Commercial Real Estate Loan Defaults and Remedies (TX)

A Practical Guidance® Practice Note by
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This practice note discusses standard borrower defaults and lender remedies in commercial real estate financing transactions in Texas, with a focus on the nonjudicial foreclosure process. It also provides an overview of deeds in lieu of foreclosure and receivership under Texas law. This note includes negotiation tips and best practices for counsel to the borrower and the lender.

For further guidance, see Commercial Real Estate Financing Transactions (TX), Foreclosure of Real Property, Bankruptcy Issues Affecting Real Estate Loan Transactions, and Workouts of Commercial Real Estate Loans.

For related forms and additional resources, see Commercial Real Estate Acquisition Loan Resource Kit (TX).

Background and Structure

Commercial real estate loan documents in Texas, like in all other states, are often highly negotiated. Lenders want to protect their interest by (1) structuring the loan to ensure that the real property can service the debt and (2) restricting the borrower—using affirmative and negative covenants—from taking actions that could result in additional risk to the property or its cash flow. When a borrower has violated its obligations and covenants under the loan, the borrower is in default. Lenders usually have a broad range of remedies available to them in order to recoup the distributed loan amount.

Loans can be structured as:

- Full recourse loans, where the borrower is responsible for the full amount of the loan once lender has exercised its rights against the collateral
- Nonrecourse loans, where the lender can go after the collateral secured by the loan only and cannot seek deficiency from the borrower –or–
- Nonrecourse loans with carve-outs, where the loan is nonrecourse except for certain circumstances, such as fraud, misappropriation, and bankruptcy, which allow for the lender to seek the full loan amount or certain expenses or losses from the borrower

Typically, commercial real estate lenders structure their loans as nonrecourse loans with carve-outs.

If there is a guarantor, the guarantor may be liable for the full loan amount or may be guaranteeing only the nonrecourse carve-outs of the borrower. Of course, when the borrower is structured as a single purpose entity (SPE), there is little value in the borrower entity other than its interest in the property. In assessing any potential remedy following a default, the lender will need to take into account the specific recourse obligations and financial capabilities of the borrower and guarantor.

In Texas, a deed of trust is the primary instrument used to secure a loan on commercial real estate. A deed of trust creates a nonpossessory lien on the mortgaged property in favor of the lender who is granted a power of sale that is exercised by the trustee. Johnson v. Snell, 504 S.W.2d 397 (Tex. 1973).

Loan Defaults

Borrower defaults under loan documents usually fall into one of two buckets: monetary defaults or nonmonetary defaults. The type of default will affect how the lender chooses to exercise its remedies or whether it instead considers a forbearance or workout scenario with the borrower. Lenders are more likely to waive or extend cure periods for nonmonetary defaults than for monetary defaults, and are more likely to proceed with remedies once the borrower has stopped paying the amounts it owes.

Monetary Defaults

A monetary default arises when the borrower fails to pay interest, principal, or other amounts that it owes to the lender under the loan documents. This could be a failure to pay debt service, reserve replenishment amounts, default interest, or legal fees. Loan documents often do not give the borrower a cure period for monetary defaults; however, some lenders may allow for very short cure right (e.g., 10 days or less). Lenders will usually not permit any cure right for a monetary default at maturity of the loan.

Nonmonetary Defaults

A nonmonetary default is triggered when the borrower breaches a term, covenant, representation, warranty, or condition of the loan agreement. Lenders often agree to provide the borrower with notice of a default and a cure period (usually up to 30 days) for certain nonmonetary defaults.

Covenants

Affirmative covenants are actions that the borrower agrees to take, while negative covenants are actions that borrower agrees to refrain from taking.

Standard affirmative covenants include:

- Financial reporting to the lender
- Complying with financial covenants
- Maintaining SPE status
- Complying with applicable law
- Maintaining insurance on the real property
- Paying and complying with third-party obligations, such as other debt, real estate taxes, insurance, and contractual obligations
- Allowing the lender to physically inspect the premises and conduct environmental testing
- Notifying the lender of a default, event of default, or litigation

There may be covenants that are specific to the type of property or related features, such as compliance with a franchise agreement for a hotel, or condominium documents, a reciprocal easement agreement, or a declaration affecting the property.

Standard negative covenants prohibit the borrower from:

- Incurring additional debt
- Cross-collateralizing the security
- Incurring any additional liens or encumbrances
- Failing to maintain the property or pay the taxes on it or committing waste
- Selling or transferring the property
- Selling or transferring any ownership interests in the SPE
- Entering into additional leases or amending existing leases, except pursuant to preapproved guidelines
- Amending its organizational documents
- Failing to comply with environmental regulations
- Taking any action to affect the zoning of the property

Financial Covenants

There are a number of financial covenants that the lender may use to measure the performance of the property or the financial health of the borrower or guarantor:

- **Debt Service Coverage Ratio (DSCR).** DSCR is the annual net operating income (NOI) produced by the real property divided by the annual debt service (interest and any required principal amortization) due to the lender. This covenant is used to measure the level of cash flow available to service the debt. Lenders will usually require a 1.2 DSCR, meaning the property is able to support a positive cash flow.
- **Debt Yield (DY).** DY is the annual NOI as a percentage of the outstanding loan amount. DY gives the lender a sense of how long it would take to recoup the outstanding loan amount if it foreclosed on the loan and held and operated the property rather than selling it. Lenders will usually require a DY of at least 10%.
- **Loan-to-Value Ratio (LTV).** LTV is the outstanding loan amount as a percentage of the appraised value of the property. The lender uses LTV to assess whether the value of the property is sufficient to serve as collateral for the loan. Lenders usually limit LTV to no more than 70%.
- **Guarantor liquidity and net worth.** Lenders often require that the guarantor maintain a sufficient level of liquidity (for immediately available funds) and overall net

worth in order to pay its guaranteed obligations. Lenders measure net worth and liquidity requirements at certain testing periods to confirm that the guarantor is satisfying the covenants. Typical requirements are 10% of the loan amount for liquidity and 100% of the loan amount for net worth.

Representations and Warranties

A nonmonetary default can also occur if the borrower has breached a representation or warranty contained in the loan documentation. Representations and warranties are made as of the closing date, and the lender will include related covenants in the loan documents if the representation is one that the borrower must make on an ongoing basis. The borrower usually brings down representations and warranties when the lender makes post-closing disbursements or extends the loan.

Typical representations and warranties from the borrower include the following:

- The borrower has the necessary right, power, and authority to enter into the loan documents.
- The borrower holds title to the property, free of all liens and encumbrances other than those that the borrower disclosed to the lender.
- There is no litigation affecting the borrower or the property.
- The disclosures made to the lender to induce lender to make the loan, including the financial data of the borrower and guarantors, are true and correct.
- The borrower has all permits necessary to own, occupy, and operate the real property.
- The real property securing the loan complies with all applicable laws and local ordinances.
- The borrower is not subject to trade restrictions under the Patriot Act or the Office of Foreign Assets Control sanctions laws.

SPE Status

Lenders will typically require that the sponsors create a new SPE to hold title to the property as its sole asset, without any other debts or obligations. The SPE will necessarily be free of other debts and obligations. The SPE structure insulates the lender's collateral from claims by other creditors of the sponsors (so long as the borrower maintains the SPE covenants). The SPE also provides protection to the lender if the SPE files for bankruptcy. If the lender is looking to lift the automatic stay and proceed with a foreclosure, it will likely face fewer hurdles if the property is held by an SPE compared to an entity with multiple assets or businesses. For larger loans, the lender will also require that the SPE be bankruptcy remote.

Typical SPE covenants to include in the loan documents and in the organizational documents of the SPE include those that require the borrower to:

- Limit the nature, purpose, and conduct of its business to solely acquiring, owning, holding, leasing, operating, managing, maintaining, and improving the real property and to contracting for the operation, maintenance, management, and improvement of the real property
- Observe all limited liability company formalities necessary to maintain its separate existence
- Not commingle its assets or funds, including bank accounts, with those of any other person or entity
- Maintain its assets in such a manner that it is not costly or difficult to segregate such assets from those of other persons or entities
- Hold all its assets and conduct all its business in its own name, and not that of any other person or entity
- Not pledge any of its assets for the benefit of any other person or entity, other than the lender under to the loan documents
- Hold itself out to its creditors and the public as a legal entity separate and distinct from any other person or entity

Given the significant protections in place as a result of the SPE status, lenders are quick to exercise remedies for a failure to comply, and this type of failure is also usually a nonrecourse carve-out for the guarantor.

Additional Debt/Liens

Lenders usually prohibit borrowers from incurring additional debt or creating additional liens on the real property (whether through subordinate debt, mechanic's liens, tax liens, or other encumbrances) that the loan documents do not contemplate or that are not already in place at loan origination, such as mezzanine financing. For more on mezzanine financing, see Commercial Real Estate Mezzanine Financings and Intercreditor Agreements (Mortgage Lender and Mezzanine Lender).

The loan documents may allow for operational debt subject to certain limitations (e.g., no more than 1%–2% of the original loan and extending no more than 60–90 days).

Transfers

Transfer of the property will typically trigger a due-on-sale clause requiring the borrower to repay the loan as part of the sale.

Loan documents also typically prohibit transfers of direct and indirect interests or control in the borrower without lender consent. The lender may agree to permit transfers up to certain thresholds (usually under 20% of the indirect interests in the borrower or in connection with estate planning) without lender consent. The purpose of these restrictions is to make sure that the control of the borrower remains with the people who the lender conducted due diligence on at the origination of the loan. Additionally, the lender will likely have search and "know your customer" requirements that it must undertake for people or entities owning interests in the borrower over certain thresholds.

Lender Remedies

Once a default has occurred, Texas requires the lender to deliver certain notices to the borrower unless the borrower has waived them (see "Acceleration" and Nonjudicial Foreclosure Sale below). Additionally, if the loan documents provide a cure period in connection with a default, the lender must allow the cure period to run before exercising its remedies. Once the cure period, if any, has expired, lenders have a number of rights and remedies available to them in order to protect their collateral and obtain repayment of the loan.

Protection of Rents

Upon a borrower default, the lender should quickly take steps to protect its collateral. Below is a discussion of various options available to the lender to protect the property's cash flow and ensure that it will remain available to the lender.

Cash Management and Lockbox Provisions

A lockbox structure gives the lender a measure of control over the cash flow of the property. Cash management provisions are contained either in the loan agreement / deed of trust or in a standalone agreement. The provisions establish a lender-controlled account that the borrower opens with a deposit bank and can provide for either a soft or hard lockbox account:

- **Soft lockbox.** A soft lockbox requires the borrower or property manager to deposit funds directly into the account, but the funds then flow directly to the borrower.
- **Hard lockbox.** A hard lockbox requires that tenants deposit rental payments directly into the lockbox account. The borrower has view-only access to the account activity details, and the loan documents dictate how the funds in the account are applied and distributed. Typically, the funds first go toward tax and insurance escrows, debt service payments, and any other forced escrow accounts (e.g., repair or interest reserve escrows), and then any remainder goes to the borrower.

A lockbox account can be in place at closing or it can be springing, meaning that certain triggers activate the account. In many cases, lenders require a hard lockbox once triggering events are met. These triggers usually include a default under the loan or failure to meet certain DSCR thresholds, but may also include failure of an anchor tenant to renew a lease or a default or termination of a tenant lease. A borrower usually has the right to cure a lockbox trigger event, in which case the property's cash flow would no longer go through the lockbox unless and until another trigger event occurs.

Following an event of default, the lender often has the right to apply all funds in the cash management account toward the outstanding debt.

For cash management language to include in your loan agreement, see Cash Management Clause (Acquisition Loan Agreement). For a form of cash management agreement, see Cash Management Agreement.

Assignment of Leases and Rents

Texas law on assignments of leases and rents changed significantly in 2011 with the passage of the Texas Assignment of Rents Act (TARA) (Tex. Prop. Code Ann. §§ 64.001–64.062). Under TARA, a deed of trust automatically creates an assignment of rents regardless of whether or not the deed of trust contains an assignment of rents clause, and a separate assignment of leases and rents is no longer necessary. (Note, though, that most lenders still require an independent assignment of leases and rents as part of the loan documentation.) Effectively, the assignment under TARA creates a security interest in all accrued and unaccrued rents arising from the property securing the loan. This differs from the old common law, where an absolute assignment of rents clause transferred title to the lender and gave the borrower only a license to collect rent.

After a borrower defaults, the lender may choose to enforce its rights either by collecting rents from the borrower or by collecting rents directly from the tenant. The lender has the authority to collect all unpaid and future rents directly from the borrower as long as the lender notifies the borrower of its intent to enforce collection of rents. Generally, the borrower has 30 days from the time the borrower receives notice to turn over any rent

proceeds. If the borrower fails to comply, the lender can bring a civil action to collect the proceeds and reasonable attorney's fees and costs.

The lender may also collect rents directly from the tenant upon the borrower's default so long as it provides notice to the tenant that it demands direct payment of all unpaid rents and future rents. Once a tenant receives proper notice, it must remit all rent payments directly to the lender (unless the tenant previously received notice from another assignee of rents, in which case the tenant would continue paying the prior assignee). If the tenant instead remits payment to the borrower, the tenant is not discharged of its obligation to the lender, subject to one exception: If the tenant occupies the premises as its primary residence, the tenant may satisfy its obligations by remitting payment to either the borrower or the lender.

Once a tenant receives a rent collection notice from the lender, the tenant is not in default until the earlier of:

- The 10th day after the date the next regularly scheduled rental payment would be due –and–
- The 30th day after the date the tenant receives notice (unless the tenant has signed a document providing otherwise)

The lender must apply collected rents in the following order:

- Reimbursement for the lender's expenses in enforcing the assignment, including reasonable attorney's fees and costs
- Reimbursement of expenses the lender incurred to protect or maintain the property
- Payment of the secured obligation
- Payment to holders of subordinate security interests, if the lender receives a signed notice demanding payment
- Distribution of any excess proceeds to borrower

For more on assignments of leases and rents generally, see Assignment of Leases and Rents in a Commercial Real Estate Loan Transaction. For a form of assignments of leases and rents to use in Texas, see Assignment of Leases and Rents (TX).

Interest and Charges

Lenders will typically have the right to charge default (additional) interest on the outstanding loan amounts or to impose a late charge (usually 5% of the unpaid amount) when the loan is in default.

Setoff / Application of Escrow Amounts

While escrows are subject to the lien of a UCC-1 filing, lenders also often have the right to sweep all reserve funds following an event of default and apply them toward the outstanding balance of the loan. The lender should take this step quickly after calling a borrower default, particularly if there is a concern that the borrower might file bankruptcy.

Acceleration

Once a default has occurred and the borrower has failed to cure, the lender typically accelerates the loan, meaning that all of the outstanding amounts under the loan documents become due and payable. Texas law requires a notice of intent to accelerate (and lenders often include this language in the notice of default). See Ogden v. Gibralter Sav. Asso., 640 S.W.2d 232 (Tex. 1982). Unless the borrower specifically waives the notice of intent to accelerate in the loan documents, acceleration will not be valid without the notice.

After the cure period in the notice of default and notice of intent to accelerate expires, the lender sends a notice of acceleration confirming that the loan has been accelerated (unless the borrower waived this notice). The lender usually includes the notice of acceleration in the notice of foreclosure, if the lender elects to pursue a nonjudicial foreclosure. Once the lender accelerates the loan, the borrower can prevent a foreclosure only by paying the entire amount of the loan (rather than just the late payment, in the case of a monetary default). At that point, the lender is no longer obligated to accept a partial payment of the loan.

After the lender accelerates the loan, it is important for the lender to coordinate with its servicer on monthly bills and other borrower correspondence. The servicer should be careful not to send any notices to the borrower indicating that less than the full amount is due under the loan. This type of notice could be grounds for a temporary restraining order against a future foreclosure sale, as the borrower could argue that it did not receive clear and unequivocal notice of the acceleration. See Allen Sales and Service Center v. Ryan, 525 S.W.2d 863 (Tex. 1975).

Enter, Manage, and Control

The loan documents may give the lender the right to take control of the property and act as the operator. However, by exercising this right, the lender runs the risk of becoming a mortgagee in possession under Texas law; the lender could then be liable under leases at the property or for assessments (private or public) on the property.

Uniform Commercial Code (UCC) Foreclosure Sale

The lender, as a secured party under the UCC, can elect to foreclose on the personal property of the borrower with a UCC foreclosure under Article 9 of the Texas Business and Commerce Code. A foreclosure of personal property under Article 9 is a similar process to a nonjudicial foreclosure. The UCC states that the lender must give "reasonable notice" of the foreclosure of the property (Texas courts have generally found at least 10 days' notice before the sale to be reasonable) and must conduct the sale in a "commercial reasonable" manner.

A party can redeem the personal property collateral after a UCC foreclosure sale by tendering the full required amount, so long as it does so before the secured party:

- Collects the collateral (such as accounts)
- Disposes of the collateral or enters into a contract for disposition –or–
- Accepts the collateral in full or partial satisfaction of the secured debt

Deed In Lieu of Foreclosure

If a borrower is willing to walk away from the property, the lender may decide to accept a deed in lieu of foreclosure transferring the property to lender (or its affiliated designee) in satisfaction of the outstanding debt. Flag-Redfern Oil Co. v. Humble Exploration, Co., 744 S.W.2d 6 (Tex. 1987).

While there are some benefits to a deed in lieu of foreclosure—such as lender obtaining immediate control over the property, avoiding costs and expenses of a foreclosure sale, and avoiding a potential bankruptcy filing—a deed in lieu does not offer some of the benefits of a foreclosure sale, such as extinguishing subordinate liens. Texas law does protect the lender against certain subordinate liens: If the borrower failed to disclose liens or other encumbrances on the property and the lender had no notice of those liens, Tex. Prop. Code Ann. § 51.006 allows a lender to void the deed in lieu of foreclosure within four years after the transfer date. (Note that recording of a lien constitutes notice to all parties. Flag-Redfern, 744 S.W.2d at 7.)

Additionally, the lender may foreclose its debt, which extinguishes any subordinate liens, without voiding the deed in lieu of foreclosure. If the lender is willing to accept a deed in lieu, the lender must conduct proper diligence to uncover and assess any new encumbrances on the property. Further, in the deed in lieu of foreclosure agreement, the lender should clearly indicate:

- Whether the debt is being fully discharged –and–
- Whether the lender retains rights to seek a deficiency

The agreement should also include a clear non-merger provision stating that the deed of trust is not merging with the deed transferring the property.

Receiverships

If the lender is not yet willing to take title to the underlying collateral, it can still maintain a measure of control over the property by seeking a receivership. See Tex. Bus. Orgs. Code Ann. § 11.403 and Tex. Civ. Prac. & Rem. Code Ann. § 64.001. A receivership allows the lender to protect the property while retaining more control than it would through a bankruptcy filing. In order to obtain a receivership, lender must be able to show that there is some imminent harm, loss, or waste to the property.

Appointing a Receiver

Under Tex. Bus. Orgs. Code Ann. § 11.403(b), a court may appoint a receiver for the property only if:

- Circumstances exist that, in the court's view, necessitate the appointment of a receiver to conserve the property and avoid damage to interested parties
- All other requirements of law are complied with
- The court determines that other available legal and equitable remedies are inadequate –and–
- In certain instances, the lender has shown that the property is in danger of being lost, removed, or materially injured

Under Tex. Civ. Prac. & Rem. Code Ann. § 64.001, a court may appoint a receiver over the property:

- In an action by a creditor to subject the property to its claim
- In an action between partners or others jointly owning or interested in the property
- In an action by a mortgagee for the foreclosure of the mortgage and sale of the mortgaged property –or–
- Subject to certain conditions, in any other case in which the court may appoint a receiver under the rules of equity

In these cases, the party filing for the receivership must have a probable interest or right to the property, and the property must be in danger of being lost, removed, or materially injured.

Receivership Order

The receivership order sets forth the duties, power, and authority of the receiver. A lender will want these enumerated powers to be expansive and include the power to sell the property out of the receivership. If the receiver's authority is more limited, the lender may be forced to return to court to have additional powers granted to the receiver.

A property can be foreclosed while in a receivership, but Texas law typically requires court approval. First Southern Properties, Inc. v. Vallone, 533 S.W.2d 339 (Tex. 1976). While the receivership does mean that the lender loses some control over the collateral, the flexibility and tailoring available for the receivership order allows the lender to make sure that its needs are appropriately addressed.

For further guidance on receiverships, see Receivership in Real Estate Transactions.

Nonjudicial Foreclosure Sale

In Texas, the foreclosure process is very lender friendly. Foreclosures are governed by Tex. Prop. Code Ann. § 51.002. The statute is controlling with respect to the procedures it contains, and the borrower and lender generally cannot waive them.

Preliminary Steps

A nonjudicial foreclosure in Texas can take as few as 25 days, once lender has conducted its initial due diligence, but there are certain lead-time items a lender should undertake:

- **Appraisal.** The lender should get an appraisal of the property as it evaluates its options and remedies, including foreclosure or sale of the note. The appraisal will identify whether there is equity in the property.
- **Title search.** The lender should order an updated title search on the property for several reasons, including to:
    - Support additional defaults against the borrower, such as mechanic's lien filings that the lender had not received notice of
    - Review any existing easements or recorded leases that the deed of trust may be subordinated to, and assess whether these agreements should survive the sale
    - Learn more about the property the lender will likely obtain title to, including any mineral rights or covenants, conditions, and restrictions affecting the property
- **Tax lien search.** If there is a federal tax lien on the property, the lender must give the Internal Revenue Service (IRS) notice of the foreclosure sale at least 25 days prior to the sale. 26 U.S.C. § 7425(c)(1). The IRS has 120 days to redeem the property after a foreclosure sale. 26 C.F.R. § 301.7425-4. A tax lien will have priority over the recorded deed of trust and survive the foreclosure sale. Note that in Texas, the lender is not required to give notice to any other junior lienholders. Chandler v. Orgain, 302 S.W.2d 953 (Tex. Civ. App. 1957).
- **Environmental report.** Lenders typically like to get a Phase I report on the property before proceeding with a foreclosure sale to evaluate environmental issues that may have arisen after the origination of the loan. If environmental issues are present, the lender may choose to have a receivership put on the property rather than proceeding with the foreclosure sale to avoid liability that could come from being in the chain of title.

Procedural Requirements and Considerations

While Texas has an expedited nonjudicial foreclosure procedure, there are a number of strict statutory and judicially required actions that the lender must complete to take advantage of the process.

Notices

The lender must provide certain notices, unless the borrower waived them in the loan documents. The borrower will likely try to claim that the lender did not follow the required notice provisions as an attempt to get a temporary restraining order enjoining the sale. As a result, it is important for lenders to follow the requirements exactly, and it is prudent to send the notices even if the loan documents included waiver language.

- **Notice of default and intent to accelerate.** Lenders will often combine these notices in a single letter. As discussed above in "Acceleration," the lender must provide a notice of intent to accelerate the loan unless the borrower specifically waived it in the loan documents; waiver of notice of acceleration is not sufficient. The notice states the applicable defaults and provides a cure period after which time the loan will be accelerated. Loan documents typically have no cure period for monthly payments, 10-day cure periods for all other monetary defaults, and 30-day cure periods for all other defaults. Even if there is no applicable cure period in the loan documents, in order to minimize wrongful foreclosure risk, it is prudent to include at least 10 days' notice.
- **Notice of sale.** This notice sets (1) the amount of the debt being foreclosed, (2) the date and time of sale, (3) the legal description of the property, and (4) the name

and address of the trustee or substitute trustee. See Tex. Prop. Code Ann. § 51.002. Foreclosure sales in Texas take place on the first Tuesday of the month between 10:00 a.m. and 4:00 p.m. at the county courthouse where the property is located. Note that the law was changed in 2017: Foreclosure sales that would have been scheduled for January 1st or July 4th now take place on the immediately subsequent Wednesday. This notice is filed with the county clerk in the county where the property is located and is posted (typically on a bulletin board) in a designated area in the county courthouse. Of course, some deeds of trust will have additional requirements regarding posting for foreclosure, so be sure to review them for compliance.

- **Notice of foreclosure and acceleration.** This notice formally accelerates the loan and notifies the borrower of the sale. It is sent by certified mail and transmits a filed copy of the notice of sale to the borrower. The borrower must receive notice of the sale at least 21 days prior to the date of the sale (with the date of posting included in that period). Tex. Prop. Code Ann. § 51.002(b); see Hutson v. Sadler, 501 S.W.2d 728 (Tex. Civ. App. 1973).

Day of Sale

TRO / Bankruptcy Risks

The day of the sale, the lender should run PACER and litigation searches on the borrower and in the county where the property is located to make sure that the borrower has not filed a temporary restraining order or filed for bankruptcy, either of which would prevent the lender from moving forward with the sale. If the borrower obtains a temporary restraining order (which, given the expedited foreclosure process, judges are inclined to grant), then a hearing is set for 14 days.

Subordinations

One of the benefits of a foreclosure sale is that it extinguishes all subordinate liens affecting the property, including mechanic's liens, leases, and contracts. Mortgage and Trust, Inc. v. Bonner and Co., 572 S.W.2d 344 (Tex. Civ. App. 1978). (Note, though, that a mechanic's lien over removable fixtures is a preference lien that is superior to a prior recorded deed of trust. See Tex. Prop. Code Ann. § 53.123.)

There are cases where a lender may not want certain items extinguished. If there is an easement benefiting the property that is subordinate to the deed of trust, the lender may decide to subordinate the deed of trust to that easement in order to make sure it stays in place. Even if the easement runs with the land and would therefore not be extinguished by the deed of trust, lenders sometimes prefer to err on the side of caution and subordinate the deed of trust.

Often, the lender will file a subordination agreement to subordinate the deed of trust to existing leases on the property. This similarly preserves those leases so that the foreclosure sale does not extinguish them. The lender should file these subordinations of the deed of trust immediately before the sale.

SPE / Assignment of Loan

Typically, a lender will set up an SPE to take title at the foreclosure sale to minimize risk to the lender as a property owner. Since the SPE will be credit bidding (as discussed below), it is prudent to assign the loan to the SPE immediately prior to the sale instead of relying on the fact that the SPE is a wholly owned subsidiary of lender. While having the SPE credit bid for the lender has not been successfully challenged, the borrower may still argue to overturn the foreclosure sale on such grounds. To avoid this, the lender should structure the loan so that the entity credit bidding for the property is the same as the entity holding the loan.

Substitute Trustee

As Texas is a deed of trust state, the trustee or any substitute conducts the foreclosure sale on behalf of the lender. If the original trustee is not available, the lender can designate a substitute trustee to conduct the sale. The law does not require the substitution document to be recorded in the property records. However, if the loan documents include this step as a requirement (which they often do), it must be complied with to make the substitution effective. Johnson v. Koenig, 353 S.W.2d 478 (Tex. Civ. App. 1962).

Foreclosure Sale

As noted, the foreclosure sale in Texas takes place on the courthouse steps on the first Tuesday of every month in the county where the property is located. The sale must start within three hours of the initial start time posted in the notice of sale. The lender may suspend and restart the sale so long as it commences within that three-hour window. It is prudent to try to finish the sale within the three-hour time period as well.

The substitute trustee conducting the sale will need to identify the property, the terms of the sale, and any liens that will survive the foreclosure sale. It can be helpful to have copies of the legal description and notice of sale available to give to potential bidders to prevent the argument that bidding was chilled by not correctly identifying the property.

In Texas, the lender may credit bid, meaning that as part of the foreclosure sale process, the lender can bid against the amounts that the borrower owes. See McClure v. Casa Claire Apartments, Ltd., 560 S.W.2d 457 (Tex. Civ. App. 1977). The lender will need to set a bidding schedule starting at a fair value of the property and ending at the full credit bid amount (i.e., all amounts that the borrower owes to the lender, including expenses and attorney's fees). Any third-party purchaser must pay with cash, wire transfer, or a cashier's check. The lender also has the right to extend credit to a purchaser at the foreclosure sale. Chase v. First Nat'l Bank, 20 S.W. 1027 (Tex. Civ. App. 1892).

The lender can decide not to conduct the sale at any time, and no formal actions are required to abandon a foreclosure sale. If the lender wants to proceed with a foreclosure sale the next month, it must repost the notice of sale and send the notice to the borrower within 21 days before the new foreclosure date.

After the sale, the lender executes the substitute trustee's deed transferring the property and either provides it to the successful third-party bidder or, if the lender's SPE is the successful bidder (as is usually the case), files the deed immediately with the county clerk.

There is no right of redemption for a borrower in Texas once the sale has been concluded. Hampshire v. Greeves, 143 S.W. 147 (Tex. 1912).

Judicial Foreclosure Sale

It is fairly rare to have a judicial foreclosure sale in Texas given the accelerated timeline available to lenders in nonjudicial sales. A judicial foreclosure sale will take a significantly longer time period to finalize (since the court's schedule will determine the timing) and it will be substantially more expensive. With a judicial foreclosure, the lender has to prove the default allowing for the foreclosure sale. The borrower has the opportunity to defend against the default claims. If the lender is successful, the court will set the date for the foreclosure. There is a four-year statute of limitation on a suit to foreclose a deed of trust lien. See Tex. Civ. Prac. & Rem. Code Ann. § 16.035(e).

Deficiencies

If a loan is recourse to the borrower and/or the guarantor and the purchase price of the property at a foreclosure sale does not satisfy the full amount of the debt owed to the lender, the lender might be able to seek a deficiency from the borrower and/or the guarantor by suing on the note or guaranty. The loan documents will set out the rights and obligations of the parties on deficiencies. The obligor has a right to request that courts use the fair market value of the property to compute the deficiency under Tex. Prop. Code Ann. § 51.003. However, if this right is waived in the loan documents—as is typically the case—the court will use the foreclosure sale to compute the deficiency amount. For waiver language to include in your deed of trust, see Section 6.12 of Deed of Trust (TX).

Tex. Prop. Code Ann. § 51.003 imposes a two-year statute of limitations for a suit for a deficiency.

Suit on the Note or Guaranty

The lender may file a suit against the borrower and/or guarantor for the amounts owed under the loan. As with judicial foreclosure, it is not common for a lender in Texas to sue before exercising its nonjudicial foreclosure rights, but there is no requirement under Texas law that the lender first seek foreclosure action. There is a six-year statute of limitation for a suit on a real property-secured debt that is not a suit for foreclosure. See Tex. Bus. & Com. Code Ann. § 3.118. There is a four-year statute of limitation for a suit on a guaranty that begins running when the cause of action accrues (i.e., when the claim can be made upon the borrower or guarantor). Moreno v. Sterling Drug, Inc., 787 S.W.2d 348 (Tex. 1990).

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Kathleen Tarbox Muñoz's practice focuses on commercial real estate and general business transactions, including the representation of investment limited partners and commercial property dispositions. She has experience advising clients regarding the exercise of rights and remedies under complex limited partnership agreements involving low-income housing tax credits. She has also routinely represented clients in various areas of real estate related matters including acquisitions, development, dispositions and leasing, including the negotiation of related agreements and property related due diligence involving title, survey, zoning, and land use matters.

Kathleen has significant experience drafting and negotiating documentation in connection with secured and unsecured lending and regularly represents financial institutions, lenders and special servicers on matters involving origination and securitization as well as workouts, assumptions and the exercise of remedies. She has also counseled lenders in connection with secondary market transactions including pooled note sales and loan participations and related diligence.