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James W. Doyle*

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I. INTRODUCTION

LEGISLATIVE changes dominate this year's survey. The 74th Texas Legislature not only adopted a comprehensive Texas Banking Act of 1995, but also made substantial changes to Articles 3 and 4 of the Texas Business & Commerce Code. A voter initiative also passed in 1995, affecting the manner and methods by which lenders can obtain liens on homesteads. Finally, a recent opinion of the Texas Consumer Credit Commissioner may impact the willingness of lenders to engage in erstwhile home equity lending in Texas.

II. THE TEXAS BANKING ACT OF 1995

The Texas Banking Act of 1995¹ is the work product of the Texas Banking Code Revision Task Force (the "Task Force"), a group of volunteer practicing attorneys and staff members from the Texas Department of Banking (the "Banking Department"). The Task Force was formed in late 1993 with the purpose of reviewing and rewriting the then existing body of law regulating state banks in Texas.²

Subsequently, the Texas Banking Act was enacted by the 74th Texas Legislature and became effective on September 1, 1995. The Banking Act repealed almost in its entirety the preceding Banking Code, which had been in effect since 1943.³ In setting out to draft a new complete body of law to govern and regulate the business of banking, the Texas Legislature's main, general objective was to modernize and reorganize in a more complete and coherent manner the law governing the business of banking for state-chartered institutions.

The Task Force, in its work, was guided by four principles: first, to promote the dual banking system of state and nationally-chartered banks by making the former as attractive as, or more attractive than, the latter form of chartering; second, to preserve and enhance the competitive parity of banks and other forms of financial institutions; third, to reduce the regulatory burden on state-chartered banks; and fourth, to provide flexibility to banking institutions for the ease of adaptability to potential market changes ensuing in the future.⁴

This section of the article does not attempt to discuss every aspect of the new Banking Act. It will cover only three important areas of the new Act: corporate governance, constitutional parity, and discovery of customer records and examination reports. The discussion is limited to an analysis of these specific areas of the new legislation to highlight the advantages posed to practitioners. The analysis is followed by examples that may help in clarifying the modifications and understanding their advantages.

1. TEX. REV. CIV. STAT. ANN. arts. 342-1.001 through 342-9.015 (Vernon Supp. 1996) (commonly known as the "Banking Act" [hereinafter Banking Act]). Some sections of the Banking Act are applicable to both state and national banks while others are only applicable to state banks and bank holding companies.

2. Unless otherwise specifically identified in this article, the terms "bank" and "banks" refer to state-chartered institutions organized under Chapter 3 of the Banking Act; the term "national bank" refers to a banking association organized under 12 U.S.C.A. § 21 (West 1989 & Supp. 1995); and the term "banking" refers to the performance of depository institution functions of accepting deposits, discounting loans and related activities.

3. TEX. REV. CIV. STAT. ANN. arts. 342-101 through 342-1011 (Vernon 1973 & Supp. 1995) (commonly known as the "Texas Banking Code of 1943" [hereinafter Banking Code]).

4. Everett Jobe, *Expanded Rule-Making Authority Will Benefit Texas Banks*, TEXAS LAW SUPPLEMENT, Jan. 15, 1996, at 6.

A. CORPORATE GOVERNANCE

An important area that the new legislation addresses is the corporate governance of banks. The Banking Act incorporates the Texas Business Corporation Act⁵ and the Texas Miscellaneous Corporation Laws Act⁶ (the "Corporation Acts").

It was clear that the Texas Business Corporation Act did not apply to banks,⁷ and since the banking statute did not contain a full range of corporate provisions, the gaps could be very troublesome. Now, the adoption of the Corporation Acts into the new Banking Act will bring both of these bodies of law together, so that state banks, in managing their organizational and shareholders' affairs, can employ the flexibility granted by modern corporate law in Texas. Specifically, section 3.007 of the Banking Act incorporates the Corporation Acts and states that these acts apply to state banks to the extent that they are not inconsistent with proper banking practice, in which case the Finance Commission can adopt rules to modify or adapt such bodies of law to make them compatible with the Banking Act.⁸ This modernization of banking law primarily affects three main areas of corporate governance: merger powers, shareholder rights and flexibility in capital.

1. Merger Powers

Section 3.301 of the Banking Act grants a bank the power to merge with any other entity that has legal authority to participate in a merger transaction. A merger can be easily structured and consummated by following the procedures outlined in the TBCA for the merger of a domestic corporation and a foreign entity.⁹ This new merger provision represents a substantial change from the Banking Code, which allowed a state bank to merge only with other state and national banks or savings and loan associations.¹⁰ The Banking Act still requires prior approval by the Texas Banking Commissioner of a plan of merger when any surviving, new or acquiring entity that is a party or is created by the merger is a state bank or is not a financial institution.¹¹ Additionally, a bank must comply with any requirements regarding merger transactions imposed by the federal agency having primary regulatory responsibility over the institution.¹² In

5. TEX. BUS. CORP. ACT ANN. arts. 1.01-12.54 (Vernon 1973 & Supp. 1996) [hereinafter TBCA].

6. TEX. REV. CIV. STAT. ANN. art. 1302, § 1.01-7.07 (Vernon 1973 & Supp. 1996).

7. For historic background, see *Robertson v. State ex rel. Clements*, 406 S.W.2d 90, 93-94 (Tex. Civ. App.—Fort Worth 1966, writ ref'd n.r.e.), where the court held that the TBCA did not apply to banks. See also TBCA art. 2.01 § 13(4)(a) (Vernon Supp. 1996).

8. Banking Act § 3.007.

9. *Id.* § 3.301.

10. Banking Code § 342-308.

11. See *id.*; Banking Act § 3.301.

12. See the Federal Deposit Insurance Act of 1950 ("FDIA") 12 U.S.C.A. §§ 1811-35 (West 1989 & Supp. 1995) (commonly known as the "Bank Merger Act"). Section 1828(c) of the FDIA requires prior written approval of the responsible regulatory agency for any merger or consolidation of a bank or savings association insured under the FDIA with, and

general, the procedures for mergers contained in the TBCA are as modern and flexible as any in the United States. The benefits of these merger procedures are now available to banks subject to regulation by the Banking Act.

Two examples will serve to demonstrate how financial institutions interested in modifying their corporate structure or acquiring assets can benefit from the Banking Act.

Example A:

In the past, a bank interested in eliminating its holding company usually had to follow a series of elaborate steps to achieve its intended objective. This resulted in delay and additional transactional and legal fees. Specifically, a bank intending to eliminate its holding company without incurring any tax liability had to adhere to the following procedure: first, incorporate an entity as a subsidiary of the bank itself; second, merge the holding company into the newly created subsidiary; and finally, dissolve the subsidiary.¹³ If this three-step procedure was employed, tax-free reorganization provisions of the Internal Revenue Code¹⁴ were satisfied, and the elimination of the holding company could be accomplished tax-free.

Under the Banking Act, a bank interested in dissolving its holding company can do so by merely merging the company into the bank, with the bank being the surviving entity.¹⁵ So long as the merger satisfies the relevant Internal Revenue Code provisions, it would likewise be tax-free.¹⁶

Example B:

Under prior law, a bank interested in taking over an operating corporation had to acquire the target company as a subsidiary, since the Banking Code did not permit a merger between a bank and a nonbank institution.¹⁷ This type of transaction often triggered a tax liability for the selling entity, which in turn could increase the total acquisition cost to the bank.

Presently, under the new merger provisions of the Banking Act, a bank intending to acquire a corporation engaged in an approved activity may do so without triggering major tax consequences by merging the target corporation with and into the acquiring bank itself.¹⁸ So long as the bank correctly structures the transaction according to the applicable merger provisions of the Internal Revenue Code, the acquisition can be consum-

into, any bank or institution which is not insured under the FDIA. 12 U.S.C. § 1828(c) (West 1989 & Supp. 1995).

13. Jo Waller, *The Texas Banking Act Part VIII*, BANKERS DIG., Dec. 4, 1995, at 3.

14. I.R.C. § 368(a)(1)(A) (West 1988 & Supp. 1995). Of course, the holding company could not be engaged in any activities that are not permissible for the bank.

15. See Banking Act §§ 3.301-.303.

16. I.R.C. § 368(a)(1)(A) (1988).

17. Banking Code §§ 342-308, 342-309.

18. Banking Act §§ 3.301-.303; I.R.C. § 368(a)(1)(A).

mated without triggering a tax liability to either entity.¹⁹

In summary, these two examples demonstrate the simplicity and efficiency with which a bank merger or other restructuring objective can be accomplished under the TBCA, as adopted by the Banking Act.

Section 3.302 of the Banking Act establishes the criteria upon which the Banking Commissioner evaluates a proposed merger transaction, as well as the steps the Banking Commissioner will follow to grant the approval and notify the parties of the final decision. The applicant must establish that the surviving entity will be solvent and have adequate capitalization in the future; will have complied with the laws of Texas; will have discharged, assumed or maintained all deposit and other liabilities; and will be in the business of banking only if it is a depository institution, and if such, in no other business.²⁰

2. Shareholder Rights

The second area of corporate governance affected by the Banking Act's importation of the Corporation Acts is in the area of shareholder rights. Two important changes affect preemptive rights and cumulative voting.

By adopting the TBCA, the Banking Act now grants a bank flexibility to modify or completely eliminate preemptive rights to acquire shares of newly issued stock.²¹ Prior to enactment of the Banking Act, preemptive rights were automatically established as part of a bank's articles of association and could not be waived or modified even by the unanimous vote of shareholders.²² As in the old Banking Code provision, the Banking Act provides that when the articles of association do not expressly limit or deny preemptive rights, they shall be deemed granted.²³

By permitting the limitation or denial of preemptive rights the new provision carries the substantial advantage that banks can now be authorized—by shareholder amendment of the articles of association—to issue new shares of stock without first having to offer it to existing shareholders.²⁴

Under Texas corporate law, amending the article to limit or deny preemptive rights requires a board resolution and an affirmative vote of two-thirds of the shareholders.²⁵ Once the internal procedures are complied with, the bank must file an executed original and one copy of the statement of action for approval with the Banking Commissioner, who during a period of thirty-one days after the filing date may accept or re-

19. I.R.C. § 368(a)(1)(A).

20. Banking Act § 3.302(b)(1)-(b)(6).

21. Any issues arising under this topic related to federal or state securities laws are beyond the scope of this article.

22. Banking Act § 3.002(6) (amending Banking Code §§ 342-301, 342-302, 342-304).

23. *Id.*

24. *Id.*

25. *See id.* § 3.101(b); TBCA art. 4.02 § A(1).

ject the amendment.²⁶ Upon approval by the Banking Commissioner or lapse of the statutory period granted for rejection, the Commissioner shall return a certified copy of the approved amendment to the bank.²⁷

Denying preemptive rights enables a bank and its shareholders greater flexibility to issue new shares of stock without having to engage in the process of offering the new stock to all present stockholders. For example, two situations in which this flexibility is useful include the following: (1) when a bank wants to enhance management compensation benefits by offering its stock or stock options to its managerial employees; or (2) when a bank intends to raise capital from a small number of wealthy and sophisticated potential shareholders by issuing new equity securities. Additionally, a waiver or limitation of shareholders' preemptive rights is useful to a bank planning a transaction involving a stock swap or exchange to acquire another entity or assets from another party. In this last scenario, a bank could issue new shares of its capital stock to the seller without having to offer a pro rata share of the new stock issue to all existing shareholders.

Equally revolutionary in the banking context is the legitimization of cumulative voting. Unlike preemptive rights which exist unless denied in the articles of association, cumulative voting rights do not exist unless granted in the articles. This amendment to the articles of association of existing banks would be required to establish cumulative voting.

Of course cumulative voting rights are protective of the interests of minority or small shareholders. In a bank with five directors it assures that a person with one share more than sixteen and two-thirds of the shares can elect one director.²⁸

3. *Capital Flexibility Including Blank Check Powers*

A third aspect of corporate governance newly sanctioned by the Banking Act creates flexibility in capital planning. For the first time banks are permitted to have authorized, but unissued shares. The Banking Act also provides that a bank's articles of association may allow a bank's board of directors to establish a series of stock shares, as well as determine by resolution, the preferences, limitations and relative rights of shareholders of each series.²⁹ This is sometimes known as "blank check" powers. The Banking Act states that the bank must comply with the procedures established in the TBCA for establishing a new series of stock and determining the preferences and relative rights of each series.³⁰ Of course, the articles of association, as approved by the shareholders, must permit such corpo-

26. Banking Act § 3.101(d).

27. *Id.*

28. The formula for determining how many shares are needed to elect a given number of directors is: [(number of shares voting) × (number of directors you want to elect) ÷ (number of directors to be elected) + 1] + 1.

29. Banking Act §§ 3.101-3.102(a).

30. *Id.* § 3.102(b); TBCA art. 2.13.

rate action.³¹ Once the decision to establish a new series of stock has been adopted by board resolution, a statement of action outlining the plan for the establishment of the series of shares must be filed with the Banking Commissioner.³² This flexibility provided by latent capital planning has been available for many years to companies organized under the TBCA and now banks can also take advantage of this authority.³³

The Banking Act requires approval by the Banking Commissioner before the issuance of a new series and before any increase or decrease of the outstanding capital and surplus of a bank.³⁴ Section 3.103(b), however, provides various exemptions to this approval requirement including for the issuance of shares for cash, stock dividends, and transfers of profits to capital or surplus by resolution.³⁵

In conclusion, by adopting the TBCA, the Banking Act has drastically overhauled the options and procedures available to bank shareholders and boards of directors for designing and executing corporate governance. To what extent banks will employ these new provisions depends on the receptivity and initiative of the board of directors, shareholders and counsel of each individual bank. Evidence of the fact that banks are already taking advantage of these procedures is clearly shown by requests already received by the Banking Department for various alternative procedures premised on the TBCA. For instance, the Banking Department has issued an opinion which permits a bank holding company to acquire the shares of a state bank by means of a plan of exchange,³⁶ so long as all the formalities established in the TBCA for this type of transaction are followed.³⁷ Overall, adoption of the Corporation Acts by the Banking Act provides great opportunities to banks interested in conducting their corporate affairs in a more liberal manner, similar to business corporations. The resulting flexibility and convenience of this adoption should simplify and expedite the execution of corporate plans for banks.

B. CONSTITUTIONAL PARITY OF ACTIVITIES

Since 1986, state banks interested in engaging in activities not expressly permitted by either the Texas Legislature or the Banking Department, but sanctioned for national banks, have relied on the parity provision established in the Texas Constitution. Section 16(c), Article XVI of the Texas Constitution³⁸ provides that state banks shall have the same rights and privileges that are granted to national banks domiciled in Texas.³⁹

31. Banking Act § 3.102(a).

32. *Id.* § 3.102(b).

33. Of course, the articles of association of an existing bank must be amended to so provide. TBCA arts. 4.01, 4.07.

34. Banking Act §§ 3.102(b), 3.103(a).

35. *Id.* § 3.103(b).

36. Op. Tex. Gen. Couns. No. 95-32 (Sept. 6, 1995).

37. See TBCA arts 5.02-.07.

38. TEX. CONST. art. XVI, § 16(c).

39. The FDIA contains an interlocking parity provision which prohibits an insured state bank from engaging as principal in any type of activity that is not permissible for

Unfortunately, in the past there has not been much guidance as to the process of implementing this authority.

The Banking Act establishes operational procedures for invoking the constitutional parity provision. Subsections 3.010(b) through (f) now provide in great detail the requirements to be met before a bank interested in gaining approval from the Banking Commissioner may exercise rights or privileges granted to national banks.⁴⁰ The bank must submit a letter to the Banking Commissioner describing in detail the intended activity.⁴¹ The bank must also furnish evidence of the authority of national banks to engage in that same activity.⁴² During the thirty (30) days subsequent to the filing of the letter, the Banking Commissioner may require up to an additional thirty (30) days for analysis of the request or may prohibit the bank from engaging in the activity at any time in the future.⁴³ The Banking Commissioner may deny the approval to engage in such activity only if it finds that a national bank domiciled in Texas is not entitled to engage in the intended activity at issue, or where permission to engage in the activity will negatively impact the safety and soundness of the bank.⁴⁴ If the Banking Commissioner does not prohibit the activity during the statutorily prescribed period, the bank will be deemed permitted to engage in the proposed activity.⁴⁵ The benefit of having the Banking Act drafted with such great specificity is that it provides a self-enabling framework in which state banks can expeditiously solicit and receive approval to engage in a contemplated activity or challenge an adverse decision by the Banking Commissioner.⁴⁶

To assure proper implementation of this parity provision, the Banking Act contains specific language authorizing the Finance Commission to adopt rules that implement the manner in which a bank may exercise specific rights granted under this section.⁴⁷ This operational provision is in response to a case that held that the Finance Commission was not empowered to promulgate rules which did not follow from specific statutory enactments.⁴⁸

national banks, unless its primary regulatory agency determines that the activity does not pose a significant risk to the appropriate deposit insurance fund and the applicant continues to be in compliance with applicable capital requirements. 12 U.S.C.A. § 1831(a) (West 1989 & Supp. 1995). See also the FDIC Rules and Regulations relating to authorized activities for insured state banks. 12 C.F.R. § 362.4.

40. Banking Act § 3.010(b)-(f).

41. *Id.* § 3.010(b).

42. Although there is no list of permissible activities, the Office of the Comptroller of the Currency ("OCC") has published a proposed rule which lists activities that the OCC considers permissible and eligible for operating subsidiaries in gaining expedited approval. See Rules, Policies, and Procedures for Corporate Activities, 59 Fed. Reg. 61,034 (1994).

43. Banking Act § 3.010(c).

44. *Id.* § 3.010(e).

45. *Id.* § 3.010(b).

46. See Gail Randall, *A Czar is Born*, TEXAS LAW., Jan. 16, 1995, at 3-6.

47. Banking Act § 3.010(e).

48. Bank of East Texas v. Jones, 758 S.W.2d 293, 295 (Tex. App.—Tyler 1988, orig. proceeding).

C. DISCOVERY OF BANK RECORDS AND REPORTS OF EXAMINATION

Another important area addressed by the Banking Act is the discovery of bank records. The Banking Code established a procedure by which a party could obtain information from a bank and provided a means by which a customer could oppose a request for the discovery of his bank records. Provisions covering civil discovery of a bank customer's records are now codified in the Civil Practice and Remedies Code.⁴⁹ Additionally, the new legislation sets forth the procedures to be followed by a bank customer to challenge the release of records by filing a motion to quash or a motion for a protective order.⁵⁰

Section 30.007 recognizes that the subpoena order or request for discovery of financial records may come from arbitrators or government agencies as well as courts. The discovering party has to serve the bank with the request at least twenty-four days prior to the date the information is required. In addition, they must pay the bank or post a bond for the total amount of the reasonable cost for the bank to comply with the request, including attorney fees.⁵¹ When the customer whose records are being discovered is not a party to the proceeding in which the discovery order was issued, the discovering party must give notice of the proceeding to the customer whose records are being disclosed of his right to prevent disclosure by the bank and request the customer's authorization for bank compliance with the demand.⁵²

The codification makes it clear that it does not create a right of privacy in customer records held by a bank.⁵³ Section 30.007 is not applicable to bank regulators, nor to a request for records as part of a criminal case.⁵⁴

Courts and the commentators concluded that, notwithstanding the existence of article 342-705, a bank is not prohibited from voluntarily producing customer records. In Texas, courts have responded to claims that a bank has violated its obligation to not disclose customer records under article 342-705 of the Banking Code by denying such claims. In *Pelt v. State Board of Insurance*, the court held that, "under article 342-705 §1 of the Banking Code, a financial institution cannot be required to produce a customer's records, except as therein provided, although it is not forbidden from doing so voluntarily."⁵⁵ Commentators have also argued that

49. TEX. CIV. PRAC. & REM. CODE ANN. §30.007 (Vernon Supp. 1996).

50. *Id.*

51. *Id.* § 30.007(c)(1), (3).

52. *Id.* § 30.007(d).

53. The Right to Financial Privacy Act of 1978, 12 U.S.C.A. §§ 3401-3422 (West 1980 & Supp. 1984) (hereinafter "RFPA"), is a federal statute that establishes that financial institutions are prohibited from divulging financial records of any customer of the institution to a federal authority in criminal proceedings, except by following the procedures outlined in RFPA. Some of the limitations of RFPA, however, are that it does not apply to discovery by state and local governments, to summons by the Internal Revenue Service nor to reports prepared by regulatory agencies while in the process of conducting an examination of a financial institution.

54. TEX. CIV. PRAC. & REM. CODE ANN. § 30.007(d) (Vernon Supp. 1996).

55. 802 S.W.2d 822, 826 (Tex. App.—Austin 1990, no writ).

article 342-705 does not prohibit voluntary disclosure by a bank of customer records, since it is only a procedural provision.⁵⁶ The new civil practice and remedies code provision explicitly remove voluntary disclosures from the strictures of the code.

Although different in nature, another important provision is section 8.011 of the Banking Act. This section covers the discovery of work papers and reports prepared for or created by a compliance review committee of a depository institution, including both national and state banks, or their affiliates.⁵⁷ Section 8.011 provides that compliance review documents are not discoverable or admissible into evidence in a civil case, even where the document may have been previously disclosed to a government agency.⁵⁸ This protection also extends to any request for a committee member to testify as to the statements, discussions or decisions made during a meeting of the compliance review committee or included in a document revised by a member of such committee acting pursuant to responsibilities as such.⁵⁹ The purpose of this protection is to encourage banks to investigate their own operational activities and to monitor compliance with regulatory requirements and the banks own policies as well as safe, sound and fair lending practices.⁶⁰ Obviously, bank regulators are exempted from this prophylactic rule.

The Banking Act also addresses the disclosure of the reports of examination and other confidential information. Section 2.104 of the Banking Act⁶¹ provides that a financial institution, affiliate or service provider that receives confidential information (e.g., report of examination) from the Banking Department may not disclose that information to anyone who is not officially connected to the recipient, except as authorized by rules adopted under the Banking Act. The Finance Commission has adopted rules concerning the confidentiality of information.⁶² The rules provide that a person "officially connected to a financial institution" includes its holding company, officer, director, manager, attorney, auditor, independent auditor, employee, and a person reasonably designated as officially connected with the financial institution by resolution duly adopted by the institution's board of directors.⁶³ The rules also provide that a financial institution may disclose confidential information to a non-employee, such as its agent, bonding company, or a prospective acquirer, only pursuant to board resolution designating the person or entity as officially connected

56. Dan Nicewander, *Financial Record Privacy—What Are and What Should Be the Rights of the Customer of a Depository Institution*, 16 ST. MARY'S L.J. 601, 603 (1985); Risley, *Compelling Production of Bank Records in Texas*, 53 TEX. B.J. 272 (1990).

57. Banking Act § 8.011.

58. *Id.* § 8.011(c)(2).

59. *Id.*

60. Jo Waller, *The Texas Banking Act Part III*, BANKERS DIG., Oct. 30, 1985, at 3.

61. Banking Act § 2.104. A recent case has held that a financial institution may waive its work product privileges as to all adversaries by disclosing documents prepared by its counsel to regulatory agencies. See *Frankford Trust Co. v. Advest, Inc.*, No. 93-CIV-329, 1995 WL 491300 (E.D. Pa. Aug. 17, 1995).

62. See 7 TEX. ADMIN. CODE § 3.111.

63. 7 TEX. ADMIN. CODE § 3.111(c).

with the financial institution.⁶⁴ Disclosure or use of information in violation of Section 2.104 is a punishable offense.⁶⁵

Section 2.105 of the Banking Act⁶⁶ provides that discovery of confidential information pursuant to a subpoena from a person subject to the Banking Act must comply with rules adopted under the Banking Act. Section 2.105 also provides that the rules may restrict release to confidential information that is directly relevant to the legal dispute at issue and the rules may require a court-issued protective order, in the form and under the circumstances the rules specify, prior to release.⁶⁷ The Finance Commission has adopted rules attendant to the discovery of confidential information.⁶⁸ Pursuant to the rules, a financial institution that receives a subpoena for the release of confidential information must promptly notify the Banking Department of the request, provide the Banking Department with a copy of the process and the requested documents or information, and object by written motion or other means.⁶⁹ Prior to the release of confidential information, the financial institution also must file and obtain a ruling on a motion for protective order and in camera inspection.

III. REVISIONS TO CHAPTER 3 AND 4 OF THE TEXAS BUSINESS & COMMERCE CODE

Revised Articles 3 and 4 of the Uniform Commercial Code (the "UCC"), approved by the National Conference of Commissioners on Uniform State Laws in 1990, were adopted by the Texas Legislature in 1995. These new amendments to the Texas Business and Commerce Code (the "Code") became effective as of September 1, 1995.

A. CHAPTER 3—NEGOTIABLE INSTRUMENTS

The revisions to Chapter 3 of the Code are so comprehensive that the revised chapter replaces the original version.⁷⁰ The new chapter is intended to clarify aspects of the old Chapter 3 that were left to interpretation, and to reflect changes brought about by new technology and

64. The Banking Act provides that a financial institution may not disclose confidential information to a shareholder unless when acting in another capacity. TEX. REV. CIV. STAT. ANN. ART. 342-2.108.

65. Banking Act § 2.104 provides that violation is punishable as an offense under Tex. Penal Code § 37.10

66. Banking Act § 2.105. Certain recent cases have held that banks must produce examination reports when served with a third-party subpoena notwithstanding federal banking agency regulations providing that examination reports are the property of the agency and are confidential. See *In re Bankers Trust Co.*, 61 F.3d 465 (6th Cir. 1995), *petition for cert. filed*, 64 U.S.L.W. 3318 (U.S. Oct. 19, 1995) (No. 95-638).

67. Banking Act § 2.105.

68. See 7 TEX. ADMIN. CODE § 3.111(f).

69. 7 TEX. ADMIN. CODE 3.111(f)(1). The Office of the Comptroller of the Currency, the primary regulator for national banks, has issued a similar rule. See 12 C.F.R. Part 4, Subpart C.

70. JOHN KRAHMER, TEXAS COMMERCIAL LAW FOR BANK LAWYERS 3-1 (3d ed. 1994 & Supp. 1995).

modern practices. Many changes result in increased subjective elements in critical issues. The following is a summary of the most significant changes to Chapter 3.

1. *Short Title*

While minor in its practical importance, the change in the short title of Chapter 3 reflects a change in the emphasis of Chapter 3.⁷¹ The old short title, "Uniform Commercial Code—Commercial Paper" has been changed to "Uniform Commercial Code—Negotiable Instruments,"⁷² reflecting a narrowing in the emphasis of the chapter.

2. *Subject Matter*

New section 3.102 is derived in part from old section 3.103, but is explicit in stating what was implied only by its predecessor: Section 3.102 only applies to negotiable instruments, and does not apply to money, payment orders governed by Chapter 4A, or securities governed by Chapter 8.⁷³ Subsection (c) is new, explicitly providing that Federal Reserve regulations and operating circulars supersede inconsistent provisions of Chapter 3 to the extent of the inconsistency.⁷⁴

3. *Definitions*

Several important new definitions have been added to the section. One particularly significant change is a change in the definition of "good faith." The new section 3.103(a)(4) defines good faith as "honesty in fact and the observance of reasonable commercial standards of fair dealing."⁷⁵ The new language adds a more objective cast to the definition of good faith, and is consistent with the definitions of "good faith" in Chapters 2, 2A, 4, and 4A of the Code. A new definition which activates a change in emphasis in Chapters 3 and 4 is the definition of "ordinary care." The definition addresses a specific operational problem and permits payment of checks without examination of signature.⁷⁶

4. *Negotiable Instruments*

Section 3.104 is the centerpiece of Chapter 3 because it contains the key definition of "negotiable instrument."⁷⁷ Important changes in Section 3.104 include the addition of definitions for the previously undefined terms "check," "cashier's check," "teller's check," and "traveler's

71. TEX. BUS. & COM. CODE ANN. § 3.101 (Vernon 1994 & Supp. 1996) [hereinafter TEX. UCC].

72. *Id.*

73. *Id.* § 3.102.

74. *Id.* § 3.102(c). Article 4 already recognized the importance of Federal Reserve authority, giving them the effect of agreements varying terms. *Id.* 4.103(b)(c).

75. TEX. UCC § 3.103 (emphasis added).

76. This may change the result in cases like *McDowell v. Dallas Teachers Credit Union*, 772 S.W.2d 183 (Tex. App.—Dallas 1989, no writ).

77. TEX. UCC § 3.104.

check."⁷⁸ Texas lawyers are already familiar with these definitions and with the consequences because of the cases *Guaranty Federal Savings & Loan Ass'n v. Horseshoe Operating Co.*⁷⁹ and *University Savings Ass'n v. Intercontinental Consolidated Cos.*⁸⁰

5. *Issue*

New section 3.105 contains the definition of "issue." Issue means "the first delivery of an instrument by the maker or drawer, whether to a holder or nonholder, for the purpose of giving rights on the instrument to any person."⁸¹ This new definition adds the requirement that the delivery have the purpose of giving rights on the instrument. The section also adds as a defense to enforcement of an instrument, the failure of a condition to or special purpose for the instrument to be fulfilled.⁸² This defense adds to the rights of parties other than holders in due course.

6. *Unconditional Promise or Order*

A negotiable instrument must contain an unconditional promise to pay. Section 3.106 specifically identifies all provisions which, if contained in an instrument, will render the promise to pay conditional.⁸³ A promise or order is unconditional unless it states "(i) an express condition to payment, (ii) that the promise or order is subject to or governed by another writing, or (iii) that rights or obligations with respect to the promise or order are stated in another writing."⁸⁴ The section is explicit in stating that "[a] reference to another writing does not of itself make a promise or order conditional."⁸⁵ In a major departure from the previous version, the new section 3.106 states that limitation of payment to a particular source or fund does not make a promise conditional.⁸⁶

7. *Identification of the Person to Whom an Instrument is Payable*

Section 3.110(a) of the revised Code states that "[t]he person to whom an instrument is initially payable is determined by the intent of the person . . . signing as . . . the issuer of the instrument."⁸⁷ This section makes the determination subjective. This subjective element has no counterpart in the old Code. Subsection (b) of section 3.110 is also new. It states that "[i]f the signature of the issuer . . . is made by automated means . . . the payee of the instrument is determined by the intent of the person who

78. *Id.* § 3.104(f)-(i).

79. 793 S.W.2d 652 (Tex. 1990).

80. 751 S.W.2d 657 (Tex. App.—Houston [1st Dist.] 1989), *aff'd* 793 S.W.2d 652 (Tex. 1990).

81. TEX. UCC § 3.105(a) (Vernon Supp. 1996).

82. *Id.* § 3.105(b).

83. *Id.* § 3.106.

84. *Id.* § 3.106(a).

85. *Id.*

86. TEX. UCC § 3.106(b) (Vernon Supp. 1996).

87. *Id.* § 3.110(a).

supplied the name or identification of the payee, whether or not authorized to do so.”⁸⁸ This is one of the provisions incorporated into the revised Chapter 3 designed to reflect the increasing use of technology such as automated signatures.

8. *Place of Payment*

Section 3.111 is completely new to the Code and describes the place where an instrument is payable.⁸⁹ If a place is stated in the instrument, the place of payment is the place described. If no place is specified, “an instrument is payable at the address of the drawee or maker stated in the instrument. If no address is stated, the place of payment is the place of business of the drawee or maker.”⁹⁰ In the previous version of Chapter 3, there was no guidance for determining where an instrument was payable.

9. *Interest*

Section 3.112(a) states that “an instrument is not payable with interest; and interest on an interest-bearing instrument is payable from the date of the instrument”⁹¹ unless otherwise stated in the instrument. This specificity in dealing with interest-bearing instruments is a new addition to Chapter 3. Such determination had been left to the interpretation of the courts by the previous version of Chapter 3. Subsection (b) of section 3.112 is also new, and makes it clear that variable interest rate instruments are negotiable.⁹² However, Comment 2 to section 3.112 makes it clear that the section is only meant to clarify the term “interest,” and not to validate interest provisions that violate other laws.⁹³

10. *Date of an Instrument*

Section 3.113(b) contains rules for determining the date of undated instruments.⁹⁴ The subsection states that the date of an undated instrument “is the date of its issue or, in the case of an unissued instrument, the date it first comes into possession of a holder.”⁹⁵ Section 3.114(b) of the prior version of Chapter 3, which this section replaces, did not address undated instruments but, rather, dealt only with those which were antedated or postdated.

11. *Incomplete Instruments*

The rules for enforcement of incomplete instruments provided in new section 3.115 extend well past the rules provided in the prior version of

88. *Id.*

89. *Id.* § 3.111.

90. *Id.*

91. TEX. UCC § 3.112(a) (Vernon Supp. 1996).

92. *Id.* § 3.112(b). The Texas Supreme Court had already reached this result. *Amberboy v. Societe de Banque Privee*, 831 S.W.2d 793 (Tex. 1992).

93. TEX. UCC § 3.112 at cmt. 2.

94. *Id.* § 3.113(b).

95. *Id.*

that section.⁹⁶ This section provides that "if an incomplete instrument is an instrument under Section 3.104, it may be enforced according to its terms if it is not completed, or according to its terms as augmented by completion."⁹⁷ The previous version of section 3.115 only allowed enforcement of an incomplete instrument upon completion. Therefore, an instrument no longer needs to be complete in order to be enforceable.

12. *Joint and Several Liability; Contribution*

Section 3.116 establishes the rule that two or more parties who sign in the same capacity (as makers, drawers, acceptors, indorsers who indorse as joint payees, or anomalous indorsers) are jointly and severally liable in such capacity.⁹⁸ This section has no comparable counterpart in the old Chapter 3. Section 3.118(5) of the prior version of Chapter 3 allowed for joint and several liability only where the instrument specified two or more people who sign as makers, acceptors, drawers, or indorsers. Thus, joint and several liability is now automatic where two or more parties sign in the same capacity whereas joint and several liability was previously required to be expressly stated. In addition, the new section 3.116(c) specifies that the "[d]ischarge of one party having joint and several liability by a person entitled to enforce the instrument does not affect the right" of other parties having joint and several liability from receiving contribution from the discharged party.⁹⁹

13. *Statute of Limitations*

Section 3.118 contains rules for determining the statute of limitations for Chapter 3.¹⁰⁰ There were no such limitations rules in the prior version of Chapter 3 because statute of limitations questions were covered by common law. The new section, however, sets out a variety of limitations beginning with that for the enforcement of an obligation of a party to pay a note payable at a definite time. Under section 3.118, such actions must be commenced within six years after the due date of the instrument.¹⁰¹ This provision changes current Texas law which specifies that a person must bring suit on a debt within four years of the date on which the cause of action accrues.¹⁰² This is only one conflict among many that the new section creates.¹⁰³ The Committee added the following comment in an attempt to avoid much of the conflict: "[w]ith respect to actions on instruments covered by this Act, the statute of limitations provisions of section 3.118 should be interpreted to supersede, because of their

96. TEX. UCC § 3.115 (Vernon Supp. 1996).

97. *Id.* § 3.115(b).

98. *Id.* 3.116.

99. *Id.* § 3.116(c).

100. *Id.* § 3.118.

101. TEX. UCC § 3.118 (Vernon Supp. 1996).

102. TEX. CIV. PRAC. & REM. CODE ANN. § 16.004(a)(3) (Vernon 1986).

103. *See, e.g.*, TEX. CIV. PRAC. & REM. CODE ANN. §§ 16.004(a)(3), 16.065, 16.070 (Vernon 1986 & Supp. 1996).

particularity, any conflicting statute of limitations of general applicability under Texas law."¹⁰⁴ In addition, the Committee added that

because of their particular nature, the statute of limitations provisions of sections 16.035 and 16.036 of the Texas Civil Practice and Remedies Code, relating to actions with respect to debts secured by liens on real property, and section 51.003 of the Texas Property Code, relating to actions to recover deficiencies after nonjudicial foreclosures, should be interpreted to control, in appropriate circumstances, over the provisions of section 3.118.¹⁰⁵

14. *Transfer of Instruments; Rights Acquired by the Transfer*

Section 3.203(b) has no counterpart in the prior version of Chapter 3. This section is intended to provide a definition of the term "transfer."¹⁰⁶ The section states that "[a]n instrument is transferred when it is delivered by a person other than its issuer for the purpose of giving to the person receiving delivery the right to enforce the instrument."¹⁰⁷ The comments to the section make it clear that principles of property law, independent of Chapter 3, should be used to determine the ownership rights to instruments. In the previous version of Chapter 3, the determination of when a transfer occurred was left to interpretation. This new definition should make it easier to determine when a transfer has occurred and, therefore, when a party takes an instrument as a holder in due course.

15. *Indorsement*

The definition of "indorsement," provided in Section 3.204, is new to Chapter 3 and is dependent upon the intent of the signer. The signature must be made "for the purpose of (i) negotiating the instrument, (ii) restricting payment of the instrument, or (iii) incurring indorser's liability on the instrument."¹⁰⁸ However, a signature is an indorsement unless there are accompanying words that unambiguously indicate that the signature was made for a purpose other than an indorsement.¹⁰⁹ In the prior version of Chapter 3, no subjective assessment of the indorser's intent was necessary to determine whether an instrument was indorsed. This new subjective standard could make it more difficult to determine whether a signature is an indorsement were it not for the stipulation that a signature constitutes an indorsement unless it specifically states that it is not made for an indorsement.

16. *Special, Blank, and Anomalous Indorsements*

Section 3.205 adds the definition of an "anomalous indorsement."¹¹⁰

104. TEX. UCC § 3.118 (Vernon Supp. 1996).

105. TEX. UCC 3.118 (Vernon Supp. 1996).

106. *Id.* § 3.203.

107. *Id.* § 3.203(a).

108. *Id.* § 3.204(a).

109. *Id.*

110. *Id.* § 3.205(d).

Such an indorsement means "an indorsement made by a person who is not the holder of the instrument."¹¹¹ The only effect of an anomalous indorsement is to make the signor liable as an indorser to the instrument.¹¹² In addition, an anomalous indorsement does not affect how an instrument may be negotiated.

17. *Restrictive Indorsement*

The effectiveness of certain kinds of restrictive indorsements is curtailed in section 3.206 which states that "[a]n indorsement limiting payment to a particular person or otherwise prohibiting further transfer or negotiation of the instrument is not effective to prevent further transfer or negotiation of the instrument."¹¹³ The prior version of section 3.206 only specified that restrictive indorsements did not prevent further negotiation of an instrument but was silent as to the effect of a restriction limiting payment to a particular person. In addition, the new section 3.206 adds a rule providing that conditions the right of an indorsee to receive payment do not affect the right of such person to enforce the instrument.¹¹⁴ These new rules serve to increase the negotiability of instruments that contain restrictive indorsements.

18. *The Person Entitled to Enforce an Instrument*

Section 3.301 provides a new definition of the "person entitled to enforce" an instrument.¹¹⁵ Such a person is "(i) the holder of the instrument, (ii) a nonholder in possession of the instrument who has the rights of a holder, or (iii) a person not in possession of the instrument who is entitled to enforce the instrument pursuant to Section 3.309 or 3.418(d)."¹¹⁶ Moreover, such a person may be someone who is not the owner of the instrument or is in wrongful possession of the instrument. This new definition serves to broaden the category of parties that may have rights to enforce an instrument.

19. *Holder in Due Course*

The requirements for holder in due course status set forth in section 3.302 are expanded.¹¹⁷ Subsection (g) also recognizes that section 3.302 is sometimes superseded by other laws which limit or define the status of

111. *Id.*

112. TEX. UCC § 3.205 cmt. 3 (Vernon Supp. 1996).

113. *Id.* § 3.206(a).

114. *Id.* § 3.206(b).

115. *Id.* § 3.301.

116. *Id.*

117. TEX. UCC § 3.302 (Vernon Supp. 1996). In addition to the requirement that the person possessing the instrument be a holder, it is also necessary that "the instrument when issued or negotiated to the holder does not bear such apparent evidence of forgery or alteration or is not otherwise so irregular or incomplete as to call into question its authenticity." *Id.*

holder in due course for particular classes of transactions.¹¹⁸

20. *Overdue Instruments*

Section 3.304 sets down a hard and fast rule regarding the staleness of checks by recognizing that a check becomes overdue 90 days after its date.¹¹⁹ This strict 90 day rule is in contrast to the prior rule in old section 3.304(c)(3) which created a presumption that 30 days after its date, a check becomes stale.¹²⁰ This change will provide certainty to the determination of whether a person who takes such an instrument is a holder in due course.

21. *Defenses and Claims in Recoupment*

The familiar defense of failure of consideration has been replaced by a new term "claims in recoupment."¹²¹ The term "claims in recoupment" is intended to adopt the rule that the obligor may assert, only as an offset to amounts owing on the instrument, claims arising out of the same transaction with the original payee.¹²² Texas practitioners are advised to look to two Fifth Circuit Court of Appeals cases: *FDIC v. Lattimore Land Corp.*¹²³ and *Frederick v. United States*.¹²⁴

22. *Claims to an Instrument*

New section 3.306 recognizes that persons taking an instrument not as a holder in due course take subject to property or possessory rights in the instrument or its proceeds. Holders in due course take free of such claims to the instrument.

23. *Proof of Signatures and Status as a Holder in Due Course*

The only new concept contained in section 3.308 is the addition of burden of proof rules in certain circumstances.¹²⁵ The rule adds the requirement that

[i]f an action to enforce the instrument is brought against a person as the undisclosed principal of a person who signed the instrument as a party to the instrument, the plaintiff has the burden of establishing that the defendant is liable on the instrument as a represented person under Section 3.402(a).¹²⁶

118. *Id.* § 3.302(g). The prime example may be the so-called federal holder in due course doctrine and other special treatments afforded the FDIC in its bulk acquisitions in bank failure situations.

119. *Id.* § 3.304(a)(2).

120. *Id.*

121. TEX. UCC § 3.305 (Vernon Supp. 1996).

122. *Id.* cmt. 2 (STATE BAR COMMITTEE COMMENTS).

123. 656 F.2d 139, 143 (5th Cir. 1981).

124. 386 F.2d 481, 488 (5th Cir. 1967).

125. TEX. UCC § 3.308 (Vernon Supp. 1996).

126. TEX. UCC § 3.308(a) (Vernon Supp. 1996).

This burden of proof requirement, which was not part of the previous Chapter 3, ties to section 3.402(a) to permit an undisclosed principal to be liable on an instrument even though not named thereon.

24. *Enforcement of Lost, Destroyed, or Stolen Instruments*

Section 3.309 broadens the coverage of Chapter 3 in terms of a person's ability to enforce an instrument such person is not in possession of the instrument.¹²⁷ The prior version of Chapter 3 only dealt with the situation where an instrument had been lost. The language in the new section expands the application to situations where a person does not have possession of an instrument regardless of the reason he no longer possesses the instrument.

25. *Accord and Satisfaction Through Use of an Instrument*

Section 3.311 has no counterpart in old Chapter 3.¹²⁸ The section sets forth the requirements for enforcement of an accord and satisfaction through use of a negotiable instrument and is designed to present "an informal method of dispute resolution carried out by the use of a negotiable instrument."¹²⁹ The section applies if a person against whom a claim is brought proves: "(1) that person in good faith tendered an instrument to the claimant as full satisfaction of the claim; (2) the amount of the claim was unliquidated or subject to a bona fide dispute; and (3) the claimant obtained payment of the instrument."¹³⁰

Business organizations should carefully follow the strictures of section 3.311(c)(1) and provide a conspicuous notice to their customers regarding the person, office or place to which communication concerning disputed debts, including instruments tendered as full satisfaction must be sent. The logical place for such notice would be invoices, billing statements or other mailings to the organization's customers.

26. *Lost, Destroyed, or Stolen Cashier's Checks, Teller's Checks, or Certified Checks*

To go along with the new definitions of cashier's check, teller's check, and certified check in section 3.104, section 3.312 adds new rules covering situations where such instruments are lost, destroyed, or stolen.¹³¹ The new rule sets out the following requirements that a claimant must meet in order to recover payment of the amount of the missing instrument:

- (i) the claimant is the drawer or payee of a certified check or the remitter or payee of a cashier's or teller's check, (ii) the communication contains or is accompanied by a declaration of loss of the claimant with respect to the check, (iii) the communication is received at a

127. *Id.* § 3.309.

128. *Id.* § 3.311.

129. *Id.* § 3.311 cmt. 1.

130. *Id.* § 3.311(a)(1)-(3).

131. TEX. UCC § 3.312 (Vernon Supp. 1996).

time and in a manner affording the bank a reasonable time to act on it before the check is paid, and (iv) the claimant provides reasonable identification if requested by the obligated bank.¹³²

27. *Refusal to Pay a Cashier's Check, Teller's Check, or Certified Check*

Section 3.411¹³³ is also new and provides that if an "obligator bank wrongfully (i) refuses to pay a cashier's check or certified check, (ii) stops payment of a teller's check, or (iii) refuses to pay a dishonored teller's check," the person entitled to enforce the instrument is entitled to compensation for his expenses resulting from the wrongful act as well as interest lost due to nonpayment.¹³⁴

28. *Liability of Parties*

New section 3.401 creates a new exception to the well-known rule that a person is not liable on an instrument unless he or she has signed it. If an instrument is signed by an authorized agent, the principal is bound, even if the principal's name does not appear on the instrument. Another new rule with respect to signatures appears at section 3.402(c). If a representative signs his or her name as drawer of a check without indication of the representative status and the check is payable from an account of a represented person identified on the check, the signee is not liable on the check if the signature is authorized. This rule is counter to normal agency principles and effectively overrules *Griffin v. Ellinger*.¹³⁵

29. *A Change Affecting Both Articles 3 and 4*

Perhaps the most significant substantive change made in Chapters 3 and 4 is the introduction of the concept of comparative negligence. One effect of this no doubt will be to lessen summary judgment opportunities because of the inherent fact questions in comparative responsibility. Nonetheless, this new concept appears in the important loss allocation rules including section 3.404 (fictitious papers); section 3.405 (padded payroll or dishonest employees); section 3.406 (negligent contribution to material alteration or unauthorized signature) and section 4.406 (unauthorized payment). The Texas adoption also included a change of language from the Uniform Official Text. The Uniform Official Text provides that, if a person fails to exercise ordinary care in paying or taking an instrument, the other party may recover part of the loss if the failure to exercise ordinary care substantially contributed to the loss. The non-uniform amendment deletes the work "substantially."

132. *Id.* § 3.312(b).

133. *Id.* § 3.411.

134. *Id.* § 3.411(b).

135. 538 S.W.2d 97 (Tex. 1976).

30. *Transfer and Presentment Warranties*

Transfer warranties and presentment warranties receive more extensive treatment in the new code.¹³⁶ The new provision now specifies the measure of recovery,¹³⁷ a 30 day time limit for notice of a claim¹³⁸ and a bar against disclosure with respect to checks.¹³⁹ These sections are examples of the new code performing the tasks of clarification and specification.

31. *Discharge of Indorsers and Accommodation Parties*

Section 3.605 generally conforms to old section 3.606, however, the new section states that, "[d]ischarge of the obligation of a party to pay an instrument under Section 3.604 does not discharge the obligation of an indorser or accommodation party having a right of recourse against the discharged party."¹⁴⁰ This language serves to eviscerate the express "reservation of rights" concept provided for in the predecessor section and allows a party who discharges an indorser or accommodation party to maintain his or her rights against other parties without taking any further action.

B. CHAPTER 4—BANK COLLECTIONS AND DEPOSITS

The revisions to Chapter 4 of the Code, which covers bank deposits and collections, include some technical and organizational changes but few substantive modifications. Overall, the revisions to Chapter 4 of the Code attempt to modify the regulation of bank operations to reflect present-day developments in banking and commerce. Four revisions deserve specific attention.

1. *Electronic Presentment*

Under the Revised Code,¹⁴¹ banks may, by agreement, clearing house rule, or Federal regulation, provide for electronic presentment, the delivery of instruments for collection purposes by transmitting an image of an item or information describing the item.¹⁴² This substitution of information for the physical items is often referred to as "giving presentment notice" and is employed by most banks in the collection process.¹⁴³ An advantage of electronic presentment is that delivery of the actual piece of

136. Transfer warranties and presentment warranties are separated and each given a separate section in the new code; transfer warranties at § 3.416 and presentment warranties at § 3.417.

137. TEX. UCC §§ 3.416(b), 3.417(b) (Vernon Supp. 1996).

138. *Id.* §§ 3.416(c), 3.417(e).

139. *Id.*

140. TEX. UCC § 3.605(b) (Vernon Supp. 1996).

141. For practical purposes, references to the Texas Code as drafted prior to the adoption of the 1995 amendments will be referred to as the "Prior Code" and references to the Code after the adoption of the 1995 amendments will be referred to as the "Revised Code."

142. TEX. BUS. & COMM. CODE ANN. §§ 4.110-4.114 (Vernon Supp. 1996) [hereinafter "Revised Code"].

143. *Id.*

paper to the payor bank for its collection is not required, therefore eliminating an often unnecessary paper trail. This process of reducing the paperwork actually transferred between institutions for the purpose of collecting interbank balances is known as "truncation." Truncation speeds the check collection process for all parties involved.¹⁴⁴

The Prior Code did not give any explicit authority to banks for, or acknowledge the process of, giving presentment notice, as opposed to manually transferring the original piece of paper evidencing the item, because few or no electronic collection systems were established at the time the Prior Code was enacted in 1967.¹⁴⁵ Presently, most banks either have electronic collection systems established in-house or subcontract with an outside party to provide this service.

Overall, a relationship between two depository institutions regarding presentment notice by electronic transmission is governed by the terms of a clearinghouse agreement entered into by the clearinghouse.¹⁴⁶ Surprisingly, in the highly regulated banking industry, the supervising governmental agencies do not extensively regulate the process of electronic presentment of checks between banks for collection. The new Chapter 4 provisions acknowledge that most banks collect their account balances employing electronic collection methods.¹⁴⁷ Thus, the Revised Code allows the parties to independently establish the terms of their relationship, and contains only one provision regulating this relationship.¹⁴⁸ This provision establishes that the act of presentment of an item for collection under an agreement for electronic presentment is deemed to have occurred when presentment notice is received by the payor bank.¹⁴⁹ The balance of the terms governing the relationship between the institutions will proceed from the clearinghouse agreement between the banks.

2. *Encoding and Retention Warranties*

The Revised Code includes a new section on encoding and retention warranties applicable only to a party doing the encoding of a check or a

144. *Id.* As part of acknowledging present-day mechanical procedures for the processing of checks in bulk, the Revised Code provides that a depository bank which receives for collection an undorsed item automatically "becomes a holder of the item at the time it receives the item for collection" if the customer was a holder at the time of delivery and the bank satisfies the other applicable requirements for becoming a holder in due course. *Id.* §§ 4.205, 3.302. Under the Prior Code, a depository bank attempting to transfer an undorsed item for collection purposes was required to get the customer's indorsement upon receipt of the item or to supply the indorsement of its customer itself. TEX. BUS. & COM. CODE ANN. § 4.205 (Vernon 1987) [hereinafter "Prior Code"]. Under the Revised Code, indorsement for the purpose of collecting an item is made immaterial. That is, for collection purposes, the depository bank does not have to obtain the customer's indorsement or actually affix its own indorsement to the back of the item. The depository bank need only transfer the item to the payor or a collecting bank.

145. *See generally*, BARKLEY CLARK & BARBARA CLARK, *THE LAW OF BANK DEPOSITS, COLLECTIONS AND CREDIT CARDS* (Rev. ed. 1995).

146. Revised Code § 4.110(a).

147. *Id.* § 4.110 & cmt.

148. *Id.*

149. *Id.*

party retaining an item under an agreement for electronic presentment.¹⁵⁰ But when the party encoding or retaining an item is a customer of a depository bank, the bank also makes the warranty to the other collecting banks.¹⁵¹ Under this section, a breaching party warrants to any subsequent bank in the collection process, including the payor, that the encoding of an item by magnetic ink character recognition was correct and that the retention of an item complies with the terms of their electronic presentment agreement. A party to whom the warranties are made and took the item in good faith may recover from the warrantor any damages suffered from a breach.¹⁵²

3. *Proper Charging of Customer's Account*

A bank is entitled to charge an item against the account of a customer when the item is "properly payable . . . even though the charge creates an overdraft".¹⁵³ For an item to be "properly payable" it must be (1) authorized by the customer, and (2) in accordance with any agreement between the customer and the bank.¹⁵⁴ The Revised Code further establishes that a bank customer is not responsible for the amount of an overdraft unless the customer signed the payment or benefited from the proceeds of the item.¹⁵⁵ This new provision has the effect of protecting a nonsigning customer of a joint checking account who did not benefit from the proceeds of the withdrawal leading to the overdraft. This provision echoes previous case law in Texas.¹⁵⁶

Additionally, the Revised Code creates a "safe-harbor" for paying postdated checks for payor banks.¹⁵⁷ The new safe-harbor provision recognizes that most check collection systems are automated and do not allow for the verification of the date on the item presented for collection.¹⁵⁸ The new provision states that when a bank customer writes a postdated check, a payor bank will not incur liability for paying the check prior to the specified date on the item, so long as it is otherwise properly payable and the customer has not given proper notice to the bank of the postdating.¹⁵⁹ For the postdating notice to be effective, the customer must deliver the notice in such a manner as to provide the bank a "reasonable opportunity to act on it before the bank takes any action with respect to the check."¹⁶⁰ The Revised Code provides that a customer wishing to

150. Prior Code § 4.205.

151. *Id.*

152. *Id.*

153. Prior Code § 4.401(a); Revised Code § 4.401(a).

154. Revised Code § 4.401(a).

155. *Id.* § 4.401(b).

156. *See Williams v. Cullen Ctr. Bank & Trust*, 685 S.W.2d 311 (Tex. 1985), where the Supreme Court of Texas held that a nondrawing cosigner of a joint checking account could not be found liable for the balance of an overdraft on the account where the bank customer had not authorized the item nor benefited from or ratified the transaction.

157. Revised Code § 4.401(c).

158. *Id.*

159. *Id.*

160. *Id.*

defer payment of a check may do so effectively by postdating the check and notifying the payor bank of the postdating in time to permit the bank to act on the notice.¹⁶¹ If the bank acts upon presentment of a postdated check by paying the check after having received timely notice of the postdating, the bank will be held liable for any damages resulting from its acts, including damages for dishonor of items subsequently presented for collection.¹⁶²

4. *Customer's Duty to Review Account Statements*

The Revised Code has substantially modified the rights and duties of a bank customer relating to reviewing account statements in a timely fashion.¹⁶³ Three main areas have been specifically addressed.

First, the new provisions require that banks providing truncated statements—account statements showing the opening and closing balances and transactions affecting these, but not returning the actual items paid to the customer—must provide sufficient information in the statements to allow the customer to reasonably identify each item paid.¹⁶⁴ To be deemed as providing sufficient information, the bank must furnish to the customer a statement showing a description of each item, by item number, amount paid, and date of payment. Additionally, when the bank delivers a truncated statement to its customer, the bank must provide in the statement a means for the customer to communicate a request that the bank furnish specific items paid by the bank or legible copies of these items.¹⁶⁵

Second, a bank customer is required to exercise “reasonable promptness” in examining the statement and reporting to the bank any items forged or altered.¹⁶⁶ Notice to the bank of such occurrences should not be delayed over 30 days if the customer is to preserve its rights against the bank for improper payment.¹⁶⁷ The Prior Code granted only 14 days for a customer to notify the bank of any unauthorized signature or alteration before the customer was precluded from asserting such a claim.

Finally, when the customer fails to review and report any item showing any inconsistencies evident in the statement, but the bank also contributed in causing any resulting loss by failing to exercise ordinary care in paying the item, the loss is apportioned between the customer and the bank on a comparative negligence basis.¹⁶⁸ This comparative negligence test for determining liability is a substantial change from the prior provision applying to situations where both the bank and the customer were at

161. *Id.*

162. Revised Code § 4.401(c).

163. *Id.* § 4.406.

164. *Id.*

165. *Id.*

166. *Id.* § 4.406(c), (d).

167. Revised Code § 4.406(c), (d). Note that these time frames are often modified in deposit agreements.

168. *Id.* § 4.406(d), (e).

fault, which allowed the customer to assert a valid claim for the total amount of the loss against the bank for failure to exercise ordinary care in paying an item in the face of an unauthorized signature or alteration.¹⁶⁹ In the event that the item is paid in bad faith, the bank will bear the full extent of the loss.¹⁷⁰

IV. CASE LAW REVIEW

Because of the significant statutory changes that have occurred since the last time this survey was written, it is not practical given the space allocated, and a reader's attention, to recap every case decided since the last survey which touches on a banking issue. Instead, discussed below in some detail are certain significant cases.

A. ADMINISTRATIVE FREEZES

*Citizens Bank of Maryland v. Strumpf*¹⁷¹ clearly leads the survey list of 1995 banking cases. This long awaited case provides that an administrative freeze of a debtor's depository account does not violate the automatic stay provisions of the Bankruptcy Code.¹⁷² In this case Strumpf was both a borrower and a depositor at Citizens Bank. At the time he initiated his bankruptcy proceeding he had funds on deposit in an account. Upon learning of his bankruptcy the bank froze the funds on deposit. The Court, in an opinion authored by Justice Scalia, indicates that the bank's temporary refusal to pay items presented was neither a taking of possession of the debtor's property nor an exercising of control over it within the framework of prohibited conduct of the automatic stay.¹⁷³ The Court carefully distinguished between the administrative freeze established by the bank and an act of setoff, which is stayed by the filing of a bankruptcy.¹⁷⁴ This distinction is interesting because immediately upon placing the administrative hold on the account the bank filed a motion seeking permission to exercise its right of setoff.¹⁷⁵

Of equal interest is the Court's disposition of the debtor's argument that the administrative hold violated the automatic stay because it was an act to obtain the possession of the property of the estate or to exercise control over property of the estate.¹⁷⁶ By viewing the depository relationship as one of contract, as opposed to one where the bank has possession of the debtor's property (i.e. money), the Court is able to dismiss the debtor's argument by saying ". . . if a bank account consisted of money belonging to the depositor and held by the bank then a violation of 362(a)(3), i.e. an act to obtain possession of property of the estate or to

169. Prior Code § 4.406(c).

170. Revised Code § 4.406(e).

171. 116 S. Ct. 286 (1995).

172. See, 11 U.S.C.A. § 362 (West 1993 & Supp. 1995).

173. *Strumpf*, 116 S.Ct. at 290.

174. *Id.* at 289.

175. *Id.* at 288.

176. *Id.* at 290, citing 11 U.S.C.A. § 362(a)(3) (West 1993 & Supp. 1995).

exercise control over property of the estate" may have occurred.¹⁷⁷ The Court categorized the depository relationship as "nothing more or less than a promise to pay, from the bank to the depositor . . . and [the bank's] temporary refusal to pay was neither a taking of the [debtor's] property nor an exercise in control over it, but merely a refusal to perform its promise."¹⁷⁸

This case is remarkable not only in the consumer setting, but in the more important area of cash collateral contests. It will not take long for most debtor's counsel to advise their clients to withdraw all funds on deposit at a bank that they have borrowed money from prior to filing a petition in bankruptcy. It may be more difficult for the typical business, particularly where their funds are sent to a lockbox, to cause those funds to be withdrawn from a bank prior to bankruptcy. While prohibitions against using cash collateral without an agreement from a lender already exist under the Bankruptcy Code, it is not unusual for a debtor in possession to spend cash collateral before an order is entered authorizing its use. The tool created by *Strumpf* will allow banks to place administrative freezes on cash collateral. It is important to note that the Court did not address the debtor's claim that he had been damaged by the bank's freeze which covered *more* money than he owed the bank.¹⁷⁹ This seems a clear signal that no more than is owed should be frozen. The facts of the *Strumpf* case indicate that it appears to make no difference whether the funds subject to the administrative freeze are pre-petition funds or post-petition funds. *Strumpf* filed for relief under Chapter 13 on January 25, 1991.¹⁸⁰ The bank did not place the administrative hold on the account until October 2, 1991.¹⁸¹ Thus the Court makes no distinction between pre-petition debt and post petition property of the estate.

B. BFP's

*Gallas v. Car Biz, Inc.*¹⁸² again highlights the importance of the Certificate of Title Act.¹⁸³ Sight drafts and automobile transactions are, and continue to be, a fertile ground for fraud. *Gallas* illustrates that no matter how bona fide the purchase, only where that purchase results in the transfer of a certificate of title does the purchaser become the owner.¹⁸⁴ In this case, Heart Attack Autos ("Heart Attack") gave Car Biz, the seller of an automobile, a three-day sight draft in return for a Ford Explorer. Car Biz delivered possession of the vehicle to Heart Attack and began the process of transferring title to the vehicle. Heart Attack, a dealer in automobiles, then sold the vehicle to Gallas (the plaintiff) for

177. *Strumpf*, 116 S.Ct. at 290.

178. *Id.*

179. *Id.* at 289.

180. *Id.* at 288.

181. *Id.*

182. No. 05-94-01754-CV, 1995 WL 689567 (Tex. App.—Dallas, Nov. 8, 1995, no writ).

183. Certificate of Title Act, TEX. TRANSP. CODE ANN. §§ 501.001-.159 (Vernon 1996).

184. *Gallas*, 1995 WL 689567, at *3.

\$14,000. Heart Attack gave Gallas possession of the vehicle, but not a certificate of title. Instead, Gallas filled out an Application for Title and relied upon Heart Attack's representation that the title was in the process of being issued. When Heart Attack's sight draft was returned unpaid, Car Biz reported the vehicle stolen and never transferred title to Heart Attack. Gallas was arrested for driving a stolen vehicle and later sued seeking declaratory judgment as the owner of the vehicle, entitled to specific performance of the transfer of the title. While a jury awarded Gallas the vehicle and directed Car Biz to convey title, on a Motion for Judgment Notwithstanding Verdict, the trial court held that Car Biz was the owner of the vehicle and ordered Gallas to deliver the vehicle to the seller. Over the dissent of Judge J. Wright, the appeals court affirmed the trial court. Since Heart Attack never acquired title it did not have and could not pass good title to a bona fide purchaser.¹⁸⁵

C. ARBITRATION

Arbitration clauses continue to find their way into more and more bank loan documents. Therefore, the bank practitioner should be aware that the Texas General Arbitration Act, which is modelled after the Uniform Arbitration Act, has been moved from Article 224 to Chapter 171 of the Civil Practice & Remedies Code.¹⁸⁶ In moving the statute the Legislature made generally cosmetic changes to the statute. While arbitration decisions are not published, the practitioner should be aware that the courts continue to broadly interpret arbitration clauses, even though in the banking context such clauses are generally the work product of the bank's counsel and are written to allow the bank to seek judicial enforcement of its rights, including judicial collection action, without waiving the bank's right to later seek arbitration of any dispute that might arise if the borrower asserts defenses and/or counterclaims. Such arbitration clauses in bank documents come into play only where a lender has instituted collection actions and the borrower brings a counterclaim. Contractual provisions can then establish that a lender's right to arbitration is not waived by seeking judicial action first. Thus, the adoption of such an arbitration program should be carefully considered by banks and their counsel.

The Texas Supreme Court has recently recognized that mere delay does not waive a right to arbitration. This is significant because in many workout scenarios a borrower will assert counterclaims against a bank. These counterclaims will be held in abeyance while the bank and borrower negotiate. Where those efforts to amicably resolve their differences end in failure, a claim of waiver will often be made in an attempt to prevent arbitration. In *Prudential Securities, Inc. v. Marshall*¹⁸⁷ the Texas Supreme Court makes clear that a party urging that delay represents a waiver of a right to arbitrate, carries the burden of proof in establishing

185. *Id.*

186. TEX. CIV. PRAC. & REM. CODE ANN. § 171.001-.023 (Vernon Supp. 1996).

187. 909 S.W.2d 896 (Tex. 1995).

that any such delay results in prejudice.¹⁸⁸ Where the delay is during a workout effort it is going to be difficult for most borrowers to carry their burden that the delay was prejudicial.

D. GUARANTIES

The impact of confirmation of a bankruptcy reorganization plan upon the liability of a guarantor was addressed in *Austin Hardwoods, Inc. v. Vanden Berghe*.¹⁸⁹ Vanden Berghe was the guarantor of the obligations of Frame Industries Suppliers, Inc. to Austin Hardwoods, Inc. Frame Industries filed Chapter 11 bankruptcy, and had their Chapter 11 plan confirmed. The terms of the plan provided for a 50% payment of all unsecured debt, through installment payments to be made over time. Austin was the holder of an unsecured claim. The plan of reorganization further contained the following clause:

8.01 SATISFACTION. All creditors and parties in interest who have or assert Claims in any class shall, upon Confirmation of this Plan, be deemed to have acknowledged that their respective Claims are fully satisfied by the distribution provided herein, each of which Claims, whether known or unknown, scheduled or unscheduled, filed or unfiled, asserted or assertable, is declared and shall be, for all purposes, upon the entry of the Order confirming this Plan, satisfied in full.¹⁹⁰

The court held that the provisions of § 524(e) of the Bankruptcy Code, which states "discharge of the debt of a debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt" applied, even though the plan provided that the debt was satisfied.¹⁹¹ Thus the court confirmed that the satisfaction of Frame Industries' debt through their plan of reorganization does not have the effect of relieving the guarantor of any liability.¹⁹²

E. D'OENCH, DUHME & CO

The scope of the requirement that agreements be in writing and contained in the minutes of an institution in order to avoid the defense established by *D'Oench, Duhme*¹⁹³ are further illustrated by *Bluebonnet Savings Bank v. Jones Country, Inc.*¹⁹⁴ The case law requirements of *D'Oench, Duhme & Co.* have been essentially embodied in a federal statute.¹⁹⁵ As adopted by statute, however, the broad shield this defense has provided the government in the past has been substantially tamed. Now

188. *Id.* at 898-99.

189. No. 08-94-0086-CV, 1995 WL 681232 (Tex. App.—El Paso, Nov. 16, 1995, no writ) (not yet released for publication, subject to revision or withdrawal).

190. *Id.* at *3.

191. 11 U.S.C.A. § 524(e) (1996).

192. *Austin*, 1995 WL 681232, at *3.

193. *D'Oench, Duhme & Co. v. Federal Deposit Ins. Corp.*, 315 U.S. 447 (1942).

194. 911 S.W.2d 871 (Tex. App.—Beaumont 1995, no writ).

195. *See* 12 U.S.C.A. 1823(e) (1995).

an agreement is enforceable against the FDIC as receiver if it has either been approved by the board or its loan committee.¹⁹⁶

Under the facts of *Bluebonnet*, Jones Country (plaintiff) financed a bus through Home Savings, which required the plaintiff to maintain insurance on the bus. The insurance was financed by the savings and loan under a separate note. When that note was initially executed, funds were wire transferred to an insurance broker and an insurance certificate was issued. At the end of the year, the underlying debt was refinanced and a new note was executed. The savings and loan's records, however, did not contain a certificate of insurance or a receipt from the insurance carrier indicating the policy was renewed. During the second year, the bus was involved in an accident and Jones Country was notified by their supposed insurance carrier that no insurance policy existed on the bus. Jones Country then contacted Home Savings and was assured that coverage existed. Accordingly, Jones Country continued to make payments on the note which financed the insurance premiums. A suit was ultimately filed against Jones Country who employed its own counsel to defend the lawsuit. The bus owner settled the case, and incurred not only settlement charges, but attorneys' fees. Home Savings was declared insolvent, and its assets were transferred to the FSLIC as receiver.¹⁹⁷

The issue is whether the documentary evidence was sufficient to establish the elements of the D'Oench, Duhme defense, i.e. was the agreement to provide insurance sufficiently documented. The court treated the D'Oench Duhme defense like a statute of frauds defense—since there was some evidence of the written agreement, was it enough? The majority found that the note memorialized an agreement that Home Savings was to procure an insurance policy by transmitting the proceeds of the loan to the insurance company. The dissent, viewing the same facts, found only an agreement to loan money for the purpose of procuring insurance and not an agreement to procure such insurance. The majority stated that the "in writing" requirement of D'Oench, Duhme is subject to analysis of what a "reasonably prudent bank examiner" would have concluded constitutes a writing within the bank's file. The reading continues a trend of narrowing the broad scope of the D'Oench, Duhme defense.¹⁹⁸

F. LIMITED BANKING ASSOCIATIONS

It appears that the efforts to create Texas limited banking associations in order to prevent the double taxation of dividend income, has failed. The Internal Revenue Service ("IRS") has issued a Private Letter Rul-

196. *Bluebonnet*, 911 S.W.2d at 873, 874.

197. The FSLIC is now the FDIC. See Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (1989).

198. See, e.g., *Cadle Co., Inc. v. Wallach Concrete, Inc.*, 897 P.2d 1104 (N.M. 1995); *F.I. DuPont DeNemours & Co v. FDIC*, 45 F.3d 458 (D.C. Cir. 1995); *John v. RTC*, 39 F.3d 773 (7th Cir. 1994); *RTC v. Midwest Fed. Sav. Bank*, 36 F.3d 785 (9th Cir. 1993); *Erba Finca v. FDIC*, 855 F. Supp. 9 (D. Mass 1994).

ing¹⁹⁹ indicating that a bank reorganized as a Texas limited banking association will not be classified as a partnership under section 7701(a)(2) of the Internal Revenue Code. The IRS relied in part upon an application which the bank filed with Federal Deposit Insurance Corporation indicating that, as reorganized, it should be considered incorporated under Texas law. As a result of this ruling, the IRS appears to have negated the main benefit attendant to Texas limited banking associations.

V. TEXAS CONSUMER CREDIT COMMISSIONER'S OPINIONS CONCERNING HOME EQUITY LENDING

The issue of home equity lending has been a lively topic in Texas since 1986. Congress' removal that year from the Internal Revenue Code of the deduction for interest expense incurred on consumer debt, and the creation of a deduction for interest expense incurred on "home equity loans"²⁰⁰ has spurred the interest of both Texas lenders and consumers. Texas is the only state which does not permit such qualifying home equity loans.

The advent in 1986 of this provision in the Internal Revenue Code prompted lenders in Texas to solicit the opinion of the Texas Consumer Credit Commissioner concerning the availability of this type of lending in Texas. The Commissioner issued a formal interpretive letter,²⁰¹ finding that a Texas lender who engages in "home equity lending" would be engaging in an activity that is a per se violation of the Texas Deceptive Trade Practices Act since the lien obtained would be unenforceable²⁰² according to the prohibition in the Texas Constitution against liens on homesteads for purposes other than purchase money loans or liens in favor of mechanics or materialmen who improve the homestead or for taxes.²⁰³ Interpretive Letter 86-6 understood that the Internal Revenue Code requires a valid lien in order to support a deduction for interest expense on a home equity loan, and since the lien would be invalid in Texas under the provisions of the Texas Constitution, no tax deduction would be available.²⁰⁴ Finally, the Commissioner concluded that he could find no provision in Texas that authorizes "home equity lending" under subtitle 2 of the Texas Credit Code.²⁰⁵ The rationale of Interpretive Letter 86-6 was that Chapters 3 and 4 of the Texas Credit Code, which authorize installment lending in general, prohibit the taking of any interest

199. Priv. Ltr. Rul. 95-51-032 (Sept. 27, 1995).

200. The term "home equity loan" is a loan that meets the parameters of the Internal Revenue Code set forth at 26 U.S.C.A. § 163(h)(3)(C)(ii) (1995) which states that the amount of debt shall not exceed the greater of the equity in the taxpayer's principal residence or \$100,000. There is no limitation in the Internal Revenue Code on how the funds are to be used.

201. Tex. Consumer Credit Comm'r Letter No. 86-6 (Dec. 16, 1986) [hereinafter Interpretive Letter 86-6].

202. *Id.*

203. TEX. CONST. art. XVI, § 50.

204. Interpretive Letter 86-6.

205. *Id.*

in real property as collateral, and that Chapter 5, which authorizes loans secured by inferior liens on residences, requires those liens to be valid.²⁰⁶

Congress later clarified the matter of whether the lien must be enforceable in order to support the deduction of interest expense for Federal Income Tax purposes. The adoption of the Technical and Miscellaneous Revenue Act of 1988 removes any doubt as to the necessity of an enforceable lien on a residence supporting an interest rate deduction on a home equity loan.²⁰⁷ As a result, section 163(h)(4)(C) of the Internal Revenue Code now provides:

Unenforceable security interests. Indebtedness shall not fail to be treated as secured by any property solely because, under any applicable State or local homestead or other debtor protection law in effect on August 16, 1986, the security interest is ineffective or the enforceability of the security interest is restricted.

The legislative history indicates that Congress had Texas in mind when they passed the 1988 Act.

The bill provides that interest on a loan secured by a recorded deed of trust, mortgage, or other security interest in a taxpayer's principal or second residence, in a State such as Texas where such security instrument will be rendered ineffective or the enforceability of such instrument will be otherwise restricted by State and local homestead or other debtor protection law such as the Texas homestead law, shall be treated as qualified residence interest, provided that such interest is otherwise qualified residence interest.²⁰⁸

Changed circumstances have dictated a reexamination of these issues. In two new interpretive letters,²⁰⁹ the Consumer Credit Commissioner examines the underpinnings of Interpretive Letter 86-6.1.²¹⁰

The new commissioner acknowledges the changes to the Internal Revenue Code that clarifies the issue of the enforceability of the lien for federal income tax purposes. She further opines that her predecessor's declarations in the areas of the Internal Revenue Code and the Deceptive Trade Practices Act were beyond his statutory authority.²¹¹

The Texas Consumer Credit Commissioner's authority to issue opinions is limited to matters arising under the Credit Code.²¹² In recognizing this limited authority and in withdrawing 86-6, the Commissioner does a

206. *Id.*

207. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342 (1988).

208. S. REP. NO. 100-445, 100th Cong., 2d Sess. 37 (1988), reprinted in 1988 U.S.C.C.A.N. 4515, 4561.

209. TEX. CONSUMER CREDIT COMM'R LETTER NO. 95-1 and 95-2 (Feb. 9, 1996) [hereinafter Interpretive Letter 95-1 and 95-2, respectively].

210. Interestingly the General Counsel of the Texas Department of Banking has also issued a letter saying that a bank does not violate any statute by accepting an unenforceable lien on a homestead in order to permit interest deductions by the borrower for income tax purposes. Opinion 94-86.

211. "I find, however, that I do not have the authority to interpret the DTPA because any interpretative authority . . . is limited to Title 79." Interpretive Letter 95-1.

212. TEX. REV. CIV. STAT. ANN. art. 5069-2.02A(10) (Vernon 1987 & Supp. 1996).

great service to Texas lenders by lessening the chilling effect arising out of Interpretive Letter 86-6. The suggestion that any loan secured by an invalid lien would be a violation of the Texas Deceptive Trade Practices Act justifiably chilled the interest of Texas lenders to test these waters. Removing any direct precedential value from 86-6 may embolden some Texas lenders to create products, with adequate disclosures to consumers about the invalidity of the lien granted, providing Texas taxpayers the same deduction for interest expense that taxpayers in other states enjoy.

However, the Commissioner indicated, in her Interpretive Ruling that she still sees Chapter 5 as an impediment to this type of lending because no other enabling statutes in this state authorizing this type of lending, overlooks the more limited application of Chapter 5. Extensive usury reform took place in Texas in 1981.²¹³ The general 10% usury ceiling was increased to a minimum of 18%.²¹⁴ As a part of this general usury reform, Chapters 3, 4, and 5 of the Texas Credit Code were amended to allow lenders to lend at either the old add-on interest rate maximums, or any simple interest equivalent authorized by the 1981 general usury reform.

In making these general interest rate reforms applicable to the Texas Credit Code, the Legislature clarified the scope and application of the Texas Credit Code. Curiously, nowhere in the original Texas Credit Code were there limitations indicating that it was applicable only to consumer lending. In enacting the general usury reform in 1981, the Legislature narrowed the scope of Chapters 3, 4, and 5 and clearly indicated that those provisions of the Texas Credit Code deal only with loans that are extended primarily for personal, family, or household use.²¹⁵

When Commissioner Endsley issued Interpretive Ruling 86-6, his concern about finding an enabling statute authorizing a creditor to make a loan secured by an unenforceable second lien on residential property focused on Chapter 5 of the Texas Credit Code where the purpose of the loan was *primarily personal, family, or household and where the loan is repayable in substantial equal monthly installments*.²¹⁶ However, a loan either for "investment" purposes or a loan for personal, family, or house-

213. Tex. H.B. 1228, § 5, 67th Leg., R.S. (Act approved May 8, 1981).

214. TEX. REV. CIV. STAT. ANN. art. 5069-1.04(a), (b) (Vernon 1987 & Supp. 1996). The maximum is now 24% (on loans in general, and a maximum of 28% on extensions of credit in an amount in excess of \$250,000).

215. See, e.g., TEX. REV. CIV. STAT. ANN. art. 5069-1.04(n)(2) (Vernon 1987).

Any loan made under this Article that is extended *primarily for personal, family, or household use* but not for business, commercial, investment, agricultural, or similar purposes, *and that is predominantly payable in monthly installments and is described by Section (1), Article 5.01, of this Title and Sections (1), (3), and (4), Article 5.02, of this Title* and that is made, negotiated, or arranged by a person engaged in the business of making, negotiating, or arranging those types of loans, *is subject to Chapter 5 of this Title*, and any person except a bank or savings and loan association engaged in that business shall obtain a license under Chapter 3 of this Title.

Id. (Emphasis added) (footnote omitted).

216. TEX. REV. CIV. STAT. ANN. art. 5069-1.04(n)(2) (Vernon 1987).

hold purposes which is not repayable in substantial equal monthly installments²¹⁷ would not fall on Chapter 5 of the Texas Credit Code. It seems clear now that chapter one might be used to validate the proposed lending.

Commissioner's Interpretive Ruling 95-1 overturns an opinion that both, because of changes in the law and an overly broad scope to begin with, unfairly chilled Texas lenders' willingness to provide a vehicle which would allow the citizens of the State of Texas to be treated on an equitable basis with taxpayers in other states. Ruling 95-1, however, did not fully appreciate the historical perspective from which the Texas Credit Code arises, and wholly overlooked the clear language of the general usury reform enacted in 1981 which limited the reach of Chapter 5 to a narrow area as to recognize the general applicability of chapter one.

VI. PROPOSITION 4 AND ITS EFFECT UPON TEXAS HOMESTEADS

In Interpretive Ruling 95-1, the Commissioner suggests that legislative reform is needed to clarify the issue of home equity lending in Texas, not action by her office. Proving that the Legislature can successfully act in this area, Senate Joint Resolution 46 was passed in the last legislative session as a proposed constitutional amendment dealing with owelty of partition on homesteads and federal tax liens which attach to homesteads. On November 4, 1995, the proposition received sufficient voter approval to become law.

Proposition 4 amended Article 16 section 50 of the Texas Constitution to recognize the enforceability of a lien granted as part of an owelty of partition and to permit the refinancing of a federal tax lien against a homestead.²¹⁸ The statutory change corresponding to the constitutional amendment appears at section 41.001 of the Property Code.²¹⁹

Proposition 4 was designed to clarify Texas case law and overrule the holding of three seminal homestead cases. But it can also be seen as an inroad into the sacrosanct belief that a lien against the homestead in Texas should only be permitted for a purchase money lien or for liens in favor of mechanics or materialmen who improve the homestead or for ad valorem taxes.

The three modern homestead cases which Proposition 4 overrules are as follows:

The case of *In re J. R. Buffington*²²⁰ held that when two spouses who own a homestead prior to a divorce, and as part of the divorce dissolution of property one spouse conveys to the other his or her undivided one-half interest and evidences that conveyance by an owelty deed of partition,

217. Interpretative Letter 81-34 indicates that the 1981 amendments effectively removed the requirement that the monthly installments be substantially equal.

218. TEX. CONST. art. XVI, § 50.

219. TEX. PROP. CODE ANN. § 41.001 (Vernon 1987 & Supp. 1996).

220. 167 B.R. 833 (Bankr. E.D. Tex. 1994).

utilizing either a vendor's and/or a contractual lien to secure the payment of the sum to be received in return for that conveyance.²²¹ The selling spouse's security interest extends only to the one-half undivided interest in the former homestead which that spouse conveyed.²²² Upon a default by the spouse who retains the homestead, the conveying spouse is entitled to foreclose only upon the undivided one-half interest to which the lien attached.²²³ While well reasoned and in harmony with the constitutional concept that a purchase money lien can only attach to an interest sold, such a holding provides for a rather anomalous result. Namely, the selling spouse, after having foreclosed on the one-half interest pledged, may then have to seek judicial intervention in the form of a partition lawsuit requiring the sale of the home in order to receive the economic benefit of the original bargain. By recognizing the unmarketable nature of an undivided one-half interest in the most common form of community real property (i.e., a house), this amendment to the Constitution allows a lien on a Texas homestead to be valid even where that lien attaches to the one-half interest was not sold.

A second case dramatically affected by Proposition 4 was *Crowder v. Benchmark Bank*.²²⁴ The case was subsequently reversed by the Texas Supreme Court.²²⁵ Thus, the statutory and case law are now consistent that a party can succeed in a federal tax lien against Texas homestead property.

Interestingly, Proposition 4 also overturned *In Re Niland*,²²⁶ a decision, the minority opinion notes as providing an unduly harsh result to lenders by making them the party harmed by declaring invalid a lien taken against property that a defrauding owner wrongfully claims is not his homestead. As early as 1890 in *Texas Land & Loan Co. v. Blalock*, the Texas Supreme Court has held that no estoppel can arise in favor of a lender who has attempted to secure a lien on a homestead in actual use and possession of the family, based on declarations of the husband and wife made orally or in writing *contrary to the fact*.²²⁷ The court in *Blalock* indicated that to hold otherwise would practically abrogate the Constitution.²²⁸ *In re Niland* was a modern reaffirmation of this approach.

Proposition 4 adopts a more modern approach that shifts the burden of proof to the homestead claimant who must prove that the lender had actual knowledge of the occupation of the property as their homestead, in order to invalidate a lien given through the issuance of a false homestead affidavit.²²⁹ Clearly the constitutional amendment reflects a movement,

221. *Id.* at 836.

222. *Id.*

223. *Id.*

224. 889 S.W.2d 525 (Tex. App.—Dallas 1994, writ granted).

225. 39 TEX. SUP. CR. J. 361 (Mar. 7, 1996).

226. 825 F.2d 801 (5th Cir. 1987).

227. 76 Tex. 85, 89, 13 S.W. 12, 13 (1890) (emphasis added).

228. *Id.*

229. TEX. CONST. art. XVI, § 50; TEX. PROP. CODE ANN. § 41.001 (Vernon 1987 & Supp. 1996).

however slight, from the absolute homestead exemption tradition in Texas. By easing the mechanism of tapping the equity in homesteads, Proposition 4 will prevent many future forced sales.