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TEXAS HOME EQUITY: A BIG WIN FOR LENDERS

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Every now and then we are reminded that chivalry is not dead. According to the Texas Supreme Court, neither is the Doctrine of Equitable Subrogation. And we can all be thankful for both.

THE *ZEPEDA* CASE

In *Federal Home Loan Mortgage Corporation v. Zepeda,* Case No. 19-0712 (Tex. April 24, 2020), the Texas Supreme Court, answering a certified question from the 5th Circuit, held that a lender that makes a 50(a)(6) home equity loan that in part refinances a prior, valid lien on the borrower's homestead property is entitled to subrogation, even if the lender failed to correct a curable defect in the home equity loan documents under Article 16, Section 50 (a)(6) of the Texas Constitution ("Section 50(a)(6)").

THE FACTUAL BACKGROUND

Ms. Zepeda purchased her home in 2007. Four years later, she obtained a Texas home equity loan from Embrace Home Loans ("Embrace") that paid the purchase money lien in full. After discovering that the Texas Fair Market Value Acknowledgement ("FMV Acknowledgement") she signed at closing had not been executed by the lender as required by Texas law, Ms. Zepeda's legal counsel notified Embrace of this failure to comply and requested it be cured within 60 days in accordance with "Section 50(a)(6)". Embrace responded by sending Ms. Zepeda yet another FMV Acknowledgement unsigned by the lender and later sold the loan to Freddie Mac. Ms. Zepeda's legal counsel notified Freddie Mac of the failure to comply, giving them the opportunity to cure the failure within 60 days. Freddie Mac did not respond, resulting in this suit to quiet title asserting that, due to its failure to comply with Section 50(a)(6), Freddie Mac did not have a valid lien against her home.

In *Zepeda,* neither party disputed there was a clear failure by the lender to comply with one of the specific requirements for Section 50(a)(6) home equity loans. Further, it was undisputed that the lender had failed to cure the defect after having been provided written notice offering the opportunity to do so.

Attorneys for Ms. Zepeda argued the doctrine of subrogation was abolished by Texas voters when adopting changes to Section 50(a)(6) in the 1990s, specifically pointing to Section 50(a)(6)(Q)(x) providing for a lender's forfeiture of all principal and interest paid on the loan if the lender caused a constitutional defect in the loan documents and did not cure it within 60 days of receiving notice of its failure to comply.

THE TEXAS SUPREME COURT'S DECISION

But the Texas Supreme Court rejected that same reasoning in the famous case of *LaSalle Bank Nat'l Ass'n v. White,* 246 S.W.3d 616 (2007) and instead decided that because of Texas' long-standing doctrine of equitable subrogation, the lender can enforce its lien to the extent of the amount of the purchase money loan that it paid off even though it failed to cure the defect.

A REFRESHER ON THE TEXAS DOCTRINE OF EQUITABLE SUBROGATION

As noted in *Zepeda,* Texas has recognized the doctrine of equitable subrogation from as early as 1890. See *Land & Loan Co. v. Blalock,* 76 Tex. 85 (1890).

In 1895, an early panel of the Texas Supreme Court concluded: "Perhaps the courts of no state have gone further in applying the doctrine of subrogation than has the court of this state, of which we cite a few

instances. One who discharges the vendor's lien upon lands even the homestead, either by paying as surety, or at the request of the debtor, or at a judicial sale, which, for irregularities in the process, fails to convey the title, is entitled to be subrogated to the lien of the creditor to the extent of the payment so made." *Faires v. Cockerell,* 88 Tex. 428, 437 (1895).

Equitable subrogation is, essentially, the substitution of a new lender for the original lender on a prior mortgage indebtedness. The new lender that pays off the existing mortgage debt with the proceeds of its loan to the borrower becomes subrogated to the rights of the original lienholder and becomes an equitable assignee of the existing first lien, and may keep the lien alive and enforce it for that new lender's own benefit. Another way to think of it is that the new lender is said to "stand in the shoes" of the previous purchase money lender.

Zepeda reaffirms the historic strength of subrogation in Texas and serves as a reminder of the balance between a Texas homeowner's constitutional right to mortgage homestead property and a lender's right to subrogation when paying off existing mortgage debt with mortgage loan proceeds.

A LESSON FOR LENDERS

The *Zepeda* decision also includes a sober reminder that equitable subrogation does not leave a lender completely whole because the amount of the subrogated first lien is usually less than the total amount of the home equity loan on which the borrower defaulted. In practical terms, this means, for example, that if a lender makes a Section 50(a)(6) loan in the amount of $300,000 (comprised of a $250,000 purchase money payoff, plus $50,000 cash out) the doctrine of subrogation secures the lender's lien for $250,000 but not for the additional $50,000. It is one thing to risk $50,000 because the home equity loan was defective. It is quite another to have the entire $300,000 at risk.

While the weight of the doctrine in many cases is substantial, so is the weight of the loss of additional loan proceeds, attorney's costs and fees. If anything, *Zepeda* reminds lenders of the importance of verifiable procedures to ensure notices of failure to comply with Section 50(a)(6) are properly handled.

A DESIRED OUTCOME FOR LENDERS AND BORROWERS ALIKE

If the *Zepeda* Court had ruled for the consumer and denied equitable subrogation, all future cash out refi loans would be much riskier and likely more expensive. Indeed, had the Court ruled differently, some lenders might have decided to no longer offer cash out refi loans, due to the increased risk.

Zepeda once and for all clarifies that on a Section 50(a)(6) loan in Texas, a lender who pays off a prior, valid lien against a borrower's homestead property is entitled to subrogation to the extent of the payoff proceeds, even if the home equity lien is later found to be ineffective or unenforceable due to a lender's failure to timely correct a curable defect in the closing documents.

So just as we can rejoice in reappearances of chivalry in today's world, we also rejoice in the continuation of this favorable tradition in Texas jurisprudence and for the benefits it continues to bring for the residential finance needs of Texans today!