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BANKING LAW

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I. CASE LAW

A. DIRECTORS' AND OFFICERS' LIABILITY

1. Business Judgment Rule

IN *Federal Deposit Insurance Corp. v. Brown*¹ the United States District Court for the Southern District of Texas held that the Texas business judgment rule immunizes directors of banks located in Texas from liability provided that the directors' actions are not self-interested, fraudulent, beyond their authority, or grossly negligent. In *Brown* the court did not consider 12 U.S.C. § 1821(k)² stating that "12 U.S.C. § 1821(k) creates a substantive standard of care, and therefore does not apply retroactively, the court must look to the law as it existed at the time of the alleged acts and omissions in this case"³ The court relied upon *Cates v. Sparkman*⁴ as

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1. 812 F. Supp. 722 (S.D. Tex. 1992).

2. Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), 12 U.S.C. § 1821(k) (Supp. I 1989) provides:

A director or officer of an insured depository institution may be held personally liable for monetary damages in any civil action by, on behalf of, or at the request or direction of the Corporation, which action is prosecuted wholly or partially for the benefit of the Corporation—

- (1) acting as conservator or receiver of such institution,
- (2) acting based upon a suit, claim, or cause of action purchased from, assigned by, or otherwise conveyed by such receiver or conservator, or
- (3) acting based upon a suit, claim, or cause of action purchased from, assigned by, or otherwise conveyed in whole or in part by an insured depository institution or its affiliate in connection with assistance provided under section 1823 of this title, for gross negligence, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care (than gross negligence) including intention tortious conduct, as such terms are defined and determined under applicable State law. Nothing in this paragraph shall impair or affect any right of the Corporation under other applicable law.

Id.

3. *Brown*, 812 F. Supp. at 726.

4. 73 Tex. 619, 11 S.W. 846 (1889).

the genesis for the business judgment rule. In *Cates* the Supreme Court of Texas concluded that the negligence of a director, no matter how unwise or imprudent, does not constitute a breach of duty if the acts of the director were "within the exercise of their discretion and judgment in the development or prosecution of the enterprise in which their interests are involved" ⁵ Applying the reasoning in *Cates*, the court in *Gearhart Industries v. Smith International, Inc.* ⁶ concluded that " . . . Texas courts to this day will not impose liability upon a non-interested corporate director unless the challenged action is *ultra vires* or is tainted by fraud. . . . Such is the business judgment rule in Texas." ⁷ The court in *Brown* held that the business judgment rule remains a viable doctrine in state courts with a viable rationale of "encouraging citizens to serve as corporate directors by immunizing them from acts and omissions that in hindsight proved to be wrong, as long as the directors were not personally interested in the transaction or did not act fraudulently or contrary to their lawful authority." ⁸ The court noted that the business judgment rule protects actions that with the benefit of hindsight could have been different stating that with "better or more current appraisals, more or better security for the loan . . . , almost any loan could have been made more secure, or at least the bank could have suffered a smaller loss on it." ⁹ Further, the court stated that "[t]he business judgment rule protects bank directors from being guarantors on loans made by banks" and "encourages directors to exercise their judgment in making loans and not to foreclose credit markets to all but blue-chip borrowers." ¹⁰

The court rejected two arguments by the FDIC that bank directors owe a higher duty than non-bank directors. The FDIC argued that *FDIC v. Wheat* ¹¹ established that the business judgment rule does not preclude an action for negligence against disinterested directors of a bank. The court distinguished *Wheat* in noting that Sudderth, the director found liable in *Wheat*, had a personal interest in the transaction for which he was found liable, whereas the defendant directors in this case had no such personal interest. Further, the court noted that Sudderth did not argue on appeal that he did not breach his duty of care of good faith because the business judgment rule precluded liability for negligence under Texas law. Instead, he argued only that he owed no duty because (1) there was no evidence of his

5. *Brown*, 812 F. Supp. at 724 (quoting *Cates*, 11 S.W. at 849).

6. 741 F.2d 707, 721 (5th Cir. 1984).

7. *Brown*, 812 F. Supp. at 724 (quoting *Gearhart*, 741 F.2d at 721). *But see* Resolution Trust Corp. v. Hays, Civ. A. No. SA-92-CA-0653, 1992 WL 512414, at *1 (W.D. Tex. Dec. 2, 1992), where the court denied a Motion to Dismiss filed by an outside director alleging his actions or omissions were protected by the business judgment rule. The court held such an interpretation of *Gearhart* "would be tantamount to adopting a rule that the only duty owed by the directors of a corporation to the corporation is the rather minimal duty of not committing fraud or *ultra vires* acts." *Id.*

8. *Brown*, 812 F. Supp. at 723. *But see Hays* at *21 where the court held that "[b]efore the business judgment rule even comes into play, the director has the obligation of showing that he met his fiduciary duties." *Id.*

9. *Brown*, 812 F. Supp. at 723.

10. *Id.*

11. 970 F.2d 124 (5th Cir. 1992).

knowledge of the loan in question and (2) he was no longer a director of the bank when the loan closed. Finally, the court distinguished *Wheat*, noting that the business judgment rule was discussed only in terms of whether the jury charge was correct, not whether the FDIC's allegations of negligence stated a claim.¹²

In addition, the court rejected the FDIC's argument that the business judgment rule shields directors and officers in suits by shareholders for their own benefit, but not in suits on behalf of the corporation, stating that the FDIC cited no authority for such a proposition.¹³ The court held that its opinion in *Holmes*¹⁴ was incorrect to the extent that it barred claims for gross negligence against a disinterested corporate director. The court went on to examine a number of cases in order to clarify the meaning of grossly negligent conduct of a director.¹⁵

The court also held that the business judgment rule does not protect the directors if they abdicated their responsibility and failed to exercise any judgment. Relying on *Joy v. North*,¹⁶ the court stated that the business judgment rule "does not apply in cases, e.g., in which the corporate decision lacks a business purpose, is tainted by conflict of interest, is so egregious as to amount to a no-win, decision or results from an obvious and prolonged failure to exercise oversight or supervision."¹⁷ Thus, "[t]he business judgment rule necessarily presumes that the directors exercised their judgment."¹⁸

The court considered whether a federal standard of care should be imposed because RepublicBank - Houston was a national bank. Holding that no federal standard of care was applicable, the court relied on *FDIC v. Ernst & Young*¹⁹ for the proposition that absent a specific statutory right, the FDIC is to be treated like any other litigant.²⁰

Finally, the court ordered the FDIC to replead its complaint, noting that the court could not tell whether the various duties allegedly breached were based in tort or in contract and, if in tort, whether based on negligence, gross negligence, or breach of fiduciary duty. The FDIC had alleged a non-exhaustive laundry list of directors' duties and breaches of those duties, com-

12. *Brown*, 812 F. Supp. at 725.

13. *Id.* at 724.

14. *Resolution Trust Corp. v. Holmes*, Civil Action No. H-92-0753 (S.D. Tex. April 10, 1992).

15. *Cates v. Sparkman*, 73 Tex. 619, 11 S.W. 846 (1889), did not expressly use the term "gross negligence" but stated that "injurious practices, abuse of power, and oppression on the part of the company or its controlling agency clearly subversive of the rights of the minority, or of a shareholder" are not protected by the rule. *Cates*, 11 S.W. at 849. *Burk Royalty Company v. Walls*, 616 S.W.2d 911, 920 (Tex. 1981), defined gross negligence as "an entire want of care." In *Jewel v. Sal-O-Dent Labs., Inc.*, 69 S.W.2d 544, 546 (Tex. Civ. App.—Eastland 1934, writ ref'd), the court contrasted acts "indicating reckless mismanagement, or that the acts were not done, or authorized, in an honest exercise of the judgment of the board of directors, and in the interest of the corporation." *Jewel*, 69 S.W.2d at 546.

16. 692 F.2d 880, 886 (2d Cir. 1982), cert. denied, 460 U.S. 1051 (1983).

17. *Brown*, 812 F. Supp. at 726.

18. *Id.*

19. 967 F.2d 166, 169-70 (5th Cir. 1992).

20. *Brown*, 812 F. Supp. at 726.

binning all of the duties and breaches together as justifying liability under all four of its causes of action in its pleadings. The court ordered the FDIC to replead, alleging specifically by defendant each act or omission, naming: (1) the specific duty implicated and, if the duty is based on a contract, the precise contract, and the contract language that creates the duty; (2) how the duty was breached; (3) when and how the duty first damaged the Republic Bank - Houston for the amount of the damages; and (4) how the damages were calculated.²¹

In *Resolution Trust Corporation v. Norris*²² the United States District Court for the Southern District of Texas expanded upon and followed its earlier holding in *Brown*. In *Norris* the Resolution Trust Corporation (the RTC) sued the former outside directors of Commonwealth Savings Association (Commonwealth) alleging a breach of the duty of due care, negligence, gross negligence, and negligence per se resulting in over \$200 million in losses to the thrift.²³ As in *Brown*, the court declined to retroactively apply 12 U.S.C. § 1821(k), and the court relied on *Gearhart*²⁴ for its holding that non-interested corporate directors are protected by the Texas business judgment rule unless their actions are fraudulent or *ultra vires*.

The RTC alleged that the directors' actions approving certain real estate loans was *ultra vires* because the loans violated federal and state regulations relating to the form and approach of the appraisals used to support the loan applications. The RTC argued that state and federal regulatory agencies had issued Reports of Examination that criticized certain loan and underwriting practices at Commonwealth, including the use of inadequate or defective appraisals. The RTC argued that the approval of the loans by the defendants constituted *ultra vires* acts because the defendants had ignored warnings from the Federal Home Loan Bank Board and the Texas Savings and Loan Department "by failing to put into place proper review and lending procedures, and by ratifying loans that did not comply with state and federal regulations and Commonwealth's Bylaws."²⁵ The court noted that *ultra vires* acts are defined by Texas law as "acts beyond the scope of the powers of a corporation as defined by its charter or the laws of the state of incorporation."²⁶ Relying on *Briggs v. Spaulding*²⁷ and *Fitzpatrick v. FDIC*,²⁸ the court noted that no allegation that directors knowingly committed illegal acts or acts outside their authority was made by the RTC. The court stated that "[t]he failure to monitor the acts of the loan officers and other individuals charged with preparing loans and presenting them to the Board for approval is not an *ultra vires* act such that directors may be held

21. *Id.* at 727.

22. 830 F. Supp. 351 (S.D. Tex. 1993).

23. *Id.* at 354.

24. 741 F.2d at 721.

25. *Norris*, 830 F. Supp. at 355.

26. *Id.* at 357 (citing *Gearhart*, 741 F.2d at 719; *Staaacke v. Routledge*, 111 Tex. 489, 241 S.W. 994, 998-99 (1922)).

27. 141 U.S. 132 (1891).

28. 765 F.2d 569, 577 (6th Cir. 1985).

personally liable for the results."²⁹

The court also considered the RTC's claim that the defendants had breached a duty of loyalty to Commonwealth. The RTC argued that the directors were "interested" in the loan transactions because they tried "to conceal the institution's financial condition from the regulators in order to forestall regulatory intervention and maintain control of Commonwealth."³⁰ The RTC also argued that because the directors were acting to keep their jobs, they were "interested directors." Relying on the definition of an interested director as set forth in *Gearhart*,³¹ the court noted that the defendant directors did not fit in any of these categories and dismissed the claim for a breach of duty of loyalty due to a desire to "entrench themselves" as directors of Commonwealth.

2. Affirmative Defenses

In *Federal Deposit Insurance Corp. v. Niblo*³² the United States District Court for the Northern District of Texas reviewed a number of affirmative defenses asserted by defendant directors. The defendants were directors of Texas Bank and Trust Company, Sweetwater, Texas (TBT) which was placed in liquidation on July 27, 1989. The FDIC was appointed as receiver of TBT at that time. The FDIC in its corporate capacity³³ brought an action against certain officers and directors of TBT alleging, among other things, negligence and breach of fiduciary duty. The complaint alleges that the officers and directors committed certain acts and-or failed to take certain actions that led to losses of at least \$3 million in connection with six loan transactions. Applying Texas law except in areas where Texas law was clearly preempted by federal laws,³⁴ the court reviewed numerous affirmative defenses asserted by the defendants.

The court examined the affirmative defense of waiver relying on *First Interstate Bank of Arizona, N.A. v. Interfund Corp.*,³⁵ for the definition of waiver as "the voluntary, intentional relinquishment of a known right or intentional conduct inconsistent with claiming that right."³⁶ The FDIC ar-

29. *Norris*, 830 F. Supp. at 357.

30. *Id.* at 358.

31. The *Gearhart* court stated:

A director is considered "interested" if he or she (1) makes a personal profit from a transaction by dealing with the corporation or usurps a corporate opportunity, . . . (2) buys or sells assets of the corporation, . . . (3) transacts business in his director's capacity with a second corporation of which he is also a director or significantly financially associated, . . . or (4) transacts business in his director's capacity with a family member.

Gearhart, 741 F.2d at 719-20 (citations omitted).

32. 821 F. Supp. 441 (N.D. Tex. 1993).

33. The FDIC conducts its business in several different capacities: FDIC-Corporation acts as an insurer, regulator, and-or liquidator of assets purchased or assigned from FDIC-Receiver; FDIC-Receiver acts as receiver of any failed institution for which it has been appointed receiver for the purposes of liquidation or winding-up the affairs of an insured institution, or for arranging a purchase and assumption transaction. *Niblo*, 821 F. Supp. at 449.

34. *Id.* at 449 n.14.

35. 924 F.2d 588, 595 (5th Cir. 1991).

36. *Niblo*, 821 F. Supp. at 451.

gued that the defense of waiver was insufficient as a matter of law because it called into question the conduct of the FDIC.³⁷ Further, the FDIC argued that the affirmative defense of waiver should be stricken because the FDIC owed no duty to the defendants. The court rejected this argument, refusing to strike the affirmative defense of waiver stating “[w]aiver does not rest upon any duty owed to the other party, but rather a party’s duty to itself to act upon or lose a specific right.”³⁸

Relying on *Heckler v. Community Health Services of Crawford County, Inc.*,³⁹ the court declined to strike the affirmative defense estoppel. The court, however, noted that “ ‘a party seeking to estop the government bears a quite heavy burden’; in addition to establishing the four elements of estoppel . . . the party [must] ‘allege more than mere negligence, delay, inaction, or failure to follow an internal agency guideline.’ ”⁴⁰

The court rejected the FDIC’s argument that the affirmative defense of failure to mitigate damages should be stricken because it was insufficient as a matter of law. The court relied upon *Gideon v. Johns-Manville Sales Corp.*,⁴¹ stating:

[w]hile it is commonly said that an injured party has a ‘duty’ to minimize damages, this is a misnomer, for the victim owes no duty to the person who hurts him. The principal, correctly stated, is that the injured person may not recover damages that do not result proximately from the defendant’s breach of duty. Damages that might be avoided or mitigated are, therefore, not recoverable.⁴²

The court reasoned that “a plaintiff’s duty to mitigate its damages is owed to itself if that plaintiff desires to have full satisfaction of its damages,”⁴³ and the court therefore allowed the affirmative defense of mitigation of damages.

The court also considered whether the Texas rule of comparative responsibility providing “[i]n an action in which a claimant seeks damages for harm other than personal injury, property damage, or death, arising out of any action grounded in negligence, . . . a claimant may recover damages only if his percentage of responsibility is less than or equal to 50 percent”⁴⁴ was applicable in this case. The court drew a distinction between the actions of FDIC-Corporate and FDIC-Receiver noting that they are separate entities and cannot be held accountable for the actions of the other.⁴⁵ The court held that as a result of the FDIC-Receiver and FDIC-Corporate being separate entities, the defendant would only be able to examine the actions of FDIC-Corporate after it acquired the present cause of action and the loans

37. *Id.* at 451-52 (citing *FDIC v. Isham*, 782 F. Supp. 524, 532 (D. Colo. 1992); *FDIC v. Crosby*, 774 F. Supp. 584 (W.D. Wash. 1991)).

38. *Niblo*, 821 F. Supp. at 452.

39. 467 U.S. 51, 59 (1984).

40. *Mangaroo v. Nelson*, 864 F.2d 1202, 1204-05 (5th Cir. 1989) (quoting *Fano v. O’Neill*, 806 F.2d 1262, 1265 (5th Cir. 1987)).

41. 761 F.2d 1129, 1139 (5th Cir. 1985).

42. *Niblo*, 821 F. Supp. at 453.

43. *Id.* at 453.

44. TEX. CIV. PRAC. & REM. CODE ANN. § 33.001 (Vernon Supp. 1994).

45. *See FDIC v. Condit*, 861 F.2d 853 (5th Cir. 1988).

related thereto; the defendants, however, were precluded from asserting the defense of comparative responsibility to the extent they sought to examine the conduct of the FDIC in its capacities as insurer, regulator, receiver, or liquidator of TBT. The court noted that FDIC-Corporate's conduct seemed to be more related to issues of proximate causation of the loss and mitigation of damages, and that it would be subject to examination under the affirmative defenses of mitigation of damages or no proximate causation.⁴⁶

The court also allowed the business judgment rule to be asserted as an affirmative defense. Relying on *FDIC v. Wheat*,⁴⁷ the court stated that the business judgment rule for banks provides that:

a director or officer of a bank shall not be liable for claims against him if, in the discharge of his duties, he exercised ordinary care and acted in good faith and honestly exercised his best business judgment within the limits of the actual authority of his position with the bank. A director or officer of a bank shall not be held liable for honest mistake of judgment if he acted with due care, in good faith, and in furtherance of a rational business purpose.⁴⁸

The court also allowed the affirmative defense that the FDIC should have removed officers and directors for engaging in unsafe and unsound practices under 12 U.S.C. § 1818(d)(1)(ii), (iii).⁴⁹ The court noted that the statute does not impose a duty on the FDIC to remove directors in such circumstances, but the court indicated that the defendants may show that the FDIC abused its discretion in not exercising its right to remove directors and officers.⁵⁰

3. *Directors' and Officers' Liability Insurance*

a. Regulatory Exclusion

In *Bartley v. National Union Fire Insurance Company of Pittsburgh*⁵¹ the United States District Court for the Northern District of Texas examined the scope of the insurance coverage of the former officers and directors of First RepublicBank—Dallas and First RepublicBank—Houston. In *Bartley* the FDIC sued former officers and directors of the First RepublicBanks located in Dallas and Houston for negligence and breaches of their common law and statutory duties as officers and directors. The plaintiff directors and officers brought an action seeking declaratory judgment regarding the coverage obligations of National Union Fire Insurance Company of Pittsburgh (National Union) under an officers' and directors' liability insurance policy and a Binder that superseded the policy (the Binder). The plaintiffs claimed that they were insureds under the National Union policy that became effective on June 6, 1987 and expired on June 6, 1988 (the Policy or the Year One Policy) and a Binder for a policy to be effective in 1988 and 1989. The

46. *Niblo*, 821 F. Supp. at 456.

47. 970 F.2d 124, 130-31 n.13 (5th Cir. 1992).

48. *Niblo*, 821 F. Supp. at 458 (citing 12 U.S.C. § 1818(d)(1)(ii) & (iii) (Supp. I 1989)).

49. *Id.* at 461.

50. *Niblo*, 821 F. Supp. at 461.

51. 824 F. Supp. 624 (N.D. Tex. 1992).

Binder became effective on June 6, 1988. On June 23, 1989, while the Binder was still in effect, the officers and directors received notice that the FDIC would bring claims against them. The plaintiffs then forwarded this notice to National Union, which denied that the claims brought by the FDIC were covered by the policies. The plaintiffs alleged: (1) a breach of contract claim against National Union for its failure to provide coverage for the claims brought by the FDIC; (2) a declaratory judgment action seeking a declaration that, under the National Union policies, plaintiffs have the right to coverage for the FDIC's claims and the cost of defending such claim; (3) National Union breached its duty of good faith and fair dealing and was grossly negligent; and (4) National Union violated article 21.21 of the Texas Insurance Code.⁵²

The endorsement to the Year One Policy specifically excluded coverage for suits brought by regulatory agencies such as the FDIC.⁵³ National Union contended that the plaintiffs' complaint failed to state a claim because the Binder and the Year One Policy were both subject to the regulatory exclusion contained in the endorsement to the Year One Policy. The plaintiffs argued that the Binder did not incorporate the terms of the endorsement contained in the regulatory exclusion.

The Binder referred to the "policy as expiring" and National Union argued that such language referred to the entire Year One Policy, not just the forms that made up the policy without its endorsements. Applying Texas law concerning the interpretation of contracts, the court noted "[i]n construing a written contract, the primary concern of the court is to ascertain the true intentions of the parties as expressed in the instrument."⁵⁴ Following the general rule that "[o]rdinarily, all parts of the contract are to be taken together, and such meaning shall be given to them as will carry out and effectuate to the fullest extent the intention of the parties,"⁵⁵ the court reviewed the language of the entire contract and held that the phrase "policy as expiring" refers to the entire Year One Policy, including the endorsements.⁵⁶ Therefore, the regulatory exclusion was applicable.

The plaintiffs also contended that the regulatory exclusion was ambiguous alleging that the phrase "based upon or attributable to any action or proceeding brought by or on behalf of the [FDIC]"⁵⁷ could reasonably be con-

52. *Bartley*, 824 F. Supp. at 628.

53. The Endorsement provided:

In consideration of the premium charged, it is hereby understood and agreed that the insurer shall NOT be liable to make any payment for loss in connection with any claim based upon or attributable to any action or proceeding brought by or on behalf of the [FDIC], including any type of legal action which [the FDIC has] the legal right to bring as receiver, conservator, liquidator or otherwise; whether such action or proceeding is brought in the name of [the FDIC] or by or on behalf of [the FDIC] in the name of any other entity or solely in the name of any Third Party.

Id. at 629.

54. *Coker v. Coker*, 650 S.W.2d 391, 393 (Tex. 1983).

55. *General Indem. Co. v. Pepper*, 161 Tex. 263, 339 S.W.2d 660, 661 (1960).

56. *Bartley*, 824 F. Supp. at 631.

57. *Id.* at 632.

strued to apply only to claims asserted by the FDIC against third parties and not to claims asserted by the FDIC directly against the officers and directors of an institution. The court relied on *St. Paul Fire and Marine Insurance Co. v. FDIC*⁵⁸ where it was held that an identical regulatory exclusion that excluded coverage "based upon or attributable to any action or proceeding brought by or on behalf of the [FDIC]"⁵⁹ was unambiguous. The court in *St. Paul Fire* noted that the insurer's "intent to preclude [coverage for] all suits brought by the FDIC could not be stated in more explicit language"⁶⁰ The court also cited *Gary v. American Casualty Co.*⁶¹ and *FDIC v. American Casualty*⁶² as cases finding language that was identical or very similar to the language at issue to be unambiguous. Thus, the court concluded that the regulatory exclusion excluded National Union's liability for the type of claims for which the plaintiffs sought coverage.

The court also rejected the plaintiffs' argument that the regulatory exclusion was contrary to public policy relying on the Fifth Circuit's recent decision in *Fidelity & Deposit Company of Maryland v. Conner*.⁶³ The court noted that the plaintiffs' argument that the Financial Institutions Reform, Recovery, and Enforcement Act of 1989⁶⁴ "provides a dominant public policy which would justify voiding the regulatory exclusion on public policy grounds was [previously] rejected by the Fifth Circuit."⁶⁵

The court then discussed the plaintiffs' claim that the application of the regulatory endorsement would effect an unconscionable result. Relying on the test set forth in *Wade v. Austin*,⁶⁶ the court stated

two types of abuses must generally be present to produce a finding of unconscionability. First, plaintiffs must show "procedural abuse" in the formation of the contract, such as a gross disparity in bargaining ability. . . . Second, [plaintiffs] must also demonstrate "substantive abuse," or unfairness in the formal terms of the contract.⁶⁷

In order to demonstrate substantive unconscionability, the plaintiffs had the burden of showing that the terms of their contract with National Union were plainly oppressive. The court held that the plaintiffs did not meet this burden finding that "the regulatory exclusion appears to be merely an allocation of the risk agreed to by two commercial entities. . . . [and] that the exclusion was 'voluntarily entered into, and [was] not the result of mistake, fraud, or oppression.'"⁶⁸

Plaintiffs then argued that the doctrine of reasonable expectations should

58. 765 F. Supp. 538 (D. Minn. 1991).

59. *Bartley*, 824 F. Supp. at 633 (quoting *St. Paul Fire*, 765 F. Supp. at 541).

60. *St. Paul Fire*, 765 F. Supp. at 549.

61. 753 F. Supp. 1547, 1550-51 (W.D. Okla. 1990).

62. 975 F.2d 677 (10th Cir. 1992).

63. 973 F.2d 1236 (5th Cir. 1992); see *FDIC v. American Casualty*, 975 F.2d 677 (10th Cir. 1992); *St. Paul Fire and Marine Ins. Co. v. FDIC*, 968 F.2d 695, 702 (8th Cir. 1992).

64. 12 U.S.C. §§ 1811-1833(e) (Supp. I 1989).

65. *Bartley*, 824 F. Supp. at 634.

66. 524 S.W.2d 79, 86 (Tex. Civ. App.—Texarkana 1975, no writ).

67. *Bartley*, 824 F. Supp. at 635 (citing *Wade*, 524 S.W.2d at 86).

68. *Id.*

be applicable. This doctrine provides that the objectively reasonable expectations of insureds should be honored “‘even though painstaking study of the policy provisions would have negated those expectations.’”⁶⁹ Relying on *Forbau v. Aetna Life Insurance Co.*,⁷⁰ the court rejected the plaintiffs’ argument noting that “the reasonable expectations doctrine is premised upon the presence of an ambiguity in the contract in question; it is not available in the face of an unambiguous contract such as the one at issue in the present case.”⁷¹

b. Notice of Claim

In *McCullough v. Fidelity & Deposit Co.*⁷² the Fifth Circuit reviewed whether adequate notice had been given to Fidelity and Deposit Company of Maryland (F&D) to trigger coverage under a “claims made” insurance policy. In *McCullough*, F&D issued four directors’ and officers’ (D and O) liability policies to four affiliate banks and to three subsidiary banks of Harris County Bancshares, Inc. The policies covered claims made against insured officers and directors if the required notice was given to the insurer during the policy period. Section 6(a) expanded the coverage to cover claims made after the expiration of the policy term if certain written notice of the potential claims was given to F&D during the policy period. Section 6 of the policy provided:

(a) [i]f during the policy period, or during the extended discovery period if the right is exercised by the Bank or the Directors and Officers in accordance with Clause 2, the Bank or the Directors and Officers shall: . . . (2) become aware of any act, error, or omission which may subsequently give rise to a claim being made against the Directors and Officers, or any of them, for a specified Wrongful Act; and shall during such period give written notice thereof to the Company as soon as practicable and prior to the date of termination of the policy, then any claim which may subsequently be made against the Directors and Officers arising out of such Wrongful Act shall, for the purpose of this policy, be treated as a claim made during the Policy Year or the extended discovery period in which such notice was first given.⁷³

F&D contended that this language required the bank to notify it of “specified Wrongful Acts” of Directors and Officers having claim potential.⁷⁴ The plaintiff argued that the notice can be in the broader form of “any act, error or omission” which may give rise to a claim for specified wrongful acts.⁷⁵ Reviewing the plain language of the policy, the court held that F&D’s reading of the language was correct.

The court then reviewed whether actions taken by the bank constituted

69. *Id.* at 635-36 (citing *Rodman v. State Farm Mut. Auto Ins. Co.*, 208 N.W.2d 903, 906 (Iowa 1973)).

70. 36 Tex. Sup. Ct. J. 140, 1993 WL 141397 (May 5, 1993).

71. *Bartley*, 824 F. Supp. at 636 (citing *Forbau*, 36 Tex. Sup. Ct. J. at 143 n.8, 144).

72. 2 F.3d 110 (5th Cir. 1993).

73. *McCullough*, 2 F.3d at 111.

74. *Id.* at 112.

75. *Id.*

notice of specified wrongful acts in accordance with the policy provisions. During the policy period, the banks provided F&D with quarterly reports of financial condition that described increasing loan losses and delinquencies. Further, the banks provided F&D with a 1984 annual report in conjunction with the renewal of their policies in 1985. The annual report contained a footnote which referred to the issuance of a cease and desist order to one of the subsidiary banks by its primary regulator, the Office of the Comptroller of the Currency (the OCC). The bank, however, did not send the cease and desist order itself. In addition, F&D expressed concern about the bank's "problem with the Feds"⁷⁶ in correspondence between F&D and the bank, and F&D informed the banks that it intended to cancel their policies midterm, effective October 9, 1985.

The plaintiff contended that F&D was put on notice of acts or omissions of directors and officers which could later give rise to claims for specified wrongful acts by the reference to the cease and desist order in the annual report and the further reports of the banks' deteriorating financial condition. Further, the plaintiff argued that the term "wrongful act" in the policy included a breach of duty and the information furnished to F&D was adequate to inform it that the insured officers and directors had breached their duty to properly supervise the bank's lending operations. The court rejected these arguments holding that even if it is assumed that

notice of the issuance of the cease and desist order informs the insurer that the bank is having some difficulty, the issuance of such an order does not identify specified wrongful acts. The banks gave F&D no notice of the particular subsidiary involved, the particular agents, officers or directors involved, the time period during which the events occurred, the identity of potential claimants, and the specific unsound practices

...⁷⁷

Relying on *American Casualty Co. v. FDIC*⁷⁸ and *California Union Insurance Co. v. American Diversified Savings Bank*,⁷⁹ the court held that notice of an institution's worsening financial condition does not constitute notice of an officer's or director's act, error or omission. Further, it was held that rising delinquencies in bad loan portfolios are insufficient to constitute notice of specified wrongful acts.

c. Termination of Insurance Coverage Upon Takeover

In *United States Fire Insurance Co. v. FDIC*⁸⁰ the Fifth Circuit reviewed whether a savings and loan which placed itself under voluntary supervisory control by the Texas Savings and Loan Commission constituted a "takeover" of a savings and loan for purposes of termination of the savings and loan's insurance coverage under Savings and Loan Blanket Bond Standard Form No. 22 (Form 22).

76. *Id.* at 111.

77. *Id.* at 113.

78. 944 F.2d 455, 460 (8th Cir. 1991).

79. 914 F.2d 1271, 1277-78 (9th Cir. 1990), *cert. denied*, 498 U.S. 1088 (1991).

80. 981 F.2d 850 (5th Cir. 1993).

Empire Savings and Loan Association (Empire), a Texas chartered savings and loan and its predecessor, Town East Savings and Loan Association, purchased a Form 22 Blanket Bond from the United States Fire Insurance Company (U.S. Fire) which became effective on August 5, 1978. The provisions of the Bond provided that the Bond would automatically terminate "immediately upon the taking over of the Insured by a receiver or other liquidator or by State or Federal Officials."⁸¹ Empire began to face problems due to questionable lending practices in the early 1980s and received a temporary cease and desist order from the Federal Home Loan Bank Board in 1983. On January 9, 1984, the Texas Savings and Loan Commission issued a cease and desist order. Upon the issuance of such order, Empire placed itself under voluntary supervisory control by the Texas Savings and Loan Commission. Sometime after January 9, 1984, actions by Empire employees that might have supported claims under the Bond were discovered. U.S. Fire contended that the claims were not covered under the Bond because they were not discovered prior to the takeover on January 9, 1984. The FDIC argued that the term "taking over" is ambiguous and that section 11(c) of the Bond under which the Bond was terminated, was unenforceable because it was contrary to federal law and violated public policy. In addition, the FDIC contended that a takeover did not occur within the meaning of section 11(c).

Relying on *Sharp v. FSLIC*,⁸² the court rejected the FDIC's arguments regarding public policy, enforceability of section 11(c) and ambiguity by stating that *Sharp* "makes clear that a takeover does not have to be in the form of a receivership or liquidation, but occurs at any time the government assumes control over a thrift institution."⁸³ The court held that a taking over had occurred because Empire was prohibited by the supervisory takeover from engaging in activities that are the core functions of a savings and loan such as lending or investing any of its funds, withdrawing any bank accounts, encumbering any assets or incurring any debt including accepting deposits without approval. The court stated "[w]e are not concerned with the manner in which the order was implemented in determining the application of § 11, but rather its effect. The Bond's termination provision does not require a 'hostile' or 'involuntary' taking over but merely requires a 'taking over,' regardless of whether it be by consent or by force of law."⁸⁴

The court also noted that had there been any ambiguity in the language of the Bond, it should not be construed against U.S. Fire because the Bond was drafted jointly by the American Banker's Association and the American Surety Association, not by U.S. Fire.

81. *U.S. Fire Ins. Co.*, 981 F.2d at 850.

82. 858 F.2d 1042 (5th Cir. 1988).

83. *U.S. Fire Ins. Co.*, 981 F.2d at 851 (citing *Sharp*, 858 F.2d at 1045).

84. *Id.* at 851 (citing *Sharp*, 858 F.2d at 1045-46).

B. PROFESSIONAL LIABILITY

1. *Measure of Damages*

In *Federal Deposit Insurance Corp. v. Thompson & Knight*⁸⁵ the United States District Court of the Northern District of Texas ruled on a summary judgment motion that the FDIC could not recover from a law firm and one of its lawyers for legal malpractice. The action arose out of activities alleged to occur from January 1982 until October 14, 1988 in relation to Olney Savings Association (OSA) and its wholly owned subsidiaries, Olney Mortgage Resources (OMR) and Olney Service Corporation (OSC). OSA was a state chartered, federally insured savings association. OMR and OSC were private corporations. On October 14, 1988, the Federal Home Loan Bank Board (the FHLBB) declared OSA insolvent and appointed the Federal Savings Loan Insurance Corporation (FSLIC) as receiver (FSLIC/Receiver) for OSA. By operation of law, OSA's assets and liabilities were transferred to FSLIC/Receiver and FSLIC/Receiver succeeded to the rights, titles, powers and privileges of OSA, its members, directors and officers.⁸⁶ On that same date, an acquisition agreement between FSLIC/Receiver and NuOlney Savings Association (AmWest) transferring almost all of OSA's assets to AmWest was entered into between the FSLIC/Receiver and AmWest. The loans and collateral at issue in this case and the stock of OSC and OMR were included in the assets transferred to AmWest pursuant to the acquisition agreement. FSLIC/Receiver retained only certain office leases, furniture, fixtures, equipment, and specified claims against former officers, directors, shareholders and attorneys and agents of OSA. In addition to the acquisition agreement, a separate receiver's agreement was entered into on October 14, 1988 between FSLIC/Receiver and FSLIC in its corporate capacity. The receiver's agreement conveyed the assets that FSLIC/Receiver had retained to FSLIC/Corporate. Therefore, FSLIC/Receiver was left without any assets. In addition, an assistance agreement between the FSLIC and AmWest entered into on October 14, 1988 provided that the FSLIC in its corporate capacity would provide financial assistance and indemnification as to certain "covered" assets acquired by AmWest.

The FHLBB and the FSLIC were abolished pursuant to the provisions of FIRREA upon its enactment in August 1989 and the Federal Savings and Loan Insurance Corporation Resolution Fund (the Fund) managed by the FDIC, was created. All assets of the FSLIC, including those assets the FSLIC/Receiver had transferred to the FSLIC by the receiver's agreement, were transferred to the Fund. The FDIC then filed the action against Thompson & Knight, a law firm, Rose (an attorney at Thompson and Knight), certain former directors of OSA, a former officer and director of OMR and OSC, former shareholders of OSA, Myers Financial Corporation (MFC), the successor to Myers Development Corporation (MDC) and

85. 816 F. Supp. 1123 (N.D. Tex. 1993).

86. 12 U.S.C. § 1729(c)(B)(i)(II) (1988); see *FSLIC v. Oldenburg*, 671 F. Supp. 720, 723 (D. Utah 1987).

Michael A. Myers (Myers), an individual who controlled MFC and MDC and was involved in certain transactions with OSA, OSC and OMR. While the court gave no details on the charges, they allege in part that transactions among OSA, its subsidiaries, Myers and his corporation were so favorable to Myers, and so unfavorable to OSA, that OSA bore virtually all the risks while Myers stood to make nearly all the gains. It was also alleged that Rose understood and assisted in the transactions, and overlooked legal violations in their execution.⁸⁷ The FDIC alleged that the negligence and wrongful acts of the defendants caused damage to OSA and its subsidiaries in excess of \$50,000,000.⁸⁸ A motion for summary judgment was brought claiming that neither the FDIC nor its predecessors had suffered any damages. It was undisputed in the motion that the FSLIC/FDIC has paid out approximately \$40,000,000 to AmWest under the assistance agreement on transactions related to the FDIC's action to recover against the defendants. Further, the FDIC alleged that before the failure of OSA, OSA lost at least \$8,000,000 on the transactions at issue.⁸⁹

The court relied upon the measure of damage rule expressed in *Corsicana National Bank v. Johnson*⁹⁰ concluding that no recovery for losses on the loans in question can be had by OSA, FSLIC/Receiver or the ultimate assignee of either of them. The measure of damage rule in *Corsicana* states:

[T]he cause of action against [the wrongdoing director] accrued . . . when the Bank through his act parted with the money loaned, receiving in return only negotiable paper that it could not lawfully accept because the transaction was prohibited by § 5200, Rev. Stats. The damage as well as the injury was complete at that time, and the Bank was not obliged to await the maturity of the notes, because immediately it became the duty of the officers or directors who knowingly participated in making the excessive loan to undue the wrong done by taking the notes off the hands of the Bank and restoring to it the money that had been loaned. Of course, whatever of value the Bank recovered from the borrowers on account of the loan would go in diminution of the damages

. . .
. . .

[I]t is plain that the transaction of February 12, 1908, in which the Bank sold the Fleming and Templeton notes and indebtedness to the loan company for their full face value, was prima facie tantamount to a satisfaction of the damages the Bank had sustained by reason of the excessive loan Had the disposition made of them in February, 1908, been valid and unassailable, it would have borne the appearance of a satisfaction of the damages only because the two corporations were legally separate⁹¹ The court explained that the proper reading of *Corsicana*: is that if a lending institution, or someone acting for it, transfers an illegally made loan in exchange for its full face value, the

87. 3 BANK BAIL OUT LITIG. NEWS 3 (1993).

88. FDIC v. Thompson & Knight, 816 F. Supp. at 1125.

89. 3 BANK BAIL OUT LITIG. NEWS 3 (1993).

90. 251 U.S. 68 (1919).

91. *Thompson & Knight*, 816 F. Supp. at 1130 (citing *Corsicana*, 251 U.S. at 86-87).

risk of loss related to the loan has been removed from the lending institution and has been placed with the transferee, AmWest in this case. This is another way to say that when such a transfer occurs, the losses that apparently existed at the time the loan was made are eliminated; and, whatever damages would otherwise be measured by those losses are satisfied by the transfer.

The court relied on summary judgment evidence provided by the affidavit of William R. Welch, CPA (Welch) which was filed as a part of the FDIC's motion for leave to file a supplemental affidavit in opposition to the motion for summary judgment.⁹² In his affidavit, Welch treats the allocation of the purchase price for the assets acquired by AmWest pursuant to the acquisition agreement to be the equivalent of "book value" of the loans, which he defined to be "the loan's principal balance plus any accrued but unpaid interest."⁹³ Applying *Corsicana* to these facts, the court stated,

if Welch is correct on that subject (and there is nothing in the summary judgment record to indicate that he is not), then under the rules expressed by the Supreme Court in *Corsicana* on the subject of measure of damages, there would be no damages as to the loans in question because OSA, through FSLIC/receiver, would have received "their full face value" in exchange for their transfer to AmWest.

The court found it irrelevant that the assistance agreement was part of the overall deal between AmWest and the FSLIC/Receiver. The court quoted Welch's testimony several times for the proposition that all risk of loss on the loans transferred by FSLIC/Receiver is to be borne by AmWest in the absence of the assistance agreement. The court also indicated that the FDIC partially concurred with this analysis stating that "in a telephone conference between the court and counsel on March 3, 1993, counsel for FDIC confirmed that FDIC is not asserting in this action any claim derivative through the assistance agreement."⁹⁴ Relying on *FDIC v. Ernst and Young*,⁹⁵ the court held that the FDIC as assignee has no greater or different rights than its assignor. Thus, the FDIC was not entitled to recover for losses that neither OSA nor OSA's receiver suffered.

The court also noted that the FDIC could not assert claims against Thompson & Knight or Rose for legal malpractice in any capacity other than as the ultimate assignee of OSA's receiver. The court stated that

92. *Id.*

93. *Id.* at 1131.

94. *Id.* at 1126. The following exchange occurred between the court and counsel for FDIC during the March 3 telephone conference:

THE COURT: I am not asking you to disclose any secrets that you would prefer not to disclose, but has FDIC accepted the proposition that it is not going to be able to recover in this lawsuit payments it made by virtue of obligations it assumed under the Assistance Agreement?

MR. GENTRY: Yes, Your Honor, I believe that is correct.

THE COURT: So that's really not an impediment to the negotiations, some notion that they can recover under that?

MR. GENTRY: No, Your Honor.

Id. at 1126 n.3.

95. 967 F.2d 166, 169-70 (5th Cir. 1992).

"[u]nder Texas law, persons outside the attorney-client relationship have no cause of action for legal malpractice."⁹⁶ Holding that no independent duty was owed by Thompson & Knight and Rose to the FSLIC, FDIC or AmWest, the court held that "any loss suffered by FSLIC, FDIC, or AmWest cannot be charged against [Thompson & Knight] or Rose."⁹⁷

C. ENFORCEMENT OF LIENS

1. Relinquishment of Security Interest

In *Amarillo National Bank v. Komatsu Zenoah America, Inc.*⁹⁸ the court determined under what circumstances a bank relinquishes its security interest in a debtor's collateral as a result of the debtor transferring the collateral to a third party. In *Komatsu* the Amarillo National Bank (the Bank) received two notes from Connally Implement & Supply Co., Inc. (CISCO) secured by a written security agreement in "all inventory, accounts, notes, proceeds, [and] goods" owned by CISCO.⁹⁹ The agreement also provided that the debtor would not remove any specified collateral "*except goods identified herein as inventory.*"¹⁰⁰ CISCO purchased on credit certain inventory items from Komatsu. After the Bank had perfected its security interest in CISCO's inventory, CISCO returned the items to Komatsu in partial satisfaction of CISCO's debt to Komatsu. Komatsu did not perfect its purchase money security interest in the property. Subsequently, the Bank sued Komatsu for conversion but the district court ruled that the Bank had relinquished its security interest in the items by authorizing their transfer, and granted Komatsu's summary judgment motion. The Fifth Circuit reversed.¹⁰¹

It determined that the Bank's security interest survived the transfer if the transfer was made without the bank's consent.¹⁰² The court rejected Komatsu's argument that the clause excepting inventory from the general prohibition of unauthorized transfers meant that the Bank authorized Cisco's transfer to Komatsu.¹⁰³ The court found that Komatsu's argument would be correct only if CISCO had transferred "inventory" to Komatsu. The district court had found that this was the case based on the definition of "inventory" in Black's Law Dictionary, but the appellate court held that Black's was inapplicable because the security agreement provided that definitions in the U.C.C. were to apply.¹⁰⁴ For defining "inventory," the court relied on Official Comment 3 to section 9.109 of the U.C.C. which stated: "The prin-

96. *Thompson & Knight*, 816 F. Supp. at 1128.

97. *Id.* at 1129.

98. 991 F.2d 273 (5th Cir. 1993).

99. *Id.* at 274.

100. *Id.* at 275. The full clause read: "Debtor will not (*without Bank's consent*): remove the collateral from the location specified herein; allow the collateral to become an accession to other goods; sell, lease otherwise transfer, manufacture, process, assemble, or further under contracts of service, the collateral, *except goods identified herein as inventory.*" *Id.*

101. *Id.*

102. *Id.* (citing TEX. BUS. & COM. CODE § 9.306(b) (Tex. UCC) (Vernon 1991)).

103. *Id.*

104. *Id.* at 275-76.

cial test to determine whether goods are inventory is that they are held for immediate or ultimate sale. Implicit in the definition is the criterion that the prospective sale is in *the ordinary course of business*."¹⁰⁵ Here, the transfer was in partial satisfaction of CISCO's money debt to Komatsu and thus under the U.C.C.'s definition, the transfer was not in "the ordinary course of business."¹⁰⁶ Therefore, the Bank did not authorize the transfer.¹⁰⁷ As a result, the Bank had a valid conversion claim.

2. Sufficiency of Security Agreement

a. Possession and Purchase Money Security Interests

A purchase money security interest (PMSI) arises in equipment when the seller of equipment also finances the sale and perfects a security interest in the equipment. A PMSI that "is perfected at the time the debtor takes possession of the collateral or within twenty (20) days thereafter" takes priority over an earlier perfected security interest.¹⁰⁸ In a case determining the definition of "possession" for purposes of section 9.312(d) of the Texas Uniform Commercial Code, the Texas Supreme Court greatly strengthened the priority rights of a holder of an "after acquired property" security interest relative to a holder of a PMSI.¹⁰⁹ In *Cockrell* the court was asked to determine when "possession" occurs; the court answered, sensibly enough, that possession occurs when the purchaser/debtor has control over the property, irrespective of whether such control is exclusive.¹¹⁰

In *Cockrell*, John H. Cockrell, Jr. (Cockrell) owned a mini-blind factory operating out of a leased warehouse. On August 1, 1985, he contracted to sell the business and all of its assets to Kevin and Richard Sydnor (collectively, the Sydnors) for \$5,000 cash and a \$130,000 note secured by the assets of the business. Prior to this time, the Sydnors had executed a \$40,000 promissory note with the Bank of Denton which was backed by a security interest in all equipment then owned or subsequently acquired by the Sydnors. On the same day as the sale, the Sydnors occupied the warehouse and began operating the business. Cockrell also continued to occupy the warehouse and assist the Sydnors in running the business until October 3, 1985, when he vacated the premises and handed his keys to the Sydnors. Cockrell perfected his PMSI in the premises on October 20, 1985. The Sydnors subsequently defaulted on their note to the Bank which seized and sold all the equipment. Cockrell brought suit, claiming that since his security interest had priority, the bank's foreclosure and sale amounted to conversion.

105. *Id.* at 276.

106. *Id.* at 276-77. See also *Permian Petroleum Co. v. Petroleos Mexicanos*, 934 F.2d 635, 648 (5th Cir. 1991) (explaining that under § 1.201(9), one who transfers goods in total or partial satisfaction of a money debt is not a buyer in the ordinary course of business).

107. *Id.* at 277.

108. See TEX. BUS. & COM. CODE ANN. § 9.312(d) (Tex. UCC) (Vernon 1991) (emphasis added).

109. *Citizens Nat'l Bank of Denton v. Cockrell*, 850 S.W.2d 462 (Tex. 1993).

110. *Id.* at 466.

The trial court ultimately found in the bank's favor but was reversed by the appellate court, which concluded that possession under section 9.312(d) only refers to "power over property exercisable to the exclusion of all other persons."¹¹¹ Under this definition, the Sydnors did not have exclusive control over the property until Cockrell vacated the premises on October 3, 1985. Therefore, his PMSI was perfected within the twenty-day period and trumped the bank's security interest.

The Texas Supreme Court reversed the appellate court. It reasoned that the U.C.C. drafters' choice to have the purchase-money priority rule turn on the definition of possession indicated "a desire that the commencement of the grace period be easily ascertainable."¹¹² This desire would be thwarted if the definition of possession required exclusive control, because then it would acquire "a meaning different from the simple physical control that to outside parties suggests ownership rights."¹¹³ The court pointed out that the Sydnors were using the warehouse as their place of business and, to an outside creditor, it would appear that they had possession of the equipment because they had physical control over it. The court suggested that to require exclusive control would place an undue burden on a secured creditor who would have to verify that no other parties had access to the equipment. Therefore, the Sydnors obtained possession when they occupied the premises and began using the equipment on August 1, 1985. The court concluded that since Cockrell did not attempt to perfect his interest until October 7, 1985—more than twenty days after possession occurred—the bank's prior security interest had priority over Cockrell's interest.¹¹⁴

b. After-Acquired Property Security Interests and Intangible Property

In *Orix Credit Alliance v. Omnibank*¹¹⁵ the Houston Court of Appeals had to determine the priority for security interests held by two different creditors. One creditor, Orix Credit Alliance (Orix), received from the debtor an after-acquired property security interest which covered "all other goods, chattels, machinery, equipment, inventory, accounts, chattel paper, notes receivable, accounts receivable, furniture, fixtures and property of every kind and nature, wherever located, now or hereafter belonging to Mortgagor."¹¹⁶

The debtor later sold his business to BFI Special Services, Inc. (BFI), and received, as consideration for signing a non-competition covenant, one-quarter of one percent of BFI's gross revenues from its asbestos-abatement business. The debtor then borrowed money from another creditor who filed a financing statement concerning its security interest in the proceeds from the non-competition covenant. The debtor subsequently defaulted on his debt to both creditors.

111. *Id.*

112. *Id.* at 465.

113. *Id.*

114. *Id.* at 466.

115. 858 S.W.2d 586 (Tex. App.—Houston [14th Dist.] 1993, writ requested).

116. *Id.* at 588.

Orix argued that it was entitled to the proceeds from the non-competition covenant under its after-acquired property security interest because this interest covered all personal property, and the proceeds from the covenant constituted personal property.¹¹⁷ The court disagreed, citing the Black's Law Dictionary definition of "tangible" and holding that the security interest only covered personal property "wherever located."¹¹⁸ The court reasoned that because only *tangible* personal property could have a physical location, the security interest was limited to tangible personal property.¹¹⁹ Continuing, the court declared that, based on Black's definition of "intangibles," a right to receive payments under a covenant not to compete has no physical form and cannot be seen or touched; thus, as a result, the rights constituted was intangible property.¹²⁰ Therefore, the court concluded, "the description contained in the security agreement, clearly referring to tangible property, did not describe or identify the collateral at issue here, intangible property."¹²¹

The court rejected Orix's argument that the debtor's right to the proceeds was a type of "account" described in the security interest. The court held that an account is "any right to payment for goods sold or leased or for services rendered"¹²² The court found that no goods were sold or leased in connection with the debtor's grant of the covenant not to compete and that the term "services rendered" implied active performance, which was not the case here because the debtor refrained from performance.

In any event, the court reasoned that "a party rendering a service confers something of value upon the party receiving the service,"¹²³ and concluded that the debtor did not confer a value on BFI. Therefore, since the proceeds were not an account, they must fall within the catch-all category of general intangibles.¹²⁴ This opinion drew a dissent finding that the majority placed too much emphasis on the words "wherever located."¹²⁵ For the dissenter, intangible assets were covered by the security interest because its language included the phrase "property of every kind and nature."¹²⁶

There are some aspects to the majority's case besides the argument put forth by the dissent. First, it uses Black's definition of "tangible," which is defined as "[h]aving or possessing physical form. . . ."¹²⁷ However, Black's does not have a definition for "intangible."¹²⁸ In its place, the majority uses the definition for "intangibles" which is an accounting term referring to "[p]roperty that is a 'right' such as a patent, copyright, trademark, etc.,

117. *Id.* at 590.

118. *Id.*

119. *Id.* at 591 (citing BLACK'S LAW DICTIONARY 1456 (6th ed. 1990)).

120. *Id.* (citing BLACK'S at 809).

121. *Id.*

122. *Id.* at 593 (citing TEX. BUS. & COM. CODE ANN. § 9.106 (Tex. UCC) (Vernon 1991)).

123. *Id.*

124. *Id.*

125. *Id.* at 594-95 (Draughn, J., dissenting).

126. *Id.*

127. BLACK'S LAW DICTIONARY 1456 (6th ed. 1990).

128. *See id.* at 808-09.

. . . .¹²⁹ Under this definition, the court has little trouble including the proceeds from a covenant not to compete.

These definitions were not appropriate, however, considering that the majority held that the description contained in the security agreement, clearly referring to *tangible property*, did not describe or identify the collateral which was at issue here - namely *intangible property*.¹³⁰ The definitions were inappropriate because Black's defines the terms "tangible property" and "intangible property." The definition for "tangible property" is quite similar to the definition for "tangible."¹³¹ In contrast, the definition of "intangible property" is: "As used chiefly in the law of taxation, this term means such property as has no intrinsic and marketable value, but is merely the representative or evidence of value, such as certificates of stock, promissory notes, copyrights, and franchisees."¹³² This definition clearly includes the items specifically mentioned in the security agreement of "accounts, chattel paper, notes receivable, accounts receivable, . . ."¹³³ because none of these scraps of paper have any intrinsic value. Therefore, since these items are "merely representative evidence of value," as defined by Black's, the security interest clearly envisioned including intangible property. Furthermore, this conclusion avoids the majority's tortured analysis concerning whether the proceeds of a covenant not to compete are an "account," whereby they conclude that the proceeds are not an account because, among other things, a covenant not to compete does not confer any value on the purchaser.¹³⁴ The court's conclusion probably comes as a surprise to many business people who apparently have squandered their companies' revenues by purchasing such "valueless" covenants.

Assuming that this case will remain good law, one solution to avoid this problem would be to modify the language of the interest to make absolutely clear that intangible property is included. For example: "property of every kind and nature, wherever located, *and notwithstanding the foregoing, all intangible property*, now or hereafter belonging to Mortgagor." Possibly, such linguistic overkill will not be needed because writ has been requested in this case and perhaps the Texas Supreme Court will revisit the issue.

c. Dragnet Clauses

In *FDIC v. Bodin Concrete Co.*¹³⁵ the court considered the limits of a "dragnet clause" in a deed of trust. In *Bodin*, Randy Ross executed to First Bank of Rowlett a \$200,000 promissory note secured by a deed of trust on a tract of land. The deed of trust provided that it secured, in addition to the \$200,000 note, the payment of all other "debts, notes, obligations and liabili-

129. *Id.* at 809.

130. *Orix*, 858 S.W.2d at 591 (emphasis added).

131. *See* BLACK'S at 1456.

132. *Id.* at 809.

133. *Orix*, 858 S.W.2d at 588.

134. *Id.* at 593.

135. No. 87-291, 1993 WL 533832 (Tex. App.—Dallas August 19, 1993, writ requested).

ties . . . which may hereafter . . . be owing"¹³⁶ by Ross to the bank. Later, the bank filed suit against Ross to collect several notes Ross executed *prior* to the execution of the \$200,000 note. As a result, Ross and the bank entered into a settlement agreement which mutually released the parties from any cause of action, and a merger provision which provided that the agreement superseded all prior written and oral agreements concerning the subject matter of the settlement. No mention was made in the settlement agreement of the \$200,000 note or the deed of trust.

Ross then purchased building materials from certain suppliers but was unable to pay. The suppliers filed separate statutory mechanic's lien affidavits on the tract of land secured by the bank's deed of trust. Ross subsequently defaulted on payments under the settlement agreement, and the bank foreclosed on the tract of land, purchased it, and applied the proceeds as a credit against the amounts owing under the settlement agreement. The suppliers then brought a declaratory judgment action against the bank seeking a judicial declaration that the bank's sale was void on various grounds. The trial court granted summary judgment for the bank.¹³⁷ On appeal, the FDIC (as receiver) was substituted for the bank. The appellate court held that the suppliers had constitutional, but not statutory, mechanic's liens and remanded the case to the trial court.¹³⁸ At trial, the court found, among other things, that the suppliers held superior liens.¹³⁹ The appellate court reversed and remanded.

The FDIC argued that the bank's dragnet clause included all the prior notes and not just any new funds advanced in the future or under the promissory note. Relying on *Estes v. Republic National Bank*,¹⁴⁰ the court found that the language "debts . . . which may hereafter . . . be owing"¹⁴¹ referred only to Ross' future debt. In *Estes*, the court found, without explanation, that the dragnet clause included past and future debts.¹⁴² The *Bodin* court reasoned that in *Estes* the dragnet clause contained a statement concerning "all other indebtedness . . . owing," which the *Bodin* court determined referred to past debt, and another statement concerning "all other indebtedness . . . which may hereafter become owing,"¹⁴³ which the *Bodin* court determined referred to future debt. Here, the court reasoned, the dragnet clause only contained language similar to the latter statement so that the bank's dragnet clause encompassed only future debt.¹⁴⁴ Therefore, the bank had no right to foreclose on the property once Ross defaulted on the settlement agreement.¹⁴⁵

The court did find, however, that the bank's right of foreclosure under the

136. *Id.* at *1.

137. *Id.* at *2.

138. *Id.*

139. *Id.* at *3.

140. 462 S.W.2d 273 (Tex. 1970).

141. *Bodin Concrete Co.*, 1993 WL 533832 at *4.

142. 462 S.W.2d at 276.

143. *Bodin Concrete Co.*, 1993 WL 533832 at *4.

144. *Id.* at *5.

145. *Id.* at *6.

deed of trust concerning the \$200,000 note was not cut off by the terms of the settlement agreement. The court found that the release provision of the security agreement referred only to "causes of action," and that a right to a nonjudicial foreclosure was not a cause of action and was therefore excluded from the release provision.¹⁴⁶ Furthermore, the merger provision was inapplicable "[b]ecause we have already determined the deed of trust did not secure payment of this pre-existing indebtedness, [therefore] the deed of trust did not relate to the subject matter of the settlement agreement."¹⁴⁷ The court therefore reversed the district court's determination that the settlement agreement had extinguished the bank's right of foreclosure under the deed of trust.

The court also reversed the district court's determination that the constitutional mechanic's liens were superior to the deed of trust.¹⁴⁸ The court found that a constitutional mechanic's lien is superior to a prior recorded deed of trust only "if the materials supplied can be removed without material injury to the land, pre-existing improvements, or the improvements and materials themselves."¹⁴⁹ Here, there was no evidence concerning material injury, so the court remanded the question to the trial court for further inquiry.¹⁵⁰

3. Commercial Reasonableness

Last Survey period, we reported a case requiring the debtor to affirmatively plead commercial reasonableness.¹⁵¹ Another case coming to this same conclusion is *McDonald v. Foster Mortgage Corp.*,¹⁵² where the debtor sought to overturn a summary judgment in favor of the Resolution Trust Corporation (RTC) by claiming its foreclosure and sale of the debtor's mortgaged residence had not been commercially reasonable. The appellate court upheld the summary judgment because the debtor had answered with a general denial and had failed to affirmatively plead commercial reasonableness. The court held that "[c]ommercial reasonableness is a defense which must be pled by the debtor, not an element of the lender's cause of action."¹⁵³ Therefore, the lender had no obligation to offer proof rebutting such a defense until after it was affirmatively asserted by the debtor.¹⁵⁴

4. Deposit Accounts

During the last Survey period, we reported on *FDIC v. Golden Imports*,

146. *Id.*

147. *Id.* at *7.

148. *Id.* at *10.

149. *Id.* (citing Justice Mortgage Investors v. C.B. Thompson Constr. Co., 533 S.W.2d 939, 944 (Tex. Civ. App.—Amarillo 1976, writ ref'd n.r.e.)).

150. *Id.* at *11.

151. See *Greathouse v. Charter Nat'l Bank-Southwest*, 851 S.W.2d 173 (Tex. 1992).

152. 834 S.W.2d 573 (Tex. App.—Houston [14th Dist.] 1992, writ denied).

153. *Id.* at 576 (citing *Smith v. FDIC*, 800 S.W.2d 648, 650 (Tex. App.—Houston [14th Dist.] 1987, writ denied)).

154. *Id.*

Inc.,¹⁵⁵ in which the court determined that a bank's right to setoff the funds on deposit in an account where the bank is acting as a secured creditor holding a security interest in the account does not exempt it from the common law equitable set-off rule.¹⁵⁶ Under this rule, the bank is charged with the duty to inquire into the ownership of the account and, if necessary, pay the funds over to the equitable owner—unless the bank had changed its position to its detriment.¹⁵⁷ The bank seized the funds from the deposit account but did not make any further inquiry when it discovered that the funds were being held for another party. Also, the bank did not change its position to its detriment, so it was liable for conversion.¹⁵⁸ Furthermore, it was liable for punitive damages because malice could be inferred from a knowing conversion.¹⁵⁹ This opinion has been subsequently withdrawn and replaced by *FDIC v. Golden Imports, Inc.*¹⁶⁰

In this new opinion, the court did not change its holding that the bank was subject to the equitable set-off rule or that it was liable for conversion for failing to abide by the rule.¹⁶¹ Also, the court still found that malice and gross negligence necessary to support an award of punitive damages may be inferred from knowing conversion; and that evidence existed supporting such an inference in this case.¹⁶² The court, in a departure from the earlier opinion, reversed the award of punitive damages because the bank subsequently went into receivership by the FDIC and since the bank did not post a supersedeas bond before its appeal, any award of punitive damages would have to come from the FDIC which is protected from paying such awards based on the doctrine of sovereign immunity.¹⁶³

5. *Post-Repossession Liability for Ad Valorem Taxes*

The Corpus Christi Court of Appeals determined that a taxing entity may impose ad valorem taxes on a secured party in possession, or with the right of possession, even though the actual legal title is not in that party's name.¹⁶⁴ General Electric Capital Corporation (GECC) financed individual purchases of mobile homes and retained a security interest in them. During the late Eighties, hundreds of purchasers defaulted on the loans and GECC repossessed the mobile homes. The taxing authorities attempted to collect delinquent property taxes on the homes, but GECC argued that it was not the owner of the property based on its duties under the U.C.C. to preserve the

155. No. 01-88-00307-CV, 1991 WL 204175 (Tex. App.—Houston [1st Dist.] Oct. 10, 1991).

156. *Id.* at *3.

157. *Id.*

158. *Id.*

159. *Id.*

160. 859 S.W.2d 635 (Tex. App.—Houston [1st Dist.] 1993, n.w.h.).

161. *Id.* at 641.

162. *Id.* at 644.

163. *Id.* at 647 (citing *Missouri Pac. R.R. v. Ault*, 256 U.S. 554, 563 (1921)).

164. *General Electric Capital Corp. v. City of Corpus Christi*, 850 S.W.2d 596 (Tex. App.—Corpus Christi 1993, writ denied).

property and sell it in a commercially reasonable manner. The taxing authorities then sued GECC for the delinquent taxes.

The *General Electric* court held that GECC was liable for the taxes. The court noted that the Texas Tax Code provides that "property taxes 'are the personal obligation of the person who *owns or acquires* the property on January 1 of the year for which the tax is imposed.'"¹⁶⁵ The court then determined that the term "owner," as used in a statute, does not have a definite meaning but varies under the circumstances.¹⁶⁶ For purposes of assessing property taxes, however, the term "owner" includes an entity which "is the record owner, or is vested with the apparent legal title, *or is in possession thereof . . .*"¹⁶⁷ The court did not disagree with GECC's argument that legal title under the U.C.C. does not pass to the security interest holder but rather "title passes directly from the debtor to the third-party purchaser in a foreclosure sale."¹⁶⁸ The court noted, however, that "[n]either the statute itself, nor the case law require taxation of the legal title holder only."¹⁶⁹ Therefore, the court held that "for purposes of ad valorem taxation, the secured party in possession is the equivalent of the title owner."¹⁷⁰

6. Valuation of Automobile Security Interest

In a Southern District of Texas Chapter 13 bankruptcy proceeding, the court decided to "split the baby" in determining the value of a creditor's security interest in an automobile.¹⁷¹ It rejected both the debtor's and creditor's arguments that the security interest should be valued based on the right to foreclose on the collateral or on the full retail price of the vehicle.¹⁷² Instead, the court held "that the proper value of a vehicle in this context is somewhere between wholesale and retail, to be determined on a case-by-case basis."¹⁷³

7. Real Estate Foreclosures

a. Notice

In the preceding Survey period, we reported a case concerning the calculation of the required 21-day minimum period for giving notice of a foreclosure sale.¹⁷⁴ In *Nelson* the bankruptcy court found that the required 21-day notice period had not been met where a trustee filed the notice after 3:59

165. *Id.* at 599 (quoting TEX. TAX CODE ANN. § 32.07 (Vernon 1992)) (emphasis added by the court).

166. *Id.* (citing *Realty Trust Co. v. Craddock*, 131 Tex. 88, 112 S.W.2d 440, 443 (Tex. 1938)).

167. *Id.* (quoting *Childress County v. State*, 127 Tex. 343, 92 S.W.2d 1011, 1015, (Tex. 1936)) (emphasis added).

168. *Id.*

169. *Id.* (emphasis in original).

170. *Id.*

171. *In re Carlan*, 157 B.R. 324 (Bankr. S.D. Tex. 1993).

172. *Id.* at 325-26.

173. *Id.* at 326.

174. See *First Nat'l Bank Mansfield v. Nelson*, 134 B.R. 838 (Bankr. N.D. Tex. 1991); TEX. PROP. CODE ANN. § 51.002(b) (Vernon 1992).

p.m. on September 15, 1987, but conducted the foreclosure sale prior to 3:59 p.m. on October 6, 1987. Therefore, the full 21-day period (counted in full 24-hour days) had not elapsed. A Texas court, *Parker v. First National Bank*, has now ruled that in calculating the 21-day period, the date of notice is included within the calculation but the date of the sale is excluded.¹⁷⁵ Therefore, the result in *Nelson* is contrary to Texas law as applied in *Parker*, because the court should have included all of September 15.

A curious facet of the *Parker* case is that the notice was sent on July 12, 1988, and the foreclosure sale was conducted on August 2, 1988.¹⁷⁶ If the day of sale is excluded from the calculation, the only way that the minimum-period requirement could have been satisfied (if *Nelson* is correct) would be by mailing the notice at exactly twelve midnight on the new day of July 12—an extremely unlikely occurrence. Unfortunately for the debtor in *Parker*, he apparently never disputed the hour when the notice was sent. This uncertainty, however, appears to have been resolved by the 1993 Texas Legislature which amended the Property Code to state, “The entire calendar day at which the notice is given, is included in computing the 20-day notice period required by this subsection, and the entire calendar day on which notice of sale is given under Subsection (b) is excluded in computing the 20-day notice period.”¹⁷⁷ This enactment enshrines in law the holding of *Parker* and seems to preclude the 24-hour-days argument endorsed by *Nelson*.

b. Irregularities

In *First State Bank v. Keilman*¹⁷⁸ the court denied the Keilmans' claims concerning alleged irregularities that resulted from First State Bank's foreclosure sale on land pledged as security by the Keilmans through a deed-of-trust lien.¹⁷⁹ The sale was conducted after posting a notice on the county courthouse bulletin board which announced the time, place, and terms of the public auction and gave a legal description of the property. Mr. Keilman went to the foreclosure sale at 10:00 a.m. on the specified date with a companion, Carl Bierman. The sale was posted to occur between 10:00 a.m. and 1:00 p.m. at the courthouse; and at approximately 10:30 a.m., Keilman left the courthouse to go to the newspaper office and to check whether the sale had been advertised in the newspaper. Shortly thereafter, the trustee, Marsha Monroe, appeared to begin the sale. Bierman asked Monroe to delay the sale until Keilman returned, but she refused. Subsequently, the bank purchased the property for a price below its fair market value. The bank applied the proceeds of the sale against the balance of the note and sued the Keilmans for the remainder. The Keilmans counterclaimed, alleging unconscionability, material alteration, wrongful foreclosure, conspiracy, and usury. The case went to trial and, based on the jury's findings, the trial court

175. 852 S.W.2d 741, 743 (Tex. App.—Austin 1993, writ requested).

176. *Id.* at 743.

177. TEX. PROP. CODE ANN. § 51.002(d) (Vernon Supp. 1994).

178. 851 S.W.2d 914 (Tex. App.—Austin 1993, writ denied).

179. *Id.* at 918.

rendered judgment in favor of both the Keilmans and the bank. The appellate court reversed and rendered that the Keilmans take nothing and remanded the case to the trial court for further proceedings.¹⁸⁰

The Keilmans contended that the foreclosure sale was wrongful because of four alleged irregularities. They argued that the posted notice did not constitute sufficient advertisement for the sale and that an advertisement should have been placed in the local newspaper. The appellate court noted that the deed of trust merely stated, "after advertising the time, place and terms of the sale . . . the Trustee shall sell the above described property."¹⁸¹ The court noted that this language did not obligate the bank to advertise the sale in any particular manner, and that the Texas Supreme Court's broad definition of "advertise," clearly included the posting of notices in public places.¹⁸² The Keilmans' second alleged irregularity was that the bank failed to sufficiently inform prospective bidders and, therefore, unfairly "chilled the bidding."¹⁸³ The court held that although the notice did not give a street address for the property, did not disclose that the bank was the seller, and did not disclose the bank's address or phone number, the notice was still sufficient under Texas law.¹⁸⁴ The Keilmans also complained that the bulletin board was cluttered and that the notice ended up beneath other papers. The court essentially held that the notice only needed to be actually posted, and what happened to it after the posting was irrelevant.¹⁸⁵ The court also rejected the Keilmans third allegation that the foreclosure sale was wrongful because it took place in their absence. The court noted that the deed of trust did not give a debtor the right to be present at the foreclosure sale, and that under Texas law the trustee has no legal duty to wait.¹⁸⁶ The last purported irregularity concerned an alleged conflict between a disclaimer of U.C.C. warranties contained in the notice and language in the deed of trust stating that the trustee shall make due conveyance to the purchaser with a general warranty binding the grantor. The court pointed out that this general warranty was the general warranty of title to the land and was not a U.C.C. warranty and was therefore not disclaimed in the notice.

In *Gainesville Oil & Gas Co. v. Farm Credit Bank*¹⁸⁷ the court considered alleged irregularities associated with the sale of a tract of land and the attached mineral rights. In *Gainesville* the plaintiffs, George and Barbara Ward, executed a deed of trust for the Farm Credit Bank for certain real property to a trustee to secure payment of a promissory note. Subsequently, they entered into a mineral lease with Gainesville Oil & Gas Co. (Gainesville) wherein they conveyed to Gainesville a leasehold mineral estate, re-

180. *Id.*

181. *Id.* at 922.

182. *Id.*

183. *Id.* at 923.

184. *Id.* (citing *Hutson v. Sadler*, 501 S.W.2d 728, 731-32 (Tex. Civ. App.—Tyler 1973, no writ)).

185. *Id.*

186. *Id.* (citing *Bering v. Republic Bank*, 581 S.W.2d 806, 808 (Tex. Civ. App.—Corpus Christi 1979, writ ref'd n.r.e.)).

187. 847 S.W.2d 655 (Tex. App.—Texarkana 1993, n.w.h.).

servicing for themselves a one-eighth royalty and a one-thirty-second override out of the working interest. Following the Ward's default, the bank held a foreclosure sale and conveyed the land and mineral rights by deed to Allan S. Ward (Ward). The Ward couple and Gainesville then brought suit against Allan Ward, the bank, and others, claiming that Ward's deed was invalid because of irregularities in the foreclosure sale and that Ward was not a good faith purchaser for value. The trial court subsequently granted the defendants' motion for summary judgment but was reversed by the appellate court which remanded for a new trial.¹⁸⁸

The Ward couple argued that some evidence existed that the foreclosure sale was invalid because the land was sold for a grossly inadequate price and that Ward, the purchaser, knew that a mineral lease existed on the land. They argued that under the general rule, a "bona fide purchaser of realty is a purchaser who buys property in good faith for a valuable consideration without knowledge, actual or constructive, of outstanding claims in a third party or parties."¹⁸⁹ The court agreed, but found that the corollary of this rule applied, which stated that "when a lienholder takes a lien in good faith and for a valuable consideration and without notice of outstanding claims or equities, a purchaser at the lien foreclosure sale, regardless of the knowledge or notice the purchaser has, takes good title from the bona fide mortgagee."¹⁹⁰ Here, the bank, as mortgagee, could not have had notice of the mineral lease because it received its lien on the property *before* the mineral lease was executed.¹⁹¹ Therefore, Ward took good title regardless of his knowledge of the mineral lease.¹⁹²

The Ward couple also contended that the district court erred in granting summary judgment because evidence existed that the Bank had assured the Ward couple that the mineral lease would not be included in the foreclosure sale. The appellate court agreed, and found that such assurances "[t]ended to lull the Ward couple into inaction and to diminish competition and stifle buyer interest in the foreclosure sale."¹⁹³ Therefore, this irregularity in the foreclosure sale, if proven, would entitle the Ward couple to damages or invalidation of the sale.¹⁹⁴

188. *Id.* at 664.

189. *Id.* at 657.

190. *Id.* (citing *Moran v. Adler*, 570 S.W.2d 883, 885 (Tex. 1978)).

191. *Id.* at 658.

192. *Id.* In a curious discussion, the court states that a purchaser might not be a good faith purchaser if he receives the property for grossly inadequate consideration because such consideration should put the purchaser on notice that other claims exist against the property. *Id.* at 661. The court did not decide this issue because it found that the plaintiffs failed to present any evidence of the property's fair market value. *Id.* at 663. This conclusion drew a concurrence, which, although otherwise agreeing with the opinion, felt that such evidence had been presented. *Id.* at 664 (Cornelius, J., concurring). This whole discussion would seem to be moot because as the court had just pointed out, under the corollary rule the mortgagee's good faith overrides any knowledge by the purchaser and therefore it would seem to be irrelevant if the grossly inadequate consideration would impute such knowledge to the purchaser.

193. *Id.* at 661.

194. *Id.* at 659 (citing *Charter Nat'l Bank-Houston v. Stevens*, 781 S.W.2d 368, 374 (Tex. App.—Houston [14th Dist.] 1989, writ denied)).

c. Equitable Subrogation and Lien Priorities

In *First National Bank of Kerrville v. O'Dell*¹⁹⁵ the court was presented with a novel fact situation where a fourth lienholder foreclosed on certain real estate without notifying the third lienholder, claiming that its purchase of the first and second lienholder notes allowed it to bypass the third lienholder entirely. In this case, Roland Walters purchased certain acreage from Charlie C. Davis III and others with a promissory note that was secured by a vendor's lien on the acreage. Walters then sold the property to Dr. David Melton O'Dell with a promissory note secured by a second lien on the property. O'Dell sold the acreage to Bandera Ranch Partnership (Bandera) for a nonrecourse promissory note secured by a third lien note. O'Dell expressly reserved the right to receive notice of any foreclosure sale under the first and second liens. Finally, the First National Bank of Kerrville made a \$570,000 loan to Bandera, and this loan was secured by a fourth lien on the acreage. Part of the loan proceeds were used to pay off the outstanding balances secured by the first and second liens. Davis and Walters, as holders of the first and second liens, executed written assignments of their liens to the bank. The \$570,000 loan between Bandera and the bank also provided that the liens securing the Davis and Walters notes were valid liens that had been renewed and extended and still had continued force and effect. O'Dell had no knowledge of this transaction.

Subsequently, Bandera defaulted on the \$570,000 loan, and the bank foreclosed on the property without giving O'Dell any notice of the foreclosure sale. The bank was the successful bidder on the acreage and purchased the property for much less than its fair market value. The next day, the bank notified O'Dell that its foreclosure sale had extinguished the rights O'Dell held in the property. O'Dell conducted his own foreclosure sale, where he was the successful bidder; then he instituted the present action to declare the bank's sale invalid. The trial court granted the bank's motion for summary judgment based on the doctrine of equitable subrogation; the Texas Supreme Court ultimately reversed.

The bank argued that it was able to cut off O'Dell's third lien without notice under the equitable subrogation doctrine because it had "stepped into the shoes" of the first and second lienholders. The court noted that when the bank supposedly extended the first and second liens it did so with parties which were not personally liable on the notes because they had signed a nonrecourse note with O'Dell under which he could only look for repayment to the underlying property based on his lien.¹⁹⁶ Under these circumstances, the court held that when the bank was "paying off" the Walters and Davis notes it was doing so on behalf of Bandera which—by virtue of its nonrecourse loan—was not liable for the notes. The court held that a bank's payment "had to be *for the benefit of the debtor*—i.e., an *obligor* on the debt—at the time of the 'subrogation' transaction. . . ."¹⁹⁷ Here, the bank paid off the

195. 856 S.W.2d 410 (Tex. 1993).

196. *Id.* at 413.

197. *Id.* at 415.

loans, but not for the benefit of anyone obligated under them. Therefore, it was not entitled to the doctrine. Furthermore, the court held that the doctrine was to prevent unjust enrichment of the debtor whose debt was paid; it was not to be used to deprive an unpaid debtor of his rights.¹⁹⁸ Finally, because the bank's actions caused its fourth lien to be improperly placed ahead of O'Dell's third lien, the court determined that it "would not allow such an inequitable result under the guise of 'equitable' subrogation."¹⁹⁹

D. LENDER LIABILITY

1. Usury

Although a claim of usury is still a thing to be feared, the Texas and federal courts seem to have redoubled their efforts during the Survey period to rear in the beast and, if not to domesticate it, at least curtail its more wide-ranging pursuits. In one important area, however, the courts have expanded the scope of the usury claim to include overdraft charges, and this development has potentially wide-ranging ramifications for banking practices.

a. NSF Check Charges

One Texas court has held that insufficient funds (NSF) check charges can support a usury claim.²⁰⁰ In this case, Tony's Tortilla Factory (the Factory) entered into several loans and a revolving line of credit with First Bank. The Factory also had two checking accounts with First Bank—an operating account and a payroll account. Both accounts were significantly overdrawn from April to December 1984. Although the bank voluntarily paid checks written on the overdrawn accounts as overdrafts, it also charged the Factory a \$20 service charge for each insufficient funds check, resulting in the Factory being charged over \$47,000 during this period. Subsequently, the Factory and others filed suit against First Bank alleging, among other things, that the service charges constituted usury. The trial court granted First Bank's motion for a directed verdict concerning this allegation.²⁰¹

The appellate court reversed and remanded, finding that the Factory had presented sufficient evidence to have its usury claim decided by a jury. The court noted that there were three essential elements for a claim of usury: "(1) a loan of money; (2) an absolute obligation that the principal be repaid; and (3) the exaction of a greater compensation than allowed by law for the use of the money by the borrower."²⁰² As to the first element, the court found that "when a bank voluntarily pays a check as an overdraft, it makes a loan to its customer."²⁰³ Therefore, the overdrafts made by First Bank were

198. *Id.*

199. *Id.* at 416.

200. *Tony's Tortilla Factory, Inc. v. First Bank*, 857 S.W.2d 580 (Tex. App.—Houston [1st Dist.] 1993, writ granted).

201. *Id.* at 584.

202. *Id.*

203. *Id.* (citing *Bryan v. Citizens Nat'l Bank*, 628 S.W.2d 761, 763 n.2 (Tex. 1982)). In a

loans.²⁰⁴ Under the second element, the court found that there was evidence that the Factory was expected to repay these loans.²⁰⁵ The court then determined under the third element that whether the charge was for the use of the lender's money or was separate and distinct from that use was a question of fact for the jury.²⁰⁶ The court pointed out that evidence existed that this charge constituted interest and was not a mere service charge since First Bank's president testified that the charge did not merely cover the cost of reprocessing the checks but that "fee income" was also derived from the NSF charges.²⁰⁷ The court also pointed out that sufficient evidence existed to show that if these charges were interest, they easily exceeded the maximum rate since repayment was expected within a week and the amount of the NSF checks ranged from \$11.44 to \$979.65 with most of the checks being between \$100 and \$400.²⁰⁸

Obviously, this holding, if allowed to stand, will require financial institutions to rethink their policies concerning overdrafts. One solution may be to have the charge reflect the actual processing cost—including applicable overhead. However, the actual cost could still be determined to be interest and, if so, could not exceed the maximum amount allowed by law. Another solution is to abolish overdrafts. Ironically, this latter solution is made more palatable because under the court's reasoning, if a bank charges a \$20 NSF fee but does not honor an overdraft then it is protected from a claim of usury because it has not engaged in a loan transaction.

b. Savings Clauses Trump Hypothetical Events

During the preceding Survey period, the principle was established that a usury savings clause will automatically limit the interest rate in a contract under which a contingency *might* occur resulting in a usurious rate of interest.²⁰⁹ Since then, two cases, one state and one federal, have reaffirmed *Affiliated Capital*.²¹⁰ In *Dorst* the bank sought to recover the remaining balance on two promissory notes executed by the Dorsts, and which were each secured by a deed of trust.²¹¹ Both deeds of trust contained identical "sales clauses" which allowed the bank to escalate the interest rate by not more than two percent each time the property was sold during the term of the note. Each deed of trust also contained a usury savings clause that provided,

separate concurrence, Justice Sam Bass, although agreeing that sufficient evidence existed to support a usury claim, disagreed with the majority's assertion that the Texas Supreme Court in *Bryan* held that an overdraft constitutes a loan as a matter of law. *Tony's*, 857 S.W.2d at 591. Apparently, the Texas Supreme Court's statement was made in dicta. *Bryan*, 628 S.W.2d at 761 n.2.

204. *Id.* at 585.

205. *Id.*

206. *Id.* at 586.

207. *Id.*

208. *Id.* at 587.

209. See *Affiliated Capital Corp. v. Commercial Federal Bank*, 834 S.W.2d 521 (Tex. App.—Austin 1992, no writ).

210. See *First State Bank v. Dorst*, 843 S.W.2d 790 (Tex. App.—Austin 1992, writ denied); *Bernie's Custom Coach v. Small Business Admin.*, 987 F.2d 1195 (5th Cir. 1993).

211. 843 S.W.2d at 791.

in pertinent part, “[n]othing herein or in said note contained shall ever entitle Beneficiary, upon the arising of any contingency whatsoever, to receive or collect interest in excess of the highest rate allowed by the applicable laws”²¹²

The Dorsts successfully argued to the trial court that the sales clauses were usurious because they could allow the bank to charge a prohibited rate of interest if the properties were sold multiple times and if the bank increased the rate of interest by two percent each time. Furthermore, the savings clauses could not reform the sales clauses because such clauses cannot rescue contracts that are explicitly usurious, and here the deed of trust, on its face, allowed a contingency that would result in a usurious interest rate. Of course, if this argument were allowed to stand, then usury savings clauses would be obsolete because it is always the case that if a loan instrument allows for a potentially usurious contingency, the contingency must necessarily be explicit.²¹³

The appellate court reversed the trial court. It agreed that “the mere presence of a savings clause in a contract will not rescue a contract that is usurious by its explicit terms.”²¹⁴ However, this is only true if the savings clause “is directly contrary to the explicit terms of the contract.”²¹⁵ The court explained this distinction:

As a simple example, a creditor may not specifically contract for a thirty percent interest rate and then avoid the imposition of usury penalties by relying on a savings clause that declares an intention not to collect usurious interest. In contrast, under the facts of the present case, the savings clause is *not* directly contrary to the explicit terms of the sales clause; rather, the savings clause supplements and explains the intent of the parties in contracting for the sales clause by limiting its application to nonusurious charges of interest.²¹⁶

In other words, “a savings clause may cure an open-ended contingency provision the operation of which *may or may not* result in a charge of usurious interest.”²¹⁷

Applying these principles to the case at hand, the court concluded that “[the] occurrence of the contingency (sale of the property) would not *necessarily* have resulted in a usurious rate.”²¹⁸ Therefore, since usury was not a necessary result of the contingency, the sales clause could be considered in light of the savings clause—and be subsequently limited or “capped” by that clause.²¹⁹ Apparently, the court’s analysis requires the implicit holding that a contingency which depends on an open-ended contract provision may only

212. *Id.* at 792 (emphasis added by the court).

213. If the language was not explicit, but rather was ambiguous, then the contract must be interpreted and the ambiguity resolved as to avoid a finding of usury. See *Bernie’s Custom Coach*, 987 F.2d at 1199.

214. *Dorst*, 843 S.W.2d at 793.

215. *Id.*

216. *Id.*

217. *Id.* (citing *Smart v. Tower Land & Inv. Co.*, 597 S.W.2d 333, 340-41 (Tex. 1980)).

218. *Id.* at 794.

219. *Id.*

be considered to the extent that the provision is triggered on a single occasion.²²⁰

The *Bernie's*²²¹ court approached this issue from a different angle but still arrived at the same result. There, Bernie's Custom Coach executed a promissory note in favor of Gulf American SBL, Inc., which was predominantly guaranteed by the Small Business Administration (SBA). The note contained an acceleration clause which mandated that Bernie's indebtedness would become due and payable upon Bernie's failure to timely pay. The note also contained a usury savings clause. Bernie defaulted on the note, which Gulf subsequently assigned to the SBA; the SBA then promptly accelerated the maturity date of the note and demanded payment. Thereafter, Bernie, Gulf, and the SBA wound up in federal district court where the court granted Gulf's summary judgment motion that the note was nonusurious and legal. The Fifth Circuit affirmed.²²²

Bernie argued that although no usurious interest had been imposed, it could have been imposed based on the acceleration clause. Bernie contended that the accelerated indebtedness could include all unearned interest which would result in an interest rate of 88.30%, well above the maximum legal rate.²²³ Furthermore, Bernie pointed out that the savings clause could be reasonably interpreted to modify the contract only insofar as it concerned the monthly interest rate and did not apply to any unearned interest that became due as a result of the acceleration clause.²²⁴

The Fifth Circuit agreed that the hypothetical event could occur under the explicit terms of the contract and that the savings clause could be read so as to be inapplicable to the acceleration clause.²²⁵ However, under the court's analysis, the touchstone was the "intent of the parties embodied in the contract."²²⁶ Under this rubric, a presumption exists that the parties intended a nonusurious contract and therefore a court "*must, if reasonably possible, give effect to the savings clause.*"²²⁷ Therefore, "[t]he savings clause in the promissory note at issue defeats any construction finding the note to be usurious."²²⁸ Here, since the savings clause could be reasonably interpreted to be either applicable or inapplicable to the acceleration clause, the

220. If this is not the case, then the court's analysis seems to be dangerously susceptible to semantic gaming. Here, the contingency did not "necessarily" result in usury because it was defined as only one sale under the sales clause. However, the Dorsts' argument was that the contingency should be defined as multiple sales with concomitant increases in the interest rate. *Id.* at 792. Under their definition of the contingency, it would "necessarily" result in a usurious rate. Therefore, the court's whole analysis turns on its definition of the contingency—which could be easily manipulated by a future court seeking to arrive at the opposite conclusion.

221. 987 F.2d 1195 (5th Cir. 1993).

222. *Id.* at 1199.

223. See TEX. REV. CIV. STAT. ANN. art. 5069-1.07 (Vernon 1987).

224. 987 F.2d at 1198-99.

225. *Id.* at 1199.

226. *Id.* at 1198 (quoting *Imperial Corp. of America v. Frenchman's Creek Corp.*, 453 F.2d 1338, 1344 (5th Cir. 1972)).

227. *Id.* (quoting *FDIC v. Claycomb*, 945 F.2d 853, 860 (5th Cir. 1991), *cert. denied*, 112 S. Ct. 2301 (1992) (emphasis added by the court)).

228. *Id.*

court found that the savings clause applied to the acceleration clause in order to give effect to the parties' intent not to enter into a usurious contract.²²⁹

This analysis differs from the *Dorst* court's analysis in a crucial aspect. Whereas the *Dorst* court analyzed the effect of the contingency, the *Bernie* court analyzed the effect of the savings clause. Both cases concerned potentially usurious contingencies that were facially permissible in their respective contracts. However, the *Dorst* court looked to whether the triggering of the contingency "may or may not" result in usurious interest, and only if it "may not" result in usury would the court then apply the contract's usury savings clause. Under this test, the contract at issue in *Bernie* would be usurious because the triggering of the contingency—accelerating the unearned interest—would definitely result in usury. Therefore, under the *Dorst* court's analysis, it would seem that a savings clause that explicitly included a contingency would not operate to eliminate that contingency if usurious interest would necessarily result from the triggering of that contingency. Under the *Bernie* court's analysis, however, contingencies that would definitely trigger usurious interest would be eliminated by the operation of the contract's savings clause if a reasonable interpretation of that clause would include such contingencies. Obviously, this analysis gives much broader effect to savings clauses and practically eliminates a usury argument based on hypothetical events for contracts that contain usury savings clauses.

c. "No Prepayment" Clauses and Homestead Loans

The usury statute, although specifying usurious rates of interest, does not specify how such interest rates should be calculated.²³⁰ Such calculations can be crucial because under article 5069-1.07(f) prepayment charges and penalties on a residential homestead loan are disallowed if the rate of interest on the loan exceeds a prescribed rate.²³¹ One court has held that in calculating the rate of interest on a residential homestead loan the interest rates for purposes of article 5069-1.07(f) "should be determined by spreading the interest over the entire term of the loan."²³² In so holding, the court rejected the debtor's argument that article 5069-1.07(f) becomes operative if the interest rate exceeds the maximum rate at any time during the loan.²³³

In this declaratory action, the trial court prohibited the holders of the real estate lien note from enforcing the lien's "no prepayment" clause. The note provided for 240 monthly payments and an annual interest rate of 9.50% for the first year, 10.00% for the second year, 11.00% for the third year, 12.00% for the fourth year, and 12.50% thereafter. It was undisputed that the lawful rate for loans for property to be used as a residential homestead

229. *Id.* at 1199.

230. See TEX. REV. CIV. STAT. ANN. art. 5069-1.07(d) (Vernon 1987).

231. *Id.* at art. 5069-1.07(f).

232. *Groseclose v. Rum*, 860 S.W.2d 554, 558 (Tex. App.—Dallas 1993, n.w.h.).

233. *Id.*

was 12.00%.²³⁴ The debtor brought suit during a year that the interest rate owed was 12.50%.

The trial court found that since this rate exceeded the rate in article 5069-1.07(d), the "no prepayment" clause could not be enforced under article 5069-1.07(f). This article provides:

If a loan for property that is to be the residential homestead of the borrower is made at a rate of interest that is greater than the rate prescribed by Subsection (d) of this Article, a prepayment charge or penalty may not be collected on the loan unless the charge or penalty is required by an agency created by federal law.²³⁵

The appellate court noted that this section refers to prepayment *charges* and does not specifically include clauses which simply prohibit prepayment.²³⁶

The holders of the note argued that subsection (f) does not include such clauses because under Texas law, unless the loan agreement provides otherwise, a borrower does not have the right to prepay a loan.²³⁷ Therefore, the "no prepayment" clause did not deprive the borrower of any rights he would otherwise have had. The appellate court disagreed and concluded that the legislative intent of subsection (f) "is to protect homeowners by allowing them to prepay loans when they finance homes at high rates of interest. This intent would be frustrated if 'no prepayment' clauses were enforced."²³⁸ Therefore, article 5069-1.07(f) includes "no prepayment" clauses even though such clauses do not impose a specific charge or penalty.

By classifying the "no prepayment" clause as being subject to article 5069-1.07(f), the court then had to decide how to determine the loan's interest rate. The debtor argued that because subsection (f) involved homesteads, its terms should be liberally construed so that if a loan exceeds the usurious rate at any time during its existence, the loan's "no prepayment" clause becomes inoperative. The appellate court declined to accept this argument because of the utter lack of authority for this position.²³⁹ Furthermore, concerning other types of contracts, usury is tested "by spreading the interest over the entire term of the contract."²⁴⁰ Therefore, the appellate court adopted this test for loans concerning homesteads, and remanded the case to the district court to calculate the interest rate based on this method.

d. Usury Is Not a Defense to Guarantor Liability

In recent years, both Texas courts and the Fifth Circuit (while interpreting Texas law) have held that a guarantor cannot raise usury as a defense to

234. *Id.* at 556 n.2; *see also* TEX. REV. CIV. STAT. ANN. art. 5069-1.07(d) (Vernon 1987).

235. TEX. REV. CIV. STAT. ANN. art. 5069-1.07(f) (Vernon 1987).

236. 860 S.W.2d at 557. The *Groseclose* court cited a Consumer Credit Commissioner opinion urging that "no prepayment" provisions in residential homestead loans be construed as prepayment charges for the purposes of article 5069-1.07(f). *Id.* (citing Op. Tex. Consumer Credit Comm'r No. 83-1 (1983)).

237. *Id.* (citing *Parker Plaza W. Partners v. Unum Pension & Ins. Co.*, 941 F.2d 349, 352 (5th Cir. 1991)).

238. *Id.*

239. *Id.* at 558.

240. *Id.* at 557 (citing *Tanner Dev. Co. v. Ferguson*, 561 S.W.2d 777, 786 (Tex. 1977)).

liability on a guaranty, so long as the guaranty itself is not a usurious transaction.²⁴¹ This principle has been reaffirmed in *Moore v. Liddell, Sapp, Zivley, Hill & LaBoon*.²⁴² In *Moore* the guarantor was granted a bank loan based on the condition that he guaranteed another's nonusurious debt. Eventually all the parties defaulted on their debt; and the guarantor was sued for collection of his debt and the debt he guaranteed. The guarantor claimed that the requirement that he guarantee another's debt was usurious based on *Alamo Lumber Co. v. Gold*.²⁴³ In *Alamo Lumber* the Texas Supreme Court ruled that if payment or assumption of another's existing debt is a condition for the extension of credit, the amount of the debt paid or assumed would be deemed additional interest for usury calculations.²⁴⁴ The *Moore* court distinguished *Alamo Lumber* and limited it to situations where a person, as a requirement for securing a loan, must *pay* another's debt—not just guarantee it.²⁴⁵ The court did not extend *Alamo Lumber* to guarantors because a guaranty is a secondary obligation and, as such, is of the nature of a contingent liability.²⁴⁶ Therefore, “[i]nclusion of a contingent liability as interest on the guarantor's separate obligation would go against the parties' expectations and greatly increase uncertainty in lending transactions.”²⁴⁷

Although the court's conclusion that a guaranty cannot serve as the basis for a charge of usury precluded a review of any of the instrument's savings clauses, this court's reasoning does have some implications concerning *Bernie's Custom Coach and Dorst*.²⁴⁸ The *Moore* court's holding, based on the parties' intentions, is fully in line with the Fifth Circuit decision *Bernie's Custom Coach*. However, there is a tension with this case and the reasoning of the previously discussed *Dorst* decision. Under *Dorst*, one would look to see if the triggered contingency would necessarily lead to usurious interest. Here the contingency—default by the primary obligor—would require the guarantor to pay all of the primary obligor's debt, which, under *Alamo Lumber*, would seem to be usurious.

e. Other “Charging” Cases

In the prior Survey period, we reviewed *McPherson Enterprises, Inc. v. Producers Cooperative Marketing Association, Inc.*,²⁴⁹ in which the Austin Court of Appeals held that in a good faith disagreement regarding the amount owed, the lender does not violate the usury statute by demanding interest on a higher principal amount, even if the actual principal amount is

241. See *First South Savings Ass'n v. First Southern Partners, II, Ltd.*, 957 F.2d 174 (5th Cir. 1992); *Bank of El Paso v. T.O. Stanley Boot Co.*, 809 S.W.2d 279, 290 (Tex. App.—El Paso 1991), *aff'd in part, rev'd in part on other grounds*, 847 S.W.2d 218 (Tex. 1992).

242. 850 S.W.2d 291 (Tex. App.—Austin 1993, writ denied).

243. 661 S.W.2d 926 (Tex. 1983).

244. *Id.* at 928.

245. *Moore*, 850 S.W.2d at 293.

246. *Id.* at 294.

247. *Id.*

248. See *supra* notes 210-29 and accompanying text.

249. 827 S.W.2d 94 (Tex. App.—Austin 1992, writ denied).

less.²⁵⁰ In this Survey period, the Austin Court of Appeals reaffirmed this holding in *Kentor v. Karotkin*.²⁵¹ Here, Michael Kentor signed a promissory note as part of a divorce settlement with his wife, Alden Karotkin (Karotkin). Kentor defaulted on the note and Karotkin hired two different attorneys, on different occasions, to seek collection of the note. Both attorneys sent Kentor collection letters which inadvertently overstated the principal amount due on the note. Kentor claimed that this overstatement resulted in a usurious charge. Relying on *McPherson*, the appellate court rejected Kentor's argument, holding that since the overstated principal amount was due to an inadvertent error, "the overcharge caused by the failure to properly credit principal does not constitute a demand for usurious interest."²⁵²

In *First State Bank v. Keilman*²⁵³ previously discussed, one of the Keilmans' usury claims was that the attorney for the Bank sent them a demand letter notifying them that the amount past due was \$12,699.92 plus interest. The Keilmans presented evidence at trial that they had an oral agreement with a loan officer that they only had to make interest-only payments and that the interest in arrears when the letter was sent was \$5,508.48. Therefore, the Bank charged the Keilmans \$7,161.44 in excess interest and that the charging of such interest constituted usury. The Bank's loan officer testified that the oral agreement allowed the Keilmans to make interest-only payments provided that those payments were timely—which was not the case—so that no excess interest was charged. The jury determined that \$360 of unauthorized interest was charged. The court ruled that there existed no rational basis for the finding and therefore the finding had to be disregarded because there was no evidence to support it.²⁵⁴

The Keilmans also contended that usury arose from the Bank's subsequent foreclosure sale wherein the Bank purchased the Keilmans' property for less than fair market value, and after applying the proceeds to the outstanding balance of their debt, sought collection of the remainder. They argued that the market value of the property received and the value of the deficiency claim pursued "constituted a charge of excessive compensation for the loan of money."²⁵⁵ The court found that no usury arose under the controlling law at the time of the transaction.²⁵⁶ However, under current law, "if a court determines that the fair market value of the foreclosed property is greater than the foreclosure sale price, the deficiency is reduced by the difference between the fair market value and the bid price, regardless of whether the foreclosure sale was regularly or irregularly conducted."²⁵⁷

250. *Id.* at 96.

251. 852 S.W.2d 261 (Tex. App.—Austin 1993, writ denied).

252. *Id.* at 267.

253. 851 S.W.2d 914 (Tex. App.—Austin 1993, writ denied).

254. *Id.* at 931.

255. *Id.* at 932.

256. *Id.*

257. *Id.* at 932 n.6 (citing TEX. PROP. CODE ANN. § 51.003 (Vernon Supp. 1992)).

2. Duty of Good Faith and Fair Dealing

Once again, Texas courts have declined the invitation proffered by borrowers to hold their lenders accountable under a standard of good faith and fair dealing. As recently affirmed by one case, "there is no duty of good faith and fair dealing arising out of the lender/borrower or mortgagor/mortgagee relationship."²⁵⁸ However, this has not stopped debtors from attempting to paint their relationship as having special attributes deserving of the duty of good faith and fair dealing.

In *Central Savings & Loan Association v. Stemmons Northwest Bank, N.A.*²⁵⁹ Central Savings & Loan Association (Central) and TriTexas Mortgage Corporation (TriTexas) entered into a mortgage servicing agreement in which TriTexas agreed to collect the debt service payments on certain of Central's mortgage loans and to provide administrative support to Central. A dispute subsequently arose over the availability of private mortgage insurance for some of the loans. In a settlement agreement, TriTexas agreed to act as the mortgage insurer for those loans, and secured its obligation by delivering to Central, as beneficiary, a letter of credit issued by Stemmons Northwest Bank, N.A. (Stemmons). Unknown to Central, Harold Peek (Peek), an officer, director, and employee of TriTexas, entered into a letter of credit indemnification agreement with Stemmons providing that he would be responsible for all expenses and claims arising from the letter if Stemmons followed his instructions regarding the letter. Stemmons, as issuer of the letter of credit, later told Central that it would not renew the letter. Central then demanded that TriTexas comply with its obligations under the settlement agreement, which it declined to do. Subsequently, Central presented the letter of credit to Stemmons, but Stemmons refused to honor it. Central then filed suit, claiming *inter alia* that Stemmons had breached its common law duty of good faith and fair dealing by dishonoring the letter of credit, and by conspiring with Peek to interfere with the letter of credit. The trial court granted summary judgment to all defendants on all issues, and the appellate court affirmed.²⁶⁰

The appellate court first rejected Central's claim that, under the common law, the letter of credit somehow created a special relationship between Central and Stemmons.²⁶¹ Central maintained that this special relationship ex-

258. *McDonald v. Foster Mortgage Corp.*, 834 S.W.2d 573, 576 (Tex. App.—Houston [14th Dist.] 1992, writ denied) (citing *FDIC v. Coleman*, 795 S.W.2d 706, 708-09 (Tex. 1990)).

259. 848 S.W.2d 232 (Tex. App.—Dallas 1992, no writ).

260. *Id.* at 236.

261. *Id.* at 240. Such a finding of a "special relationship" is crucial under the common law because a common law duty of good faith and fair dealing cannot otherwise be sustained since, under Texas law, no general duty exists. *See English v. Fischer*, 660 S.W.2d 521, 522 (Tex. 1983). Although not alleged by Central, a *statutory* duty of good faith and fair dealing exists under the Uniform Commercial Code as part of every commercial contract. *See TEX. BUS. & COM. CODE ANN.* § 1.203 (Tex. U.C.C.) (Vernon 1968). However, a breach of this duty does not create an independent cause of action but rather gives rise to a cause of action for breach of contract. *Adolph Coors Co. v. Rodriguez*, 780 S.W.2d 477, 481 (Tex. App.—Corpus Christi 1989, writ denied). Such a cause does not afford access to punitive damages and hence blunts its attractiveness to plaintiffs and their attorneys.

isted due to "the relationship of Central as beneficiary and Stemmons as the issuer of the letter of credit."²⁶² The court determined that a special relationship exists only if one of two criteria is met: (1) there is an element of trust necessary to accomplish the goals of the undertaking; or (2) there exists an imbalance of bargaining power.²⁶³ Here, the court found that no special relationship existed:

Because one business entity trusts another and relies on their contractual promise to perform the contract does not cause a special relationship. Neither does the position of the parties to a letter of credit cause an imbalance of bargaining power. We conclude that the relationship of Central as beneficiary and Stemmons as issuer in the letter of credit is an ordinary commercial contractual relationship and does not constitute the 'special relationship' necessary to give rise to a common law duty of good faith and fair dealing.²⁶⁴

As discussed below, the court also denied Central's claims for fraud, conspiracy, and tortious interference. The court's refusal to further extend tort principles into traditional contract law areas, even in a case with fairly egregious facts, seems to confirm the trend of Texas courts to resist efforts to convert simple breach of contract claims into torts with the attendant possibility of punitive damages.

3. *Deceptive Trade Practices Act*

Under section 17.50 of the Texas Deceptive Trade Practices Act (DTPA), a "consumer" is one who seeks to acquire goods or services.²⁶⁵ The issue has long been settled that one who seeks to borrow money, and nothing more, does not fall within the definition of a consumer.²⁶⁶ However, plaintiffs still try to shoehorn themselves into consumer status by attempting to link the loan proceeds to some good or service.

In *First State Bank v. McMordie*²⁶⁷ the plaintiff argued that he was a consumer even though he had been turned down for a loan because if he had received the loan he would have used the proceeds to acquire certain goods — specifically, cattle. Although he was awarded damages by the trial court, that court's decision was overturned on appeal. The appellate court agreed that a person might be a consumer under the DTPA where he receives the loan proceeds and then he uses the loan to purchase a "good or service."²⁶⁸ However, McMordie failed to present any evidence that he had "sought or acquired, by purchase or lease, cattle which form the basis of his complaint."²⁶⁹

262. *Id.* at 239.

263. *Id.* at 239-40.

264. *Id.* at 240.

265. TEX. BUS. & COM. CODE ANN. § 17.45(4) (Vernon 1987).

266. See *Riverside Nat'l Bank v. Lewis*, 603 S.W.2d 169 (Tex.), *on remand*, 605 S.W.2d 954 (Tex. Civ. App.—Houston [1st Dist.] 1980, no writ).

267. 861 S.W.2d 284 (Tex. App.—Amarillo 1993, no writ).

268. *Id.* at 286 (citing *Knight v. Int'l Harvester Credit Corp.*, 627 S.W.2d 382 (Tex. 1982); *Flenniken v. Longview Bank & Trust Co.*, 661 S.W.2d 705 (Tex. 1983)).

269. *Id.*

In *First State Bank v. Keilman*,²⁷⁰ previously discussed, one of the Keilmans' claims was that the Bank engaged in unconscionable conduct as defined under the DTPA by selling the Keilmans' property for a grossly inadequate price and that this conduct resulted in a wrongful foreclosure sale. The court noted that the DTPA has two different definitions of "unconscionable action or course of action," which require that the act: "(A) takes advantage of the lack of knowledge, ability, experience, or capacity of a person to a grossly unfair degree; or (B) results in a gross disparity between the value received and consideration paid, in a transaction involving the transfer of consideration."²⁷¹ The court found that the Keilmans' allegation implicated part (B) of the definition but that "a general finding of unconscionability under the DTPA does not necessarily prove that the foreclosure sale was wrongful."²⁷² This is because "[i]nadequacy of consideration alone does not render a foreclosure sale void if the sale was legally and fairly made."²⁷³ Since the court had already found that the sale was otherwise lawful, it rejected the Keilmans' claim because even if the property was sold for grossly inadequate consideration, that in and of itself would not render the foreclosure sale wrongful.²⁷⁴

The court also found that the Keilmans were not "consumers" under the DTPA.²⁷⁵ The Keilmans argued that they were consumers because they purchased foreclosure services to be performed by the trustee named in the deed of trust which was used to secure their loan from the Bank. They based this contention on the standard form language of the deed of trust which stated: "[O]ut of the money arising from such [foreclosure] sale, the Trustee acting shall pay . . . a commission of five percent (5%) to himself."²⁷⁶ The court found that the Keilmans' purpose in obtaining the loan was to secure an extension of credit; and that the property securing the loan was already owned by the Keilmans and simply provided additional collateral for the loan.²⁷⁷ Therefore, "an extension of credit alone does not confer consumer status under the DTPA."²⁷⁸ The court also held that the commission payable to the trustee did not constitute the purchase of a "service," because "the key principle in determining consumer status is that the goods or services purchased must be an *objective* of the transaction, not merely incidental to it."²⁷⁹

In one case, the debtor was classified as a consumer because the proceeds had been used to purchase goods.²⁸⁰ Once this fact was shown, the definition of "consumer" blossomed to include collateral services associated with

270. 851 S.W.2d 914 (Tex. App.—Austin 1993, writ denied).

271. *Id.* at 927-28 (quoting TEX. BUS. & COM. CODE ANN. § 17.45(5) (Vernon 1987)).

272. *Id.* at 927.

273. *Id.* (citing Tarrant Sav. Ass'n v. Lucky Homes, Inc., 390 S.W.2d 473 (Tex. 1965)).

274. *Id.* at 928.

275. *Id.*

276. *Id.* (alteration in original).

277. *Id.* at 929.

278. *Id.* at 928 (citing *Riverside Nat'l Bank*, 603 S.W.2d 169).

279. *Id.* at 929 (citing *FDIC v. Munn*, 804 F.2d 860, 863-64 (5th Cir. 1986)).

280. *FDIC v. F & A Equip. Leasing*, 854 S.W.2d 681 (Tex. App.—Dallas 1993, no writ).

the loan.²⁸¹ In *F & A Equipment* the court determined that a debtor is still a "consumer" under the DTPA if the collateral the debtor purchased under the original loan is later transferred to a third party with the assistance of the creditor; and the bank's services in connection with this assistance is the basis for the debtor's claim.²⁸² Here, the debtor signed a promissory note to purchase certain earth moving equipment which served as the collateral for the note.²⁸³ The debtor then transferred the equipment to a third party who signed onto the promissory notes. Subsequently, the equipment disappeared. The debtor sought damages under the DTPA wherein the bank assisted the debtor in transferring the collateral to the third party because the bank had run a credit check on the third party and knew that the party was a bad credit risk. The bank argued that the third party was the consumer and not the debtor. The court found that the bank's continuing relationship with the debtor made its later services "merely collateral to the original loans and . . . additional objectives of the same transaction."²⁸⁴ Therefore, the court concluded that the debtor was a consumer.²⁸⁵

Presumably, the third party is also a consumer because it acquired the collateral with the bank's assistance by signing onto the bank's note. This presents a problem for the bank because under the court's decision it could be held liable under the DTPA by *either* the buyer or the seller in a transaction where collateral is purchased by the seller for resale to the buyer and both sales are financed by the bank. Given the inherently antagonistic nature of the buyer-seller relationship, if either party later feels that it has been denied the benefit of its bargain, it could drag the bank into court claiming that the bank provided services to one party to the detriment of the other. For example, in this case, the debtor is basically claiming that in the bank's rush to finance the transaction, it neglected to tell the debtor of the third party's finance history. But suppose the bank did tell the debtor of the buyer's credit history, and as a result the transaction did not go through and the buyer was harmed. It would seem that the buyer could come back and challenge the validity of the credit report and argue that the bank had harmed it under the DTPA. Such a situation places the bank in the untenable position between the seller's Charybdis and the buyer's Scylla.

4. *Fraud*

Considering the fraud issues raised in *Central Savings & Loan Association v. Stemmons Northwest Bank, N.A.*,²⁸⁶ previously discussed, the court rejected Central's claim that Stemmons acted willfully, fraudulently, and in bad faith by failing to disclose to Central its indemnification agreement with Peek so that it would suffer no liability when it refused to honor Peek's com-

281. *Id.* at 691.

282. *Id.*

283. *FDIC v. F & A Equip. Leasing*, 800 S.W.2d 231, 233 (Tex. App.—Dallas 1990), *rev'd per curiam*, 835 S.W.2d 74 (Tex. 1992).

284. *F & A Equip. Leasing*, 854 S.W.2d at 691.

285. *Id.*

286. 848 S.W.2d 232 (Tex. App.—Dallas 1992, no writ).

pany's letter of credit under which Central was the beneficiary.²⁸⁷ The court noted that although the failure to perform a contract usually sounds in contract and not tort; breach of a contract to perform in the future is actionable fraud if the party entered into the contract with the intention of deceiving and with no intention of performing.²⁸⁸ Mere failure to perform is no evidence of a party's intent.²⁸⁹ Here, the court found that no evidence existed that Stemmons had no intention of performing the contract when it entered into the letter of credit.²⁹⁰

Furthermore, when a party suffers only economic injury to the subject matter of the contract and he cannot prove actual damages attributable to the fraud, then the action sounds in contract, and not in tort.²⁹¹ Again, the court found that Central had presented no evidence of damages beyond the economic injury to the subject matter of the contract.²⁹²

5. *Tortious Interference and Conspiracy*

Another claim rejected in *Central Savings & Loan Associates v. Stemmons Northwest Bank, N.A.*,²⁹³ previously discussed, concerned Peek's and Stemmon's alleged conspiracy to tortiously interfere with Central's letter of credit by entering into the indemnification agreement. The court noted that the "gist of a civil conspiracy is the damage resulting from commission of a wrong that injures another and not the conspiracy itself."²⁹⁴ Therefore, no independent liability exists for a civil conspiracy absent the existence of an actionable wrong that serves as the gravamen of the conspiracy.²⁹⁵ Hence, the court found that in order to establish a conspiracy, Central must first establish a case for tortious interference which allegedly served as the conspiracy's basis.

A case for tortious interference requires a showing of tortious acts committed by a third party.²⁹⁶ Here, Stemmons was a party to the letter of credit. Since one cannot tortiously interfere with one's own contract, Stemmons could not tortiously interfere with the letter of credit since it was a

287. *Id.* at 240.

288. *Id.* (citing *Spoljaric v. Percival Tours, Inc.*, 708 S.W.2d 432, 434 (Tex. 1986)).

289. *Id.* (citing *Crim Truck & Tractor v. Navistar Int'l Transp. Corp.*, 823 S.W.2d 591, 597 (Tex. 1992)).

290. *Id.*

291. *Id.* (citing *Jim Walter Homes, Inc. v. Reed*, 711 S.W.2d 617, 618 (Tex. 1986); *Schindler v. Austwell Farmers Coop.*, 829 S.W.2d 283, 290 (Tex. App.—Corpus Christi 1992), *aff'd as modified per curiam*, 841 S.W.2d 853 (Tex. 1992)).

292. *Id.* at 241.

293. 848 S.W.2d 232 (Tex. App.—Dallas 1992, no writ).

294. *Id.* at 241 (citing *Schlumberger Well Surveying Corp. v. Nortex Oil and Gas Corp.*, 435 S.W.2d 854, 856 (Tex. 1968)). As noted by the court, the elements of a civil conspiracy are: "(1) two or more persons; (2) an object to be accomplished; (3) a meeting of minds on the object or course of action; (4) one or more unlawful, overt acts; and (5) damages as a proximate result." *Id.* (citing *Massey v. Armco Steel Co.*, 652 S.W.2d 932, 934 (Tex. 1983)).

295. *Id.*

296. *Id.* The elements of tortious interference are: "(1) a contract existed that is subject to interference; (2) the act of interference was willful and intentional; (3) such intentional act was a proximate cause of the plaintiff's damages; and (4) actual damage or loss occurred." *Id.*

party to the letter of credit.²⁹⁷

Along similar lines, the court in *First State Bank v. Keilman*,²⁹⁸ previously discussed, rejected the debtors' claim that the Bank and trustee had engaged in a conspiracy to cheat or oppress the Keilmans by means of a wrongful foreclosure sale.²⁹⁹ Although the trustee accepted a bid from the Bank which was below the loan amount, this action was not unlawful and neither the Bank nor the trustee violated any duty they might have owed to the Keilmans.³⁰⁰ Since no underlying wrongful activity occurred, there was no basis for a civil conspiracy.³⁰¹

6. *Material Alteration*

In *Keilman*³⁰² one of the jury's findings overturned by the appellate court was the finding that First State Bank had altered the interest rate in the renewal note without the consent or authorization of the Keilmans.³⁰³ The original note issued by Frontier National Bank contained a typographical error which stated that the interest rate was the prime rate "plus two percent (12.5%) per annum."³⁰⁴ This error was corrected in the renewal note to read "plus Two percent (2%) per annum."³⁰⁵ The court held that no material alteration occurred because "[r]egardless of the typed numerals, the written words setting the interest rate at 'prime plus two percent' control the legal interpretation of the note."³⁰⁶ The court also found that the Keilmans failed to present any evidence of fraudulent intent on the Bank's part.³⁰⁷ This case is a bit disturbing in that the Bank had to go through a jury trial and the appellate process before a court reaffirmed the long-settled principle that the words control over the numerals in a written contract.

7. *Conversion*

In *Whitaker v. Bank of El Paso*³⁰⁸ the court underlined the importance for a debtor to unequivocally demand the return of—and for the repossessing bank to unequivocally refuse to return—the debtor's collateral in order for the debtor to sustain an action for conversion.³⁰⁹ In that case, Whitaker purchased eight mobile homes for cash without changing the original title deeds. Because of the confusing array of title claims, however, the Bank of El Paso held a prior security interest on the homes by virtue of a promissory note executed by an unrelated third party. When the third party defaulted

297. *Id.*

298. 851 S.W.2d 914 (Tex. App.—Austin 1993, writ denied).

299. *Id.* at 925.

300. *Id.* at 927.

301. *Id.* at 925.

302. *Id.* at 914.

303. *Id.* at 919.

304. *Id.*

305. *Id.*

306. *Id.* at 920 (citing *Guthrie v. Nat'l Homes Corp.*, 394 S.W.2d 494, 495 (Tex. 1965)).

307. *Id.* at 921.

308. 850 S.W.2d 757 (Tex. App.—El Paso 1993, no writ).

309. *Id.* at 761.

on the promissory note, the bank repossessed the mobile homes after receiving a judgment and writ of sequestration. Subsequently, Whitaker sent the bank a letter which stated in pertinent part, "If you know anything about these homes, please advise me."³¹⁰ The Bank responded by correspondence to Whitaker that it would not object to a release of the property if "you have documentation indicating that you are, in fact, the owner of some mobile homes" which the bank had repossessed.³¹¹ Whitaker then filed suit for conversion. The suit was denied based on the bank's motion for summary judgment. Whitaker appealed and the appellate court affirmed.

The appellate court held that in order to sustain a cause of action for conversion usually a "plaintiff must establish that he demanded return of the property, and that the defendant refused to return it."³¹² Although demand and refusal are not always necessary, there must always be a manifestation by the defendant of a clear repudiation of the plaintiff's rights—either through words or actions.³¹³ Therefore, "a qualified good faith refusal based on a reasonable requirement does not constitute conversion."³¹⁴ A qualified good faith refusal would include "[a] refusal to deliver property on request . . . in order to investigate the rights of the parties," where such a refusal "is made in good faith to resolve a doubtful matter."³¹⁵ However, such a qualified refusal "must be distinctly stated to the party demanding possession Any reasons for refusing to turn over the property which are not mentioned at the time of the refusal are lost and may not be raised later."³¹⁶ Applying these rules, the *Whitaker* court found that, "Whitaker never asked anyone to give him the mobile homes; at most, he asked for information about them. Defendants never refused to give him the mobile homes; at most, they made a reasonable request that he identify those which he claimed and provide some proof of his ownership interest."³¹⁷

8. *Res Judicata Defenses*

The Fifth Circuit has determined that a lender liability claim based on a loan that was part of the borrower's bankruptcy may not be asserted after the bankruptcy plan is confirmed, because of the res judicata effect of the confirmation.³¹⁸ The court determined that it was irrelevant that the lender liability claim was not raised in the bankruptcy proceeding because under the transactional test the loan disposed of under the confirmation order and the lender liability claim based on the loan are considered identical claims for res judicata purposes.³¹⁹ The claims are considered identical because the validity of the loan was a core issue in the bankruptcy proceeding and the

310. *Id.* at 761.

311. *Id.*

312. *Id.* at 760.

313. *Id.*

314. *Id.*

315. *Id.*

316. *Id.*

317. *Id.* at 762.

318. *Eubanks v. FDIC*, 977 F.2d 166 (5th Cir. 1992).

319. *Id.* at 171. In a transactional test, "the critical issue is whether the two actions were

debtor's subsequent lender liability claim concerning that loan would put into "issue the same facts which would determine, inter alia, the treatment and amount of the debt owed" the bank in the bankruptcy proceeding.³²⁰

In *Jones v. First National Bank of Anson*³²¹ the court held that the wife of a debtor who brought a claim based on the creditor bank's action of partially paying off the debtor's loan through a set-off from his joint deposit account with his wife was barred by *res judicata*.³²² The bank had obtained an earlier default judgment against the debtor based on the post-set-off amount of the loan. The court held that the wife's claim was logically related and she was in privity with her husband so that *res judicata* applied.³²³

E. DEPOSIT ACCOUNTS

1. Joint Accounts

Last year, the Texas Supreme Court decided that unless a financial institution has received written notice that withdrawals in accordance with the terms of a joint account should not be permitted from any party able to request present payment—for example, due to the death of one of the parties to the joint account—the institution will not be liable for paying in accordance with the terms of the account, regardless of the beneficial ownership of the account.³²⁴ This decision has been followed by *MBank Corpus Christi, N.A. v. Shiner*,³²⁵ which overturned the trial court's grant of summary judgment to the beneficiaries of the account.³²⁶ The trial court found that the bank was liable for paying funds to a party to a joint account after the other party had died because the account did not contain a right of survivorship. Citing to *Bandy*, the appellate court held, "between competing interests in a joint account, the bank is fully discharged from liability when it pays the other party on the account, unless one of the parties gives written notice to the bank that no payment should be made."³²⁷ Since the beneficiaries gave no written notice to the bank instructing it not to allow the surviving joint account party to withdraw the funds, the appellate court reversed the trial court's judgment in favor of the beneficiaries and rendered judgment in favor of the bank.³²⁸

2. Unauthorized Signature Liability

a. Validity of Deposit Agreement

A depositor's challenge to a bank's deposit agreement which limited to

based on the 'same nucleus of operative facts.' " (quoting *Howe v. Vaughan*, 913 F.2d 1138, 1144-45 (5th Cir. 1990)).

320. *Id.* at 172.

321. 846 S.W.2d 107 (Tex. App.—Eastland 1992, no writ).

322. *Id.* at 110.

323. *Id.* at 109-10.

324. See *Bandy v. First State Bank*, 835 S.W.2d 609, 616 (Tex. 1992).

325. 840 S.W.2d 724 (Tex. App.—Corpus Christi 1992, no writ).

326. *Id.* at 727.

327. *Id.* (citing *Bandy*, 835 S.W.2d 609).

328. *Id.*

sixty days its responsibility for its own lack of good faith or failure to exercise ordinary care in discovering an unauthorized signature on drafts presented to it, was rebuffed in *Tumlinson v. First Victoria National Bank*.³²⁹ Between September 1989 and September 1990, some forty-five checks with alleged forged signatures were drawn on the plaintiffs' joint account—until the bank was alerted to the forgeries on or about September 26, 1990. The bank's deposit agreement provided, inter alia, that a depositor must notify the bank within fourteen days of an unauthorized signature but that the bank lost this protection "if we fail to exercise ordinary care in paying an item with an unauthorized signature unless you do not notify us of the problem within 60 days of when we send or make available to you the statement and items."³³⁰

The court upheld the agreement and determined that the bank may only be liable for drafts that it honored within sixty days of the notification it received on September 26, 1990. In arriving at this conclusion, the court recognized that Texas law "ordinarily allows a depositor one year to report an unauthorized signature before his claim is cut off."³³¹ The court noted, however, that "Texas law allows parties to a depository agreement to alter their responsibilities by agreement, so long as the agreement does not 'disclaim the bank's responsibility for its own lack of good faith or failure to exercise ordinary care. . . .'"³³² The court then determined that the agreement was enforceable.³³³

b. Bar on Double Recovery

In *Temple v. FDIC*³³⁴ the court rejected the plaintiff's argument that the one recovery rule enunciated in *Bradshaw v. Baylor University*³³⁵ should be disregarded concerning a bank's liability for a forged endorsement.³³⁶ The payee argued that such claims should be analyzed under *Duncan v. Cessna Aircraft Co.*,³³⁷ wherein the Texas Supreme Court determined that *Bradshaw* did not apply and that multiple recoveries were possible in a strict-liability tort case concerning comparative fault and involving numerous defendants and plaintiffs.³³⁸ The court in distinguishing *Duncan* intimated that *Duncan* is applicable only in the tort context and that the issues here were "fully contractual in their gravamen and in which the plaintiff is suing solely because he did not recover what he contracted to receive."³³⁹ The court then held that although a payee's bank or the collecting bank may be liable for

329. 865 S.W.2d 176 (Tex. App.—Corpus Christi, n.w.h.).

330. *Id.* at 177 (emphasis omitted).

331. *Id.* at 177 (citing TEX. BUS. & COM. CODE ANN. § 4.406(d) (Vernon 1968)).

332. *Id.* (quoting TEX. BUS. & COM. CODE ANN. § 4.103(a) (Vernon 1968)).

333. *Id.* at 178.

334. 988 F.2d 24 (5th Cir. 1993).

335. 126 Tex. 99, 84 S.W.2d 703 (Tex. 1935).

336. *Temple*, 988 F.2d at 29.

337. 665 S.W.2d 414 (Tex. 1984).

338. *Temple*, 988 F.2d at 25.

339. *Id.* at 26 (quoting UNIF. COMPARATIVE FAULT ACT § 1 cmt., 12 U.L.A. 38 (Supp. 1986)).

accepting a forged check, such liability does not extend to situations where the payee has settled his claim with the forger for the full amount of the check.³⁴⁰

F. SURETIES AND GUARANTORS

In *Miller v. University Savings Association*³⁴¹ the guarantor of a defaulted note claimed that he was excused from his guaranty because the holder of the note did not notify him of the holder's intent to accelerate the maturity of the note. The court disagreed, explaining that a holder of a note does have the obligation to the maker of a note to notify the maker of the holder's intent to accelerate.³⁴² However, no such requirement exists "that notice of intent to accelerate be given to a guarantor."³⁴³

In *Chambers v. NCNB Texas National Bank*³⁴⁴ a partner who guaranteed his partnership's debt claimed that he was no longer liable on his guaranty because the partnership converted into a corporation and the underlying debt had been "replaced," i.e., renewed and extended.³⁴⁵ The court had little trouble rejecting these claims. The court found that the guaranty applied to "all renewals and extensions thereof" and characterizing the loan's renewal as a "replacement" did not invalidate the guaranty.³⁴⁶ Furthermore, the guaranty stated that a change in status of the debtor by "merger, consolidation or otherwise" does not alter the guarantor's liability.³⁴⁷ The court held that this language includes incorporation and the word "incorporation" need not be mentioned specifically in the guaranty.³⁴⁸

In *FDIC v. F & A Equipment Leasing*,³⁴⁹ previously discussed, the court determined under what circumstances a co-maker of a note subsequently becomes a surety of the note after another party signs the note and becomes principally liable under it. The pertinent facts of this case are that F & A Leasing and others (collectively, "F & A") were the original makers of a note which was subsequently signed by Bobby and Vernon Wilson (the Wilsons). Upon default, First Consolidated Bank-Pleasant Run, N.A. (the Bank) sought collection from the Wilsons and then F & A. F & A claimed that it was a surety on the note and that as such the Bank's claim was subject to the defense of collateral impairment.³⁵⁰ The FDIC, as receiver for the Bank, claimed that F & A was not a surety because it was a co-maker of the note; thus, the surety defense was not available. The district court found

340. *Id.* at 24.

341. 858 S.W.2d 33 (Tex. App.—Houston [14th Dist.] 1993, writ denied).

342. *Id.* at 36 (citing *Shumway v. Horizon Credit Corp.*, 801 S.W.2d 890, 892 (Tex. 1991)).

343. *Id.* (emphasis added) (citing *United States v. Little Joe Trawlers, Inc.*, 776 F.2d 1249, 1252 (5th Cir. 1985)).

344. 841 S.W.2d 132 (Tex. App.—Houston [14th Dist.] 1992, no writ).

345. *Id.* at 134.

346. *Id.*

347. *Id.* (emphasis added by the court).

348. *Id.*

349. 854 S.W.2d 681 (Tex. App.—Dallas 1993, no writ).

350. *Id.* at 684; see TEX. BUS. & COM. CODE ANN. § 3.606(a)(2) (Vernon 1968).

that F & A was a surety and that it could prevail on the defense of collateral impairment.

The court determined that a co-maker could be a surety (and thereby prevail on the defense of collateral impairment) if he could show: (1) that as the original maker he entered "into an agreement with another whereby the second party is to assume the note, [so that] as between them, the assumpor becomes primarily liable and the original maker becomes a surety;" and (2) that the creditor "has accepted the assumption and consented to the change. . . ." ³⁵¹ The court found that although there existed more than a scintilla of evidence supporting these two propositions, the evidence was insufficient because the overwhelming weight of the evidence supported a finding that the bank did not consent to F & A's changed status. ³⁵² Therefore, the appellate court reversed and remanded the trial court's judgment discharging F & A's liability on the note.

G. MISCELLANEOUS CASES

1. *Statute of Limitations and Adverse Domination*

In *FDIC v. Shrader & York* ³⁵³ the Fifth Circuit affirmed the grant of summary judgment to Shrader & York and its co-defendants in the legal malpractice action brought by the FDIC as successor to City Savings & Loan Association (City Savings) and Lamar Savings Association of Texas (Lamar Savings). In *Shrader* the FDIC asserted that Shrader & York, a law firm, and its individual partners negligently contributed to the failure of City Savings and Lamar Savings by doing faulty legal work in five transactions. The FDIC alleged that Shrader & York failed to give competent legal advice thereby allowing some of the transactions to violate federal laws. Further, the FDIC contended that Shrader & York allowed Stanley E. Adams, Jr. (Adams) to deceive the Lamar Savings and City Savings directors. Adams was the owner and top official of the two thrifts. The FDIC theorized, if Shrader & York had alerted the directors of City Savings and Lamar Savings of the illegal nature of the five transactions, the boards of directors would have blocked the transactions thereby averting the losses resulting from the transactions.

The United States District Court for the Southern District of Texas (the District Court) held that City Savings' and Lamar Savings' legal malpractice claims against Shrader & York were barred by the Texas statute of limitations for legal malpractice before the two savings and loans were declared insolvent and such claims were sold by the FSLIC in its receiver capacity to the FSLIC in its corporate capacity on May 18, 1988. The Texas limitation period for legal malpractice claims is two years. ³⁵⁴ The parties agreed that the occurrences giving rise to the legal malpractice claims against Shrader & York occurred before May 1986, therefore, all claims expired before May of

351. *F & A Equip.*, 854 S.W.2d at 686.

352. *Id.* at 689.

353. 991 F.2d 216 (5th Cir. 1993).

354. TEX. CIV. PRAC. & REM. CODE ANN. § 16.003 (Vernon 1986).

1988 unless the limitation period was extended by an equitable doctrine as asserted by the FDIC.

The FDIC asserted that two equitable doctrines should extend the limitation period. First, the FDIC asserted that the Texas discovery rule kept the statute of limitations from running before May of 1988. Citing *Willis v. Maverick*,³⁵⁵ the court noted that "the statute of limitations for legal malpractice actions does not begin to run until 'the claimant discovers or should have discovered through the exercise of reasonable care and diligence the facts establishing the elements of his cause of action.'"³⁵⁶ The FDIC contended that the District Court had erroneously presumed that because Adams had knowledge of City Savings' and Lamar Savings' activities, he knew of Shrader & York's malpractice. The Fifth Circuit Court noted that "[t]he FDIC's argument assumes that Texas' discovery rule requires actual knowledge."³⁵⁷ Citing *Willis*, the court stated "In fact, the limitations period on the legal malpractice claim begins to run when 'the claimant discovers or should have discovered through the exercise of reasonable care and diligence the facts establishing the elements of his cause of action.'"³⁵⁸ The court reasoned that Adams was intimately involved with the transactions at issue due to his ownership and management positions with the financial institutions. Further, the court cited a related action, *Lamar Fin. Corp. v. Adams*,³⁵⁹ in which the

FDIC accused Adams of "deliberately . . . entering into unsafe and unsound transactions" that "generated no new cash to Lamar," but "dramatically increased [Lamar's] exposure to risk," and caused Lamar to sustain losses. Moreover, the FDIC pled that Adams and others "carried out a scheme" to "disguis[e] and hid[e] from regulatory authorities, depositors, creditors, and others, the negative impact of these risky loans and investments upon [Lamar's] regulatory worth."³⁶⁰

Holding that Adams should have discovered losses caused by the schemes and other facts establishing any legal malpractice claims by City Savings and Lamar Savings against Shrader & York, the court stated "[T]he FDIC claims, in one breath, that Adams engaged in elaborate schemes to circumvent banking regulations. It cannot claim in the next breath that Adams was not aware that Shrader & York negligently facilitated those schemes."³⁶¹

The court held as a matter of law that Adams' knowledge was imputed to City Savings and Lamar Savings. The FDIC argued that the general rule of imputation should not be applied due to the FDIC's special status of successor to the FSLIC as receiver of City Savings and Lamar Savings. Relying on *FDIC V. Ernst and Young*,³⁶² the court held that "[T]he FDIC is not enti-

355. 760 S.W.2d 642, 646 (Tex. 1988).

356. *Shrader*, 991 F.2d at 221 (citing *Willis*, 760 S.W.2d at 646).

357. *Id.*

358. *Id.* at 221 (citing *Willis*, 760 S.W.2d at 646).

359. No. Civ. A. A-88-CA-183 (W.D. Tex.).

360. *Shrader*, 991 F.2d at 221 (citing *Lamar Fin. Corp. v. Adams*, No. Civ. A. A-88-CA-183 (W.D. Tex.)).

361. *Shrader*, 991 F.2d at 222.

362. 967 F.2d 166, 170 (5th Cir. 1992).

bled to special protection when it brings a tort claim against a third party on behalf of a defunct financial entity."³⁶³ The FDIC attempted to distinguish itself from *Ernst and Young* by arguing that in this case it was suing on behalf of depositors and other creditors, not just on behalf of the failed institutions. The court held that *Ernst and Young* was indistinguishable from this case noting that " 'the FDIC does not cite any statutory authority affording it special protection' . . . the FDIC has not pled or offered summary judgment evidence that City [Savings] or Lamar Savings' depositors and other creditors were clients of Shrader & York and thus able to sue Shrader & York for professional malpractice."³⁶⁴ The court noted that under Texas law an attorney can be held liable for professional malpractice only to a person with whom the attorney has privity, meaning that person must be a client.³⁶⁵ The FDIC did not explain how its position would be improved by standing in the shoes of depositors or other creditors. The court reasoned that because the knowledge of Adams was imputed to City Savings and Lamar Savings, the FSLIC had acquired stale claims against Shrader & York when it was appointed receiver of City Savings and Lamar Savings.

The FDIC also contended that Adams' knowledge should not be imputed to City Savings or Lamar Savings because Adams acted adversely to the interests of City Savings and Lamar Savings. The FDIC relied upon the general rule that a bank officer's or director's knowledge will generally not be imputed to the bank if the officer or director acts with an interest adverse to the bank.³⁶⁶ Relying on *Goldstein v. Union Nat'l Bank*,³⁶⁷ *Ernst and Young*³⁶⁸ and *Cenco, Inc. v. Seidman & Seidman*,³⁶⁹ the court stated that "to successfully establish that Adams' knowledge of the fraudulent activity was not imputed to the corporation under the discovery rule, the FDIC would have to prove that Adams acted adversely to or committed fraud against City [Savings] and/or Lamar [Savings]."³⁷⁰ Upon a review of the transactions, the court noted that the FDIC did not offer evidence that Adams personally profited from the transactions at Lamar Savings' expense nor did actions taken due to Adams' desire to maintain control over City Savings' and Lamar Savings, bring Adams' conduct within the adverse interest exception.

Finally, the FDIC argued that Adams adversely dominated City Savings and Lamar Savings; therefore, the causes of action against Shrader & York by City Savings and Lamar Savings did not begin to run until Adams was not longer in control of the institutions. The FDIC argued that the adverse domination theory should be applicable because Adams prevented City Savings and Lamar Savings from suing Shrader & York in order to avoid expo-

363. *Shrader*, 991 F.2d at 222 (citing *Ernst and Young*, 967 F.2d at 170).

364. *Id.* at 223.

365. *See* First Min. Leasing v. Blankenship, Potts, 648 S.W.2d 410 (Tex. App.—Dallas 1983, writ ref'd n.r.e.).

366. *Shrader*, 991 F.2d at 223; *see* FDIC v. Lott, 460 F.2d 82, 88 (5th Cir. 1972).

367. 109 Tex. 555, 213 S.W. 584, 590-91 (1919).

368. 967 F.2d at 171.

369. 686 F.2d 449 (7th Cir. 1982), *cert. denied*, 459 U.S. 880, (1982).

370. *Shrader*, 991 F.2d at 224.

sure of his own wrongdoing. The court rejected this argument noting that no cases from Texas or the Fifth Circuit court had been produced by the FDIC extending the adverse domination doctrine beyond corporate officers and directors.

2. *Federal v. State Statute of Limitations*

Until very recently, an unsettled question existed concerning whether the federal six-year or the Texas four-year statute of limitations period is applicable when an instrument is transferred by the FDIC to an assignee or holder, and that assignee or holder subsequently brings suit on the instrument.³⁷¹ The Texas Supreme Court has now resolved this issue and has held that the Federal six-year statute of limitation period is applicable. The Texas Supreme Court had granted writs to review two cases which arrived at opposite conclusions.³⁷² Basically, *Thweatt v. Jackson* concluded that the rights of a transferee in an instrument are the same as the rights of a transferor—and where the FDIC is the transferor—these rights include the benefit of the federal statute of limitations under section 1821(d)(14).³⁷³ The *Weatherly* court declined to follow *Thweatt*, concluding that the inherent nature of a statute of limitations is to limit the substantive right to bring a claim and is not a “right” in and of itself.³⁷⁴ While the Texas Supreme Court was deliberating the merits of *Thweatt* and *Weatherly*, another state case came out in support of *Thweatt*.³⁷⁵

As for the federal courts, the Fifth Circuit, in *FDIC v. Bledsoe*, determined that an assignee is entitled to the six-year statute based on the reasoning used in *Thweatt* that an assignee stands in the shoes of an assignor and that the federal statute does not prohibit an assignee from receiving the benefit of the six-year period.³⁷⁶ The *Bledsoe* court also noted that the federal district courts which have considered this issue have unanimously found that an assignee of the FDIC receives the benefit of the federal six-year statute.³⁷⁷

Subsequently, the Texas Supreme Court issued its opinion in *Jackson*, which expressly affirmed *Thweatt* and reversed *Weatherly*. There it held that the assignee of a note from the FDIC “receives the full rights of the as-

371. See 12 U.S.C. § 1821(d)(14) (Supp. I 1989) (Financial Institutions Reform, Recovery, and Enforcement Act) (“FIRREA”); TEX. CIV. PRAC. & REM. CODE ANN. § 16.004(a)(3) (Vernon 1986).

372. See *Federal Debt Management, Inc. v. Weatherly*, 842 S.W.2d 774 (Tex. App.—Dallas 1992, writ granted) (holding the Texas statute applies); *Thweatt v. Jackson*, 838 S.W.2d 725 (Tex. App.—Austin 1992, writ granted) (holding the federal statute applies).

373. *Thweatt*, 838 S.W.2d at 727-28.

374. *Weatherly*, 842 S.W.2d at 778.

375. See *Jon Luce Builder v. First Gibraltar Bank*, 849 S.W.2d 451 (Tex. App.—Austin 1993, writ requested) (holding that federal statute of limitations applied to holder of a loan note acquired after the original noteholder, a savings and loan association, was declared insolvent by the Federal Savings and Loan Insurance Corporation).

376. *FDIC v. Bledsoe*, 989 F.2d 805, 809-10 (5th Cir. 1993).

377. *Id.* at 809 (citing *North American Consultants v. Garlick Sales, No. CIV-91-1066-C, 1992 WL 477016 (W.D. Okla. Oct. 20, 1992); Mountain States Fin. Resources Corp. v. Agrawal, 777 F. Supp. 1550 (W.D. Okla. 1991); Fall v. Keasler, No. C-90-2-643-SW (ARB), 1991 WL 340182 (N.D. Cal. Dec. 18, 1991)*).

signor," under Texas common law.³⁷⁸ These rights include the benefit of the federal six-year statute of limitations.³⁷⁹ In so holding, the *Jackson* court rejected the argument that an assignee can receive only common law rights and not those rights which arise by statute such as an extended limitations period. The court held that a federal statute may be interpreted according to federal common law especially when, as in this area, a whole body of federal common law has grown up concerning the interpretation of this federal statute.³⁸⁰ Furthermore, although the court had previously held that a statute of limitations does not confer a "right," the court now ruled that such a statute does confer a "right" where it is used as a sword rather than as shield to block a claim.³⁸¹ Finally, the court ruled that the limitations period under section 1821(d)(14) as part of FIRREA applies retroactively to claims in existence prior to the date of FIRREA's enactment on August 9, 1989.³⁸² In so ruling, the court suggested that the only instance in which the state's four-year period would apply would be when the claim was already stale under that statute prior to the appointment of the FDIC as a receiver.³⁸³ Of course, this limited exception is well recognized.³⁸⁴ Therefore, the practical effect of the Texas Supreme Court's decision is to confer upon the assignee of a claim from the FDIC the full federal six-year limitations period. This decision should provide much needed comfort to those financial institutions which assumed claims, the enforcement of which appeared highly questionable if the Texas four-year statute was applicable.³⁸⁵

On a closely related issue, a Texas court has held that the federal six-year statute is not available to banks which were created through a reorganization with the financial assistance of the FDIC but were never in a conservatorship or receivership with the FDIC.³⁸⁶ The banks argued that the "open bank assistance transaction" which created them was in substance a receivership, thus making them successors to the FDIC, and as such, they would be entitled to the six-year statute.³⁸⁷ The court did not consider the issue of whether successors or assignees would be entitled to the six-year statute, because it found, based on its opinion in *City of Houston v. First City*,³⁸⁸ that the banks were not successors to the FDIC. In that case, the court determined that the FDIC's relationship to the banks was only as a lender.³⁸⁹ Furthermore, the Bank could not be a de facto receiver because receivership is a specific legal status, requiring a determination by the Comptroller of the

378. *Jackson v. Thweatt*, 1994 WL 70405, at *2.

379. *Id.*

380. *Id.* at *3.

381. *Id.*

382. *Id.* at *5.

383. *Id.*

384. *See FDIC v. Belli*, 981 F.2d 838, 842 (5th Cir. 1993) (holding that a special federal limitation provision will not revive a claim already barred under state law).

385. *Jackson v. Thweatt*, 1994 WL 80405 at *2.

386. *Prince v. First City Texas—Houston, N.A.*, 853 S.W.2d 691 (Tex. App.—Houston [1st Dist.] 1993, no writ).

387. *Id.* at 694.

388. 827 S.W.2d 462 (Tex. App.—Houston [1st Dist.] 1992, writ denied).

389. *Id.* at 478.

Currency and the appointment of a receiver, and none of these requirements had been met.³⁹⁰

In *FDIC v. Fuller*³⁹¹ the court determined that either under Fifth Circuit or Texas law, laches is generally not available as a defense by a debtor against a lender in a contract action.³⁹² In *Fuller* the FDIC had filed its claim within the applicable statute of limitations but the debtor argued that because of the FDIC's undue delay in filing the claim, it should be barred by the equitable doctrine of laches.³⁹³ The court found that in legal actions, including the case at hand, equitable remedies such as laches are not available.³⁹⁴ The court noted that there exists an exception to this rule in some jurisdictions (although not yet recognized in the Fifth Circuit or in Texas) for "extraordinary circumstances" where laches can be asserted even though the applicable statute of limitations has not yet run.³⁹⁵ The court questioned the efficacy of the rule because "it does not admit principled limits," but did not reject the rule because even if the exception were recognized, no "extraordinary circumstances" existed in this case.³⁹⁶ A Texas federal district court, on the other hand, has stated without exception that where "there is an applicable statute of limitations period . . . laches is unavailable."³⁹⁷

3. Sales of Annuity Contracts

On March 20, 1990, the Comptroller of the Currency issued an opinion letter authorizing national banks to sell annuity contracts.³⁹⁸ The letter concluded that 12 U.S.C. § 92, which permitted national banks to act as insurance agents in towns with less than 5,000 inhabitants, did not prohibit national banks from selling insurance in towns with more than 5,000 inhabitants, and, in any event, annuities are not a form of insurance.³⁹⁹ Although some doubt existed over the continued validity of section 92, the

390. *Id.*

391. 994 F.2d 223 (5th Cir. 1993).

392. *Id.* at 224.

393. *Id.*

394. *Id.*

395. *Id.*

396. *Id.*

397. *FDIC v. Spain*, 796 F. Supp. 241, 243 (W.D. Tex. 1992).

398. See Unpublished OCC Interpretive Letter, Mar. 20, 1990, available in LEXIS, BANKING Library, OCCUL File.

399. *Clarke*, 998 F.2d at 1296. Section 92 provides in relevant part that national banks, located and doing business in any place the population of which does not exceed five thousand inhabitants, as shown by the last preceding decennial census, may, under such rules and regulations as may be prescribed by the Comptroller of the Currency, act as the agent for any fire, life, or other insurance company authorized by the authorities of the State in which such bank is located to do business in such state, by soliciting and selling insurance and collecting premiums on policies issued by such company. . . . Act of Sept. 7, 1916, ch. 461, 39 Stat. 753 (codified at 12 U.S.C. § 92 (1926)). The 1952 edition of the U.S.C. omitted this provision and added a note explaining that Congress had repealed it in 1918. 12 U.S.C. § 92 note (1952). Although successive editions of the U.S.C. have all carried over the same note, both Congress and the courts have on occasion acted as if section 92 has remained in force. See *United States Nat'l Bank of Oregon v. Independent Ins. Agents of America, Inc.* 113 S. Ct. 2173, 2176 (1993).

Supreme Court subsequently ruled that it was still good law.⁴⁰⁰

The Fifth Circuit has now held that section 92 *prohibits* a national bank from selling annuities in towns with more than 5,000 inhabitants.⁴⁰¹ The court first determined, based on *Saxon v. Georgia Association of Independent Insurance Agents*,⁴⁰² that section 92 “authorizes national banks in towns with a population smaller than 5,000 to act as insurance agents, and impliedly prohibits national banks in towns with a population larger than 5,000 from acting as insurance agents.”⁴⁰³ The court rejected the argument that the Comptroller’s interpretation should be respected under *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*,⁴⁰⁴ which requires due deference to be given to an administrative agency’s statutory interpretation. The court concluded that “deference under *Chevron* does not permit administrative agencies to overrule precedents.”⁴⁰⁵ The court then determined that annuities are an insurance product both because historically they have been a product of insurance companies and have been regulated by the states under their insurance laws; and because functionally they “are the mirror image of life insurance” and, just as an insurance policy, “are formulated on the basis of actuarial calculations of mortality risk,” and involve a transfer of risk.⁴⁰⁶ The court then concluded that since section 92 prohibits national banks from selling annuities in towns with a population larger than 5,000 inhabitants, the opinion letter issued by the Comptroller was in violation of this section.⁴⁰⁷

4. Choice of Remedies

In *Douglas v. NCNB Texas National Bank*⁴⁰⁸ the court held that a Texas lender need not file a counterclaim against a borrower to collect on the collateral for a loan, even if the borrower has sued the lender contesting the loan’s validity.⁴⁰⁹ In *Douglas*, the borrowers on two promissory notes, Douglas Drilling, Inc., and Donald W. Douglas, contended that the FDIC could not collect on the notes because the prior holder, First Republic Bank Abilene, N.A. (FRBA), had lost its right to collect on the notes by failing to counterclaim to collect on the overdue notes in prior litigation.⁴¹⁰ This prior litigation was instituted by the borrowers and then dismissed in federal court with prejudice based on their motion. After this litigation, FRBA assigned

400. *Bank of Oregon*, 113 S. Ct. at 2187.

401. *Clarke*, 998 F.2d at 1295.

402. 399 F.2d 1010, 1012 (5th Cir. 1968).

403. *Clarke*, 998 F.2d at 1298.

404. 467 U.S. 837 (1984).

405. *Clarke*, 998 F.2d at 1300.

406. *Id.* at 1300-01.

407. *Id.* at 1303.

408. 979 F.2d 1128 (5th Cir. 1992), *cert. denied*, 114 S. Ct. 68 (1993).

409. *Id.* at 1130-31.

410. This argument was based on Rule 13(a) of the Federal Rules of Civil Procedure, which provides that a counterclaim is compulsory if it arises out of the transaction or occurrence that is the subject matter of the plaintiff’s claim. FED. R. CIV. P. 13(a) and *Douglas*, 979 F.2d at 1129. *Id.*

the two notes to the FDIC which subsequently brought suit in federal court to enforce the notes.

The Fifth Circuit found that in the prior litigation FRBA was not required to file a compulsory counterclaim because although the claims might fall within the purview of the compulsory counterclaim rule contained in Federal Rule 13(a), to so hold would violate the Rules Enabling Act.⁴¹¹ This act provides that the Federal Rules of Civil Procedure "shall not abridge, enlarge or modify any substantive right."⁴¹² The court reasoned that here, Federal Rule of Civil Procedure 97(a) "does not require the secured party to counterclaim to collect on the debt if the creditor has a contractual right to pursue a nonjudicial foreclosure."⁴¹³ If the court required, under the federal rules, that the FRBA must file a compulsory counterclaim, then it would deprive FRBA of its "substantive right [under Texas law] to elect judicial or nonjudicial foreclosure in the event of a default, and debtors have no right to force the lender to pursue a judicial foreclosure remedy."⁴¹⁴ Therefore, FRBA was not required to file as a compulsory counterclaim its claim to collect the amounts owed under the notes, and the FDIC, as a holder in due course, could assert this claim.⁴¹⁵ This decision prevents debtors from using a federal forum to accomplish what they cannot do in a state forum — delay foreclosure by forcing the creditor to use the judicial process.

5. *Novation*

In *FDIC v. Waggoner*⁴¹⁶ the court had to decide, inter alia, whether under Texas law, a note which consolidated a debtor's previous nonrecourse notes was a novation so that the renewal and extension of the original notes rendered the debtor *personally* liable under the new note. Here, the debtor originally entered into two nonrecourse notes which affirmatively rejected personal liability. These notes were subsequently combined into one consolidated note, which recited that it was a renewal and extension of the original notes but was silent as to personal liability.

The court determined that the debtor could only be personally liable under the new note "if the parties intended a novation of the debts evidenced by the first two notes."⁴¹⁷ Of the elements for a novation, the only one in doubt was whether there was "the extinguishment of the old contract."⁴¹⁸ Extinguishment of the old note must be based on the intention of the parties, and the burden of proof is on the party seeking the novation.⁴¹⁹ The court

411. *Douglas*, 979 F.2d at 1130.

412. 28 U.S.C. § 2072 (1988).

413. *Douglas*, 979 F.2d at 1130.

414. *Id.*

415. *Id.* at 1131.

416. 999 F.2d 826 (5th Cir. 1993).

417. *Id.* at 829.

418. *Id.* The elements of a novation are: "(1) a previous, valid obligation; (2) an agreement of the parties to a new contract; (3) the extinguishment of the old contract; and (4) the validity of the new contract." *Id.* The parties agreed that elements one, two, and four existed in the present case. *Id.*

419. *Id.*

concluded that although a novation may arise from inconsistencies in the two contracts, such was not the case here since much of the language in the consolidated note was taken verbatim from the original notes and the consolidated note did not involve any new money, or even a change in interest rate.⁴²⁰ Furthermore, the bank waited over two years after default before attempting to collect personally from the debtor even though the collateral was inadequate. The court found that this action evidenced the existence of an agreement not to change the debtor's status concerning his personal liability.⁴²¹ Therefore, the bank failed to prove that a novation occurred.

II. LEGISLATION

A. BANKRUPTCY AND BANK LIQUIDATIONS

1. Liquidation Priorities

The legislature adopted an amendment to Articles 342-804 of the Texas Banking Code of 1943, as amended (the Banking Code),⁴²² which gives the claims against a state bank the same priority as claims against a national bank. This amendment abolishes the "depositor preference statute" which was enacted in 1985 at the behest of the FDIC.⁴²³ The original statute provided a priority list of payouts to uninsured claimants which facilitated the FDIC's ability to enter into purchase and assumption transactions as opposed to straight insurance payouts of failed banks.⁴²⁴ However, the FDIC no longer enters into purchase and assumption transactions because it has interpreted later enacted federal legislation to require it to structure closed-bank transactions so that they do not cover uninsured depositors.⁴²⁵ This change in policy resulted in significant discrimination against state banks, when, in connection with the First City failure, the FDIC paid the claims of institutions which had sold Fed funds to national banks but did not pay the claims of institutions which had sold Fed funds to state chartered banks. The FDIC based its differential treatment on Texas's "depositor preference statute".⁴²⁶ This precedent-setting action threatened the state-federal dual banking system because it now placed "all state chartered banks at a competitive disadvantage to national banks especially regarding their participation in certain types of liquidity transactions necessary to conducting normal business."⁴²⁷ To solve this disparity, the new law, as promulgated by Senate Bill No. 238, provides that claims for payment against a state bank have the

420. *Id.* at 829-30.

421. *Id.* at 830.

422. TEX. CIV. STAT. ANN. arts. 342-804a (Vernon Supp. 1994).

423. See TEX. CIV. STAT. ANN. art. 342-804a (Vernon Supp. 1993); Senate Comm. on Inv. and Banking, BILL ANALYSIS 1, Tex. S.B. 238, 73d Leg., R.S. (1993) (hereinafter BILL ANALYSIS S.B. 238).

424. See TEXAS BANKERS ASS'N, SUMMARY OF LAWS AFFECTING BANKS ENACTED BY THE 73RD LEGISLATURE 7 (1993) (hereinafter SUMMARY).

425. Bill Analysis S.B. 238 at 1.

426. See KAREN NEELY, WHITE PAPER 6 (Indep. Bankers Ass'n of Texas 1993) (hereinafter WHITE PAPER).

427. BILL ANALYSIS S.B. 238 at 2.

same priority that similar claims would have against a national bank.⁴²⁸ As an aside, Congress is considering a bill that would impose a national "depositor preference," thereby allowing the FDIC to act to the equal detriment of both national and state chartered banks.⁴²⁹

2. *Exemption Concerning Personal Property in Bankruptcy*

House Bill No. 1828⁴³⁰ amends the Texas Property Code to make clear that although a lien or encumbrance may be placed on exempt personal property, such a "security interest or lien may not be avoided on the ground that the property is exempt. . . ."⁴³¹ This change was enacted in response to *Owen v. Owen*.⁴³² In *Owen* the Supreme Court held that section 522(f) of the Federal Bankruptcy Code⁴³³ allows debtors to avoid any nonpossessory, nonpurchase money lien on otherwise exempt property.⁴³⁴ Therefore, under this holding, a bankruptcy court must "ask first whether avoiding the lien would entitle the debtor to an exemption, and if it would, then avoid and recover the lien. . . ."⁴³⁵ Therefore, under the *Owens* ruling any security interest based on potentially exempt personal property could be voided by the bankruptcy court. The result is particularly troublesome for agricultural lenders who can no longer protect themselves on liens secured by farm equipment and vehicles.⁴³⁶ The same is true for lenders to sole proprietors who offer their tools of trade as security.⁴³⁷ The new state law attempts to cure this problem by clearly stating that such security interests cannot be discharged in bankruptcy. However, because the *Owen* court was interpreting *federal* law, this new change will not be effective until the United States Bankruptcy Code is amended.⁴³⁸ Therefore, lenders should be wary of making loans based on such security, especially since the current family personal property exemption is \$60,000.⁴³⁹

428. *Id.*

429. WHITE PAPER at 6.

430. Codified at TEX. PROP. CODE ANN. § 42.002(b) (Vernon Supp. 1994).

431. *Id.*

432. 111 S. Ct. 1833 (1991); see also HOUSE COMM. ON BUSINESS AND INDUS., BILL ANALYSIS 1, Tex. H.B. 1828, 73d Leg. R.S. (1993) (hereinafter BILL ANALYSIS H.B. 1828).

433. 11 U.S.C.A. § 522(f).

434. 111 S. Ct. at 1837. Section 522(f) applies regardless of whether a debtor choose federal or state exemptions. This law provides in pertinent part:

(f) Notwithstanding any waiver of exemptions, the debtor may avoid the fixing of a lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled under subsection (b) of this section, if such lien is—

(1) a judicial lien; or

(2) a nonpossessory, nonpurchase-money security interest. . . .

11 U.S.C. § 522(f) (1988).

435. *Owen*, 111 S. Ct. at 1837-38.

436. BILL ANALYSIS H.B. 1828 at 1.

437. *Id.*

438. See *id.* at 2.

439. See WHITE PAPER at 18.

B. LEVY ON DEPOSIT BOXES

The Comptroller may freeze and levy for the collection of delinquent taxes upon certain assets of a debtor which are in the possession of a financial institution.⁴⁴⁰ However, under prior law, safety deposit boxes and their contents were not subject to such forfeiture. This caused some concern, especially regarding the ability of the Comptroller to collect controlled substances taxes.⁴⁴¹ With the passage of House Bill No. 365, the legislature has amended the Tax Code to specifically include safety deposit boxes as assets subject to the Comptroller's levy powers.⁴⁴² The bill also provides that the Comptroller shall issue regulations "relating to inventory of the box contents, delivery of the contents, and reimbursement to the financial institution or other safe deposit box facility for drilling and other costs."⁴⁴³

C. GOVERNMENT DEPOSITS

1. *Municipal Depositories*

In the past session, the Texas Legislature significantly revised the municipal depository law.⁴⁴⁴ The prior laws governing public funds had not been amended since the 1930s, so this major overhaul was an attempt to reflect the vast changes in technology and financial services that had occurred since that time.⁴⁴⁵ Although numerous changes were enacted greatly enhancing the business opportunities for banks in dealing with municipalities, perhaps the most significant change was the inclusion of credit unions and savings and loans as permissible depositories for municipal funds.⁴⁴⁶

This change, as well as others in the new law, was enacted to give municipalities greater flexibility in managing their funds. In this respect, the law expressly allows municipalities to obtain bids from a variety of institutions.⁴⁴⁷ Also, municipalities may award their business to more than one financial institution.⁴⁴⁸ Eligible institutions can include those that do not do business within the municipality, if the municipality has a prior written policy expressly permitting such a selection and the policy requires the explicit consideration of the municipality's best interests.⁴⁴⁹ In addition, municipalities may contract for a range of other financial services besides deposits.⁴⁵⁰

440. See TEX. TAX CODE ANN. § 111.021 (Vernon 1992).

441. See HOUSE WAYS AND MEANS COMM., BILL ANALYSIS 1, Tex H.B. 365, 73d Leg., R.S. (1993) (hereinafter BILL ANALYSIS H.B. 365).

442. TEX. TAX CODE ANN. § 111.021(j) (Vernon Supp. 1994).

443. *Id.*

444. See Tex. H.B. 696, 73d Leg., R.S. (1993).

445. HOUSE COMM. ON INV. AND BANKING, BILL ANALYSIS 1, Tex. H.B. 696, 73d Leg., R.S. (1993) (hereinafter BILL ANALYSIS H.B. 696).

446. See TEX. LOC. GOV'T CODE ANN. § 105.001(4) (Vernon Supp. 1994). The new law also allows a savings and loan to be a depository for counties and school districts. See TEX. LOC. GOV'T CODE ANN. § 116.001(1) (Vernon Supp. 1994); TEX. EDUC. CODE ANN. § 23.73(2) (Vernon Supp. 1994).

447. BILL ANALYSIS H.B. 696 at 2.

448. TEX. LOC. GOV'T CODE ANN. § 105.015 (Vernon Supp. 1994).

449. *Id.* § 105.011(b)(2).

450. *Id.* § 105.018.

These other services may include investments in accordance with the municipality's investment policy and investments in certificates of deposit.⁴⁵¹ A municipality may enter into a deposit with an institution for a period not to exceed five years instead of being limited to a yearly renewal.⁴⁵² Furthermore, a municipality may negotiate the terms and conditions relating to possession, release, or substitution of security.⁴⁵³ In this respect, the new law has repealed the specific list of acceptable security for deposits and instead references the Public Funds Collateral Act at article 2529d of the Texas Civil Statute.⁴⁵⁴ Given this vastly increased negotiating power with a wide array of financial institutions, municipalities can be expected to become much more savvy and demanding customers, and banks must be prepared to provide them with the highest level of service and expertise—especially with the additional increase in competition from credit unions and savings and loans.

2. *Linked State Fund Deposits*

In an attempt to "stimulate the economy,"⁴⁵⁵ the legislature has enacted a law providing that the state will deposit its funds into banks which enter into loans with "historically underutilized businesses" and businesses located in "distressed communities."⁴⁵⁶ Basically, this scheme provides that banks which make loans to minority-owned businesses or to businesses in poverty-stricken areas will be eligible to have state funds, not to exceed three million dollars, deposited in them.⁴⁵⁷ The bank must submit each proposed loan application for approval to the Department of Commerce (the "Department") which may decide whether to accept or reject the application.⁴⁵⁸ The statute provides no guidelines for acceptance or rejection of an application and apparently the Department is foreseen as having "broad rulemaking authority" in establishing such guidelines.⁴⁵⁹ However, once the Department accepts an application and the bank makes the loan, it "shall place a linked deposit" with the bank.⁴⁶⁰ Also, no minimum amount or minimum period for the deposit is specified, and presumably, is at the discretion of the Department.⁴⁶¹ Until the Department promulgates its rules outlining its cri-

451. *Id.* § 105.071.

452. *Id.* § 105.017.

453. *Id.* § 105.051.

454. *Id.* § 105.034(a)(5).

455. HOUSE COMM. ON INV. AND BANKING, BILL ANALYSIS 1, Tex. C.S.H.B. 259, 73d Leg., R.S. (1993) (hereinafter BILL ANALYSIS C.S.H.B. 259).

456. See TEX. GOV'T CODE ANN. § 481.191 (Vernon Supp. 1994).

457. *Id.* §§ 481.193, 481.197.

458. *Id.* § 481.193(f).

459. BILL ANALYSIS C.S.H.B. 259 at 1.

460. TEX. GOV'T CODE ANN. § 481.193(g) (Vernon Supp. 1994) (emphasis added).

461. Elsewhere in the statute, the maximum eligible linked-deposit loan amount is specified as \$100,000. TEX. GOV'T CODE ANN. § 481.197(b) (Vernon Supp. 1994). This limit seems to imply that the statute envisions a dollar-for-dollar state fund deposit for an accepted loan-application amount. However, nowhere in the statute is this connection explicitly made. In any event, nothing in the statute, either explicitly or implicitly, prevents the Department from making a deposit one day and withdrawing it the next day.

teria for accepting loan applications and for establishing minimum deposits and time periods, it would be inadvisable for banks to make such loans based on the expectation of receiving this benefit.

The legislature also extended the link-fund deposit program to include loans made to borrowers producing agricultural crops in Texas: (1) who have experienced a marked decline "because of natural disasters," or (2) who use "water conservation equipment for agricultural production purposes."⁴⁶²

D. UNIFORM PROVISIONS: PERSONALTY LEASES AND WIRE TRANSFERS

House Bill No. 1113 amended several sections of the Texas Business and Commerce Code by, *inter alia*, adopting two chapters of the Uniform Commercial Code (UCC) thereby adding a Chapter 2A to the UCC regarding personal property leases and a Chapter 4A to the UCC concerning wire transfers.⁴⁶³ A full explanation of these chapters is beyond the scope of this summary, so a brief overview will have to suffice.

1. *Personal Property Leases*

Chapter 2A prescribes the rights, obligations, and remedies for parties that enter into a personal property lease. Of particular interest to creditors, these provisions include detailed rules concerning alienability of a party's interest under the lease, sale or sublease of goods by lessee, priority of liens, and special rights of creditors.⁴⁶⁴ This chapter also delineates a wide range of remedies for the lessee and lessor which are similar to the UCC's remedies for a breach of contract.⁴⁶⁵ Although many of these rules leave the law in this area unchanged, because this new statute is a wholesale revision and includes many new clarifications and additions, creditors should thoroughly review this statute in order to make any needed modifications in their current forms and practices concerning personal property leases.

2. *Electronic Wire Transfers*

Chapter 4A provides a comprehensive system for regulating electronic wire transfers, described as "payment orders" in the chapter. This chapter was passed with the intent of providing a "fast, inexpensive and reliable" transaction in this area.⁴⁶⁶ In order to assure the rapid movement of funds through electronic systems, the new law provides that if a bank fails to accept an order that it is required by contract to accept, then it is liable for breach of contract.⁴⁶⁷ Also, in order to keep such orders inexpensive, conse-

462. TEX. AGRIC. CODE ANN. § 44.001(3) (Vernon Supp. 1994).

463. *See generally* TEX. BUS. & COM. CODE ANN. ch. 2A, ch. 4A (Tex. UCC) (Vernon Supp. 1994).

464. *See id.* §§ 2A.303, 2A.305, 2A.306, 2A.307, and 2A.308.

465. *See id.* § 2A.508 *et. seq.*, § 2A.523 *et. seq.*

466. HOUSE COMM. ON BUSINESS AND INDUS. BILL ANALYSIS 6, Tex. H.B. 1113, 73d Leg., R.S. (1993) (hereinafter BILL ANALYSIS H.B. 1113).

467. TEX. BUS. & COM. CODE ANN. §§ 4A.207, 4A.208, 4A.209 (Vernon Supp. 1994).

quential damages are generally barred under this statute unless expressly contracted for.⁴⁶⁸ Finally, such transactions are made more reliable by allocating losses to banks when there are mistakes in execution of the orders.⁴⁶⁹ Again, a lender should become thoroughly familiar with this statute's provisions.

E. CHOICE OF LAW CONTRACT PROVISIONS

House Bill No. 1113, previously discussed, amended the Business and Commerce Code to allow parties who enter into business transactions involving \$1 million or more the ability to stipulate in writing that their agreement will be governed by the law of a particular jurisdiction.⁴⁷⁰ For purposes of this section, a transaction is defined to include "more than one substantially similar or related transaction entered into contemporaneously and having at least one common party."⁴⁷¹ In general, the parties' choice of law concerning validity and enforceability of the contract will be upheld—even if the law chosen is contrary to the fundamental or public policy of Texas—as long as the jurisdiction chosen bears a "reasonable relation" to the transaction.⁴⁷² As for the interpretation or construction of the contract, the law of the jurisdiction chosen need not be reasonably related to the transaction.⁴⁷³ The new law includes a laundry list of factors for determining "reasonable relation."⁴⁷⁴ It also includes a fail-safe clause where if the chosen jurisdiction's law would disallow a provision of the contract, that jurisdiction's law is inapplicable *as to that provision*, and one then looks to the law which has the most significant relation to the transaction.⁴⁷⁵ This provision is based on the principle that parties should be held to the terms of their agreement and is implemented to eliminate the results in cases such as *Foreman v. George Foreman Associates, Ltd.*,⁴⁷⁶ where the provisions of a contract were rendered unenforceable when the law specifically chosen by the parties required that such provisions be rendered unenforceable.⁴⁷⁷ This statute does not apply to certain transactions such as those concerned with real property, marriage, adoption, wills and estates, or transactions which are covered by another state or federal statute which stipulates the choice of law.⁴⁷⁸

468. *See id.* § 4A.305(b)-(c).

469. BILL ANALYSIS H.B. 1113 at 6.

470. *See* TEX. BUS. & COM. CODE ANN. § 35.51 (Vernon Supp. 1994).

471. *Id.* § 35.51(a)(1).

472. *Id.* § 35.51(b).

473. *Id.* § 35.51(c).

474. *Id.* § 35.51(d).

475. *Id.* § 35.51(e).

476. 517 F.2d 354 (9th Cir. 1975).

477. BILL ANALYSIS H.B. 1113 at 9.

478. TEX. BUS. & COM CODE ANN. § 35.51(f) (Vernon Supp. 1994). The bill also amended the code to provide that a choice of law provision in a construction contract to be performed in Texas is voidable by the obligated party to perform the construction or repair if the provision stipulates the law of a state other than Texas. *Id.* § 35.52.

F. BULK SALES

House Bill No. 1113, previously discussed, repealed Chapter 6 of the Texas Business and Commerce Code concerning bulk sales. Such a repeal was implemented based on the professed reasoning that “[m]odern commercial and legal reality no longer supports the need for regulation of bulk sales transactions;” and “[t]he benefits to creditors no longer justify the costs to society of interfering with good faith bulk sales transactions.”⁴⁷⁹

G. TEXAS CREDIT CODE

1. *Punitive Damages for Material Violations*

The legislature adopted several amendments to the Texas Consumer Credit Code. The most important change—from a lender’s standpoint—amended the amount of damages that can be sought for certain violations of the Code.⁴⁸⁰ Before this change, lenders were subject to punitive damages for highly technical violations in situations where their instruments contained the wrong typeface or lacked certain technical disclosures.⁴⁸¹ Under the new law promulgated by House Bill No. 813, the prior law’s damages provision which allowed for punitive damages is applicable only if “the violation was material and the finder of fact determines that the violation induced the obligor to enter into a transaction into which the obligor would not have entered had the violation not occurred.”⁴⁸² For technical disclosure violations which are judged immaterial, the new penalty excludes punitive damages and instead is limited to “an amount not to exceed three times the actual economic loss suffered by the obligor as a result of the violation, together with reasonable attorneys’ fees fixed by the court. . . .”⁴⁸³ Many creditors believe that this law will effectively eliminate punitive damages in this area since the errors relied on in recent cases would not fall within the statute’s materiality requirements.⁴⁸⁴

2. *Involuntary Unemployment Credit Insurance*

House Bill No. 1598 amended Chapter Three of the Texas Credit Code regarding regulated loans, so that persons making a loan under this Chapter may offer involuntary unemployment credit insurance.⁴⁸⁵ Lenders under Chapter Six regarding retail installment contracts, already may offer this

479. BILL ANALYSIS H.B. 1113 at 2.

480. See TEX. REV. CIV. STAT. ANN. art. 5069-8.01 (Vernon 1987 & Supp. 1994).

481. WHITE PAPER, *supra* note 428, at 12.

482. TEX. REV. CIV. STAT. ANN. art. 5069-8.01(b)(2) (Vernon Supp. 1994).

483. *Id.* at art. 5069-8.01(b)(1).

484. WHITE PAPER, *supra* note 428, at 12.

485. See TEX. REV. CIV. STAT. ANN. art. 5069-3.18 (Vernon Supp. 1994). Involuntary unemployment insurance provides primary coverage for the repayment of a specified number of monthly payments of a loan or retail credit obligation when the insured involuntarily loses employment income. This type of insurance has been traditionally sold as group insurance along with a credit transaction or as credit card outstanding balance protection. See HOUSE COMM. ON INV. AND BANKING, BILL ANALYSIS 1, Tex. H.B. 1598, 73d Leg., R.S. (1993) (hereinafter BILL ANALYSIS H.B. 1598).

type of insurance.⁴⁸⁶ Now lenders may offer this product for other types of installment contracts. However, the legislature also amended Chapters Three and Four of the Credit Code so as to *prohibit* lenders from *requiring* the purchase of involuntary unemployment credit insurance.⁴⁸⁷ Therefore, although at first blush, the ability of lenders to offer this insurance should facilitate lending transactions, the fact that such transactions cannot be predicated upon the purchase of this insurance leaves in considerable doubt its utility.

3. Collateral Protection Insurance

House Bill No. 1598 also amends Chapter Two to require that lenders who demand collateral protection insurance must provide written notice to the borrower—at the borrower's expense—describing the type of insurance procured, the extent of the coverage, who the insurance is designated to protect, the policy period, the total cost to the borrower, and the rate of interest to be charged on the insurance premium.⁴⁸⁸

H. INTERESTS IN DAMAGED RESIDENTIAL REAL PROPERTY

Where a lender has a mortgage, lien, deed, or security interest in a borrower's insured residential real property and that property is damaged resulting in the insurance company making a claim payment, the lender can directly receive the payment and withhold all or part of it from the insured borrower.⁴⁸⁹ Under prior law, the lender was not required to remit the insurance proceeds or to notify the insured. This was perceived by the legislature as placing an undue burden on the insured borrower who must pay for the cost of repairs to the damaged residential property.⁴⁹⁰ The legislature adopted an amendment to the Insurance Code which basically requires the lender to notify the insured borrower no later than the tenth day after the lender receives the insurance proceeds, and to inform the borrower what conditions he must fulfill before the lender will release the proceeds.⁴⁹¹ Also, if the insured borrower requests the release of the proceeds, within ten days the lender must either release the funds or notify the borrower why the funds are not being released.⁴⁹² If the lender fails to give notice, then the lender shall be liable for interest at a rate of ten percent per year on the insurance proceeds.⁴⁹³ Interest accrues on the date that the lender receives the proceeds.⁴⁹⁴ Obviously, this law will necessitate that lenders implement some system to insure compliance with the ten-day notice period.

486. See BILL ANALYSIS H.B. 1598 at 1.

487. See TEX. REV. CIV. STAT. ANN. arts. 5069-3.18(1), 5069-4.02(1) (Vernon Supp. 1994).

488. See TEX. REV. CIV. STAT. ANN. art. 5069-2.09 (Vernon Supp. 1994).

489. See HOUSE INS. COMM. BILL ANALYSIS 1, Tex. H.B. 113, 73d Leg., R.S. (1993) (hereinafter BILL ANALYSIS H.B. 113).

490. *Id.*

491. See TEX. INS. CODE ANN. art. 21.48B (Vernon Supp. 1994).

492. *Id.* at art. 21.48B, § 2.

493. *Id.* at art. 21.48B, § 3.

494. *Id.*

I. USURY

1. *Usury Cure*

In the past session, the legislature has granted some relief to creditors who have found Chapter One of the Credit Code a “nightmare” regarding the ability to avoid usury violations, and as a result “have abandoned Texas and [its] economy entirely.”⁴⁹⁵ House Bill No. 2005 amended the Credit Code to grant to lenders who have “actually discovered” a usury violation under that Code, a sixty day grace period during which they have the opportunity to take whatever actions and to make whatever adjustments are necessary in order to correct the usury violation.⁴⁹⁶ The term “actually discovered” means discovery *in fact* and the term “may not be construed, interpreted, or applied in a manner that refers to the time or date when, through reasonable diligence, an ordinarily prudent person could or should have discovered or known as a matter of law or fact the violation in question. . . .”⁴⁹⁷ This statute also includes a one-time all-inclusive grace period which grants persons who have known of usury violations in contracts for more than sixty days the opportunity to cure those defects before March 1, 1994.⁴⁹⁸

However, this limited all-purpose grace period may be, for practical purposes, superfluous. If the fairly thorough prohibition against using a date based on reasonable diligence withstands a court’s twisting of the statute’s syntax, then, as a practical matter, this means that the evidence of the date of actual discovery put forward by the lender will be extremely difficult to overcome by the obligor. Since this issue will turn on the subjective factor of knowledge, the obligor will be hard pressed to discover any evidence from the bank itself which would contradict the bank’s evidence concerning the discovery date.

In fact, a lender could cure a violation that has existed for many years if it can present some evidence that it has just learned of the violation. This may not be too difficult, since many recent court cases finding usury violations concern fairly technical issues such as fees and contingencies—and not blatant violations such as an explicit usurious interest rate. Therefore, it seems very plausible that a bank would not discover that one of its contracts contains a usury violation—even one entered into years ago—until a court case ruled that a similar fee or contingency provision was usurious.⁴⁹⁹

2. *Asset-Backed Securities*

A new change to the Texas usury laws should greatly facilitate the ability of Texas financial institutions and businesses to engage in asset securitiza-

495. HOUSE COMM. ON INV. AND BANKING, BILL ANALYSIS 2, H.B. 2005, 73d Leg., R.S. (1993) (hereinafter BILL ANALYSIS H.B. 2005).

496. TEX. REV. CIV. STAT. ANN. art. 5069-1.06(4)(A) (Vernon Supp. 1994).

497. *Id.* at art. 1.06(4)(B).

498. *Id.* at art. 1.06(4)(C).

499. See discussion concerning *Tony’s Tortilla Factory*, *supra* notes 199-207 and accompanying text.

tion.⁵⁰⁰ Senate Bill No. 551 enacts a technical clarification so that the definition of "interest" for usury purposes does not include sums paid or passed through to the holders of asset-backed securities.⁵⁰¹ Prior to this enactment, the Texas usury laws applied to asset securitization which placed Texas financial institutions and issuers of such securities at a competitive disadvantage. Furthermore, since such securities are typically issued through a special corporation or trust, the usury laws also limited the ability of Texas businesses to serve in this capacity since Texas businesses were limited in their ability to benefit from the legal fees, trustee fees, and processing fees associated with these transaction.⁵⁰² This amendment does not affect interest paid on the underlying asset.

J. DURABLE POWER OF ATTORNEY

The legislature has enacted a standard statutory form for a durable power of attorney and the rules governing this form; and has repealed the prior statutory provisions concerning the durable power of attorney.⁵⁰³ A detailed analysis of this general act is beyond the scope of this Survey, but briefly, financial institutions should be aware that under this new chapter, the statute provides that the revocation of the durable power of attorney is not effective as to a third party until the third party receives *actual* notice of the revocation.⁵⁰⁴ Also, the third party may require the holder of the durable power of attorney to execute an affidavit attesting to the fact that at the time the holder executed the power he did not have actual knowledge of the termination of the power.⁵⁰⁵ Furthermore, the standard form for a statutory durable power of attorney provides that the third party is indemnified for any claims that arise based on its reliance on the durable power of attorney.⁵⁰⁶

This act also spells out the limits of a durable power of attorney in specific transaction areas such as tax, litigation, real property, insurance, family matters, estate and trust, and banking. Concerning the construction of this power relating to banking and other financial institution transactions, a holder of a durable power of attorney may have the power to, inter alia: (1) continue, modify, or terminate an account; (2) establish, modify, or terminate an account selected by the attorney in fact; (3) hire a safe deposit box; (4) contract for other services from a financial institution; (5) withdraw by

500. Generally, asset securitization consists of raising funds via the sale of securities backed by a segregated pool of assets. Typically, such asset pools may consist of credit card receivables, equipment leases, automobile or boat loans, and commercial or residential mortgages. See SEN. COMM. ON INV. AND BANKING, BILL ANALYSIS 1, S.B. 551, 73d Leg., R.S. (1993) (hereinafter BILL ANALYSIS S.B. 551).

501. See TEX. REV. CIV. STAT. ANN. art. 5069-1.13 (Vernon Supp. 1994).

502. See BILL ANALYSIS S.B. 551 at 1.

503. See Durable Power of Attorney Act, 73d Leg., R.S., ch. 49, § 1, 1993 Tex. Gen. Laws 102-13 (Vernon) (codified at TEX. PROB. CODE ANN. ch. XII, § 481-506 (Vernon Supp. 1994)).

504. *Id.* § 488.

505. *Id.* § 487.

506. *Id.* § 490.

check, money, or property; (6) receive bank statements; (7) enter a safe deposit box or vault and add or withdraw its contents; (8) borrow money, pledge security, and renew or extend debt; (9) engage in transactions concerning negotiable or nonnegotiable paper; (10) receive and act on a sight draft, warehouse receipt, or other negotiable or nonnegotiable instrument; (11) apply and receive letters of credit, credit cards, and traveler's checks; and (12) agree to the extension of time of payment with respect to commercial paper or other financial transactions.⁵⁰⁷ In other words, there is very little that a durable power of attorney cannot do concerning transactions with financial institutions.

K. MULTI-PARTY "CONVENIENCE ACCOUNTS"

In an extensive reworking of the law in this area, well beyond the scope of this Survey, the legislature amended the Texas Probate Code to update the law regarding decedent's estates, multiple-party accounts, trusts, and other relevant areas. The most important changes from a bank's perspective concern the new rules regarding certain multi-party accounts. Under House Bill No. 1285, the legislature authorized the creation of "convenience accounts."⁵⁰⁸ This type of account is entirely owned by the named party. As a result, the convenience party can be the co-signer on the account without acquiring an ownership interest or having received a gift of the account. More importantly for the bank, the law completely releases it from liability for any payment made from the account before it receives notice not to make payments from the account.⁵⁰⁹ This immunity includes payments made to the convenience party after the owner's death but before receiving notice of the death.⁵¹⁰ It also extends to payments made to the personal representative of the deceased owner before service of a court order prohibiting such a payment.⁵¹¹ Also, the law includes a uniform single-party or multi-party account form that can be utilized in its entirety or modified by a financial institution.⁵¹²

507. *Id.* § 496.

508. *See* TEX. PROB. CODE ANN. § 438A (Vernon Supp. 1994). This exact same section and statutory language was also passed by the legislature under House Bill No. 1200. *Compare* Act of June 19, 1993, 73d Leg., R.S., ch. 846, § 27, 1993 Tex. Gen. Laws 3349 *and* Act of June 18, 1993, 73d Leg., R.S., ch. 795, § 1, 1993 Tex. Gen. Laws 3154.

509. TEX. PROB. CODE ANN. § 438A(f) (Vernon Supp. 1994).

510. *Id.* § 438A(g).

511. *Id.*

512. *See* TEX. PROB. CODE ANN. § 439A (Vernon Supp. 1994).

