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MEMORANDUM

TO: CLIENTS AND FRIENDS OF THE FIRM

FROM: Aaron Polasek

DATE: February 26, 2007

SUBJECT: Agricultural Use Land – A Plague and Pestilence upon Texas Homesteads

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Two recent court cases have cast considerable doubt upon a mortgage lender's ability to create a valid lien when making a Texas home equity loan secured by homestead property that was, or might be in the future, subject to agricultural valuation for tax purposes. These two cases, along with the Texas statutes providing for special taxation of agricultural lands and the Constitutional home equity forfeiture provisions, leave agricultural property in the state of Texas fallow for the home equity lender.

The Texas Constitution prohibits securing a home equity loan with property that is designated for agricultural use as provided by Texas statutes governing property tax, unless the property is used primarily for the production of milk [Tex. Const. art. 16, §50(a)(6)(I)]. When property is designated for agricultural use, the tax certificate issued by the taxing authorities (i.e. the county appraisal district) for the property will normally reflect the property is subject to agricultural use in one of two ways: with an "agricultural exemption" or by showing special agricultural value assigned to the property (herein, collectively, "ag use"). Land that meets certain criteria relating to agricultural use can qualify for a special agricultural appraisal, which entitles the landowner to a reduced tax against the property; Texas tax laws do not provide for an actual "agricultural exemption".[1] However, a Texas home equity loan cannot be secured by a lien on homestead property designated for ag use and any such purported lien is void as a matter of law.

Tax certificates are usually issued only once a year (often in October), reflecting any exemption(s) or special valuation the property was receiving at the time the certificate was issued. Previous practice by some lenders when processing an application for a Texas home equity loan with a tax certificate

[1] The correct nomenclature is an "agricultural appraisal" or "agricultural assessment", as opposed to an actual exemption. The designation of an "ag exemption", while helpful when trying to recognize this issue on a tax certificate, is technically incorrect, as Texas property tax statues do not provide for such an "exemption". However, even though the presence of an "ag exemption" on a tax certificate is technically incorrect, it still serves as notice that the land is designated for agricultural use and, therefore, ineligible to secure a Texas home equity loan. The import of this distinction is that not every tax certificate for property receiving the agricultural appraisal will reflect an "ag exemption". Sometimes the tax certificate will reference a numerical value of "land agricultural value", which indicates the property is designated for agricultural use.

that reflected the property was receiving ag use was to arrange to have the owner of the property request removal of the ag use from the appraisal district, obtain a letter from the appraisal district that this did in fact happen, and to verify the title office was willing to insure the property without exception to the ag use issue based on the appraisal district's letter (insuring provision 2(b) of the T-42 endorsement insures the property is not designated for ag use). A recent Texas court case, LaSalle Bank National Association, a/k/a LaSalle National Bank, as Trustee and LaSalle National Bank as Trustee Under the Pooling and Services Agreement Dated June 1, 1999, Series 1999-2 v. Lorae White and Gerald Geistweidt, 2006 WL 2871278 (Tex. App. – San Antonio)(herein "LaSalle Case") calls this practice into considerable doubt.

In the LaSalle Case, the home equity borrowers' property was designated for ag use, which was reflected on the most current tax certificates available. Testimony introduced at trial reflected the tax appraiser received a request from the owner and the lender that the ag use be removed from the property, to which the appraiser responded that the change could only be made on the following January 1st. Consequently, there was no new tax certificate issued prior to the loan closing. Subsequently the loan closed, with the files of the lender and title company containing the tax certificates that reflected the ag use. Sometime thereafter, the loan went into foreclosure and the owner filed suit seeking a declaratory judgment that the home equity lien was invalid because the lender violated the Texas Constitution by, in part, securing the loan with property that was subject to agricultural value at the time the loan closed. The trial court held for the owner, concluding the lender violated the Constitutional prohibition of securing a home equity loan with property designated for agricultural use and ruled the lender forfeited its right to receive payment under the home equity note and the lien against the property was invalid. On appeal the trial court's ruling was upheld.

The lesson to be learned from the LaSalle Case is to proceed with extreme caution, if at all, when processing a proposed home equity loan with a tax certificate that reflects an "ag exemption", ag value or any other similar designation. Without obtaining a new tax certificate that is clear of any ag use designation, a Texas home equity lender it risking lien invalidation. Lenders should review this issue, determine the title company's willingness and ability to insure the lender against loss from the ag use issue and assess the risk when making a determination to proceed with closing.

While the holding in the LaSalle Case should cause alarm in lenders,in Marketic v. U.S. Bank Nat'l Ass'n, 436 F.Supp. 2d 842 (N.D. Tex. 2006) (herein, "Marketic"), the court struck a much more onerous blow to the ability of lenders to obtain any reasonable assurances when securing a Texas home equity loan with property that is susceptible of receiving the ag use appraisal. In the Marketic case, a home equity loan was secured by property that had been receiving ag use, which was removed prior to making the loan. Evidence introduced at trial indicated the owner removed the ag use at the insistence of the lender and mortgage broker. Evidence further indicated the owner continued to engage in the agricultural-related activities that entitled the property to receive the ag use appraisal after closing, even though the ag use designation had been removed from the property by the appraisal district. Sometime after closing and funding, the owner again designated the property for ag use. The loan subsequently went into foreclosure and the owner filed suit seeking a declaratory judgment and injunctive relief to prevent the foreclosure based, in relevant part, on the designation of the property for ag use at the time of the foreclosure action. The lender moved for summary judgment on this issue, arguing the only relevant designation is the designation in effect at loan closing. On this issue, the court denied the lender's motion for summary judgment and held for the property owner, stating ". . . Marketic's property, if subsequently re-designated for agricultural use as alleged in [Marketic's] affidavit, is 'protected' from forced sale under [the Texas Constitution], regardless of how the property was designated when [Marketic] incurred the 'debt'". Interestingly,

the court did not go as far as to declare the lender's security interest in the property was invalid; the court merely declared the land was not subject to forced sale (i.e foreclosure) by the lender. This conclusion is in conflict with the language of the Texas Constitution which states a home equity loan secured by land subject to ag use is invalid [Tex. Const. art. 16 §50(a)(8)(c)]. The Marketic case was decided by a federal court, interpreting Texas state law. As such, the Marketic decision is not binding precedent in Texas state courts. However, the case has not been overturned or otherwise called into question nor has the issue arisen in a Texas court. Therefore, Marketic should serve as a dire warning to Texas home equity lenders when contemplating securing a home equity loan on property that was, or could be in the future, designated for ag use.

Texas property tax laws provide further challenges to the home equity lender. Section 23.47 of the Texas Property Tax Code prohibits a lender from requiring a property owner to remove an existing ag use designation or from requiring a property owner to agree not to apply for or receive the ag use appraisal on land that will be used to secure a contemplated loan. In theory, land that is subject to zoning or other types of land-use controls that effectively prohibit the types of activities that would qualify for agricultural use are the only safe harbor for Texas home equity lenders if the Marketic decision carries the day However, all hope is not lost. The Texas Association of Mortgage Bankers has proposed a technical corrections amendment to section 50 (a)(6)(I) of the Texas Constitution that would relieve lenders of the troublesome "future ag use" problem. HJR 72, sponsored by Representative Burt Solomons, proposes to amend the current language of section 50 (a)(6)(I) to prohibit a lender from securing a home equity loan that is designated for ag use as of the date of closing. Under this proposed amendment, a lender could rely upon the designation of the property at the time of closing, thereby removing the possibility a home equity loan secured by non-ag use property at closing could be invalidated based upon former ag use or an ag use designation placed on the property after closing. Such a Constitutional amendment requires a 2/3rd super majority vote of both Houses and ratification by a majority of Texas voters at the November 6, 2007 election. If passed, this amendment would effectively dispose of the "past or future ag designation" problem presented by the LaSalle and Marketic holdings.

The penalty a lender faces for securing a Texas home equity loan with ag use land is lien invalidation (forfeiture of principal and interest), except in instances where the borrower committed actual fraud in connection with securing the loan which, if proven by the lender, would allow the lender to seek personal liability from the borrower. The Texas Constitution does include cure provisions that allow a home equity lender to cure most defects in a Texas home equity loan, but the ag use limitation is rarely susceptible to cure. The procedure for curing a defect in a Texas home equity loan requires the lender, within 60 days of receiving notice from the borrower of the defect, refund any unauthorized fees charged in connection with the loan or otherwise modifying the loan such that the terms and provisions conform with the Constitutional requirements including, if necessary, offering the owner the right to refinance the loan, as modified and at no cost to the owner, with the same loan terms as the original extension of credit. When a home equity loan has been secured by land that is receiving ag use, there is no viable method of curing the defect; the only way to "cure" the ag use defect is to release the ag use land from the lien, leaving the lender with an unsecured, non-recourse loan. In rare instances, a lender might find only a portion of the property securing a home equity loan is receiving ag use. In these instances, there is a ray of hope for a lender. For example, assume the lender closes a home equity loan secured by 9 acres of land. Subsequently, lender discovers the land is receiving ag use. Upon further investigation, Lender finds out from the county appraisal office that the owner has divided the 9 acre tract into 2 tracts for tax purposes. Tract 1 is 8 acres and is receiving ag use, Tract 2 is 1 acre and is not receiving ag use. In this instance, if the Lender can show the 1 acre not being taxed with ag use contains the residence and uninterrupted access to a public or otherwise dedicated roadway, and the appraised value of that 1 acre tract supports the 80%

cumulative loan-to-value-ratio (measured as of the time of the original closing), Lender arguably could re-close the loan taking only that one acre as collateral, releasing the other 8 acres. While this is an example of "curing" an ag use problem, these situations are rare and, even if viable, a lender will incur additional cost, time and resources.

The current legal landscape for home equity loans secured by past, present or future ag use land is bleak. The LaSalle and Marketic cases, along with the Texas property tax laws and Constitutional forfeiture provisions leave mortgage lenders with little room for error when dealing with ag use land. Lenders should verify, for any proposed Texas home equity loan, the existing tax certificate is clear of any ag use designations and should review past tax designations for the property and current uses of the property to identify land that might lead to future ag uses and designation. Future case law and legislation may reduce the ag use dilemma for Texas home equity lenders, but for now it is imperative mortgage lenders be aware of, and maintain diligence in identifying, these issues early in the loan origination process and implement procedures to address these types of loans before loan closing.