the maximum recovery is limited to the difference in the fair market value of the property and unpaid balance of the note at the time of sale. Where the conduct of the lender or trustee can be proven to have been intentional or malicious, exemplary or punitive damages also may be recovered.

Any action to recover damages must be initiated within four years of the sale. Because only one remedy may be pursued, the borrower must be careful to choose the correct one. The following example is based on an actual case.

A Texas debtor sought damages for the wrongful appointment of a substitute trustee. The irregularity, but no resulting damages, was proven at trial. Consequently, the debtor recovered nothing. However, the court stated that the irregularity was sufficient to rescind the sale if such a remedy

had been pursued first. Because it was not, the debtor was without further recourse.

Foreclosure will continue to play an important role in the Texas real estate market into the 1990s. Even though the homeowner may have defaulted on an installment payment, Texas law requires that a subsequent foreclosure be conducted in strict conformity to Texas law and the deed of trust. Failure to comply with either may enable the homeowner to set aside the sale or sue for damages.

Examining Foreclosure Procedures

Here are some of the more strategic procedural points that a homeowner may wish to examine during or after a foreclosure. The list is not comprehensive and is not a substitute for legal counsel. The appropriate remedies for an irregularity are not included.

Did the circumstances prompting the foreclosure actually occur? For instance, was there a default on an installment payment as specified and required by the deed of trust?

Did the foreclosure take place within four years of the default? The Texas statute of limitations is four years and applies only to the delinquent payments due within the four years.

If the collateral serves as the debtor's residence, did the lender give the debtor a 20-day notice to cure the payments in default before accelerating the note? (This is mandatory and nonwaivable.) If the collateral did not serve as the debtor's residence, did the lender notify the debtor of the lender's intent to accelerate the note after the debtor defaulted on the payment? Did the lender notify the debtor that acceleration of the note had actually occurred? If not, was the right to receive such notices waived by the debtor in the deed of trust? (The interpretation of an effective waiver may require the services of an attorney.)

If the notices were effectively waived (except for the 20-day notice to cure for a debtor's residence), has the lender received late payments in the past without resorting to foreclosure? If so, the right to foreclosure without giving the required notices at a later date may be deemed improper.

Notice of Sale

Did the trustee (or substitute trustee) or the trustee's agents post notice of the intended sale on the courthouse door, file notice of the sale with the county clerk and send notices to the debtors at least 21 days in advance of the actual sale? (The day of posting, filing and sending counts as the first day of the required 21.) If a pre-1976 deed of trust requires posting at three public places 21 days in advance of sale, was this requirement met?

If the land was located in more than one county, was the notice posted and filed in each county? Did each notice contain information specifying the county in which the sale would be conducted and the time the sale would begin?

Were personal notices sent to each person liable on the note by certified mail to their last known address according to the lender's records? (If the husband and wife have separated, an individual notice may need to be sent to each spouse.)

Was the substitute trustee, if any, properly appointed by the rightful parties in accordance with the terms of the deed of trust? Among other things, did the deed of trust require the original trustee to resign? Did the deed of trust require the appointment of the new trustee to be recorded 21 days in advance of the sale?

Did the trustee conduct the sale in the area of the courthouse designated by the commissioners court and in accordance with the deed of trust and state law? Among other things, was the sale conducted on the first Tuesday of the month between 10 a.m. and 4 p.m. (but within three hours of the time specified in the notices) following the expiration of the 21-day notice period? If cash bids were required in the deed of trust, did the trustee comply? Did the trustee acknowledge and accept all bids at the sale after the notice of the sale was read? Did the trustee leave the sale before it was completed without telling

the bidders when it would reconvene? Did the trustee bid and purchase the property in his or her own behalf? (If the foreclosure sale has not occurred yet, the debtor may want to videotape the sale to preserve evidence of any irregularities.)

Did the expenses and charges levied against the debtor's interest following the sale constitute usury? Among other things, were the interest charges calculated to the date of sale or were they calculated over the duration of the note as if there had been no default? In other words, were there charges for unearned, unaccrued interest?

Receivorship Status

Was the property in receivorship at the time of the sale? A receiver may have been appointed for an insolvency proceeding or a divorce. If so, the trustee under the deed of trust has no authority to sell the land unless authorized by the court in which the receivorship was pending.

Was the debtor alive at the time of the foreclosure? If not, the administrator of the decedent's estate generally has the unconditional right to revoke the sale for up to four years after the debtor's death. (There are several exceptions to this rule.)

Was the debtor a minor? If so, the property may not be foreclosed except under the probate court's supervision if the deed of trust was executed by the minor's guardian on behalf of the minor.

Was the debtor in the armed services or discharged within three months of the proposed sale? If so, without a court order the foreclosure is prohibited by the Federal Soldiers' and Sailors' Civil Relief Act of 1940. See Volume 50 of the United States Code Annotated, Section 532(3). This federal statute applies only if the property was owned by the person before he or she went into the service. (For details, see "Obscure Law Protects Military Personnel" in *Real Estate Center Law Letter*, Vol. 5, No. 1.)

The following Real Estate Center publications contain related information.

"Transfer the Deed, Cancel the Debt: Alternative to Foreclosure," reprint 613, $2.50 out of state, $2 in Texas.

"Obscure Law Protects Military Personnel," *Real Estate Center Law Letter*, Vol. 5, No. 1, $2 out of state, $1 in Texas.

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