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MEMORANDUM

TO: Clients and Friends of the Firm

FROM: Sam J. Brown

DATE: May 10, 2006

SUBJECT: Final Summary Judgment and Temporary Stay Order Entered in *ACORN v. Finance Commission* Finding Various Home Equity Interpretive Rules Constitutionally Invalid

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BACKGROUND: SAGA OF THE ACORN DECISION

- Constitutionality of certain of the official interpretations of the Joint Regulatory Agencies, the Texas Finance Commission and Credit Union Commission (the "Commissions"), codified in 7 TAC Chapter 153 was challenged by suit filed January 29, 2004, in Cause No. GN400269 in the District Court of Travis County, Texas, 126th Judicial District, styled *Association of Community Organizations for Reform Now (ACORN), Valerie Norwood, Elise Shows, Maryann Robles-Valdez, Bobby Martin, Pamela Cooper, and Carlos Rivas, Plaintiffs, vs. Finance Commission of Texas and Credit Union Commission of Texas, Defendants*.

- Plaintiffs filed the action pursuant to Chapter 37, Texas Civil Practices and Remedies Code, pertaining to declaratory judgments, and more particularly §2001.038, Texas Government Code, which provides for determining the validity or applicability of a state agency's rule in an action for declaratory judgment if it is alleged that the rule or its threatened application interferes with or impairs a legal right or privilege of Plaintiffs. A request of the district court on motion of the Commissions to transfer the action to the Third Court of Appeals-Austin under procedures permitted by §2001.038(f) was denied by the appellate court without comment.

- Thereafter, on consideration of Plaintiffs' motion for summary judgment and Defendants' cross motion, Judge Scott H. Jenkins of the 53rd District Court informed counsel by letter dated October 7, 2005 of his intent to rule for Plaintiffs in part on their points challenging the validity of §§153.5 (Fee Cap Rule), 153.12 (Oral or Electronic Application Rule), 153.13 (*De Minimis* Fee Variance Exception to Disclosure Rule), 153.18(3) (Debt Consolidation Rule), 153.20 (Blank Spaces Rule), 153.22 (Document Copies Rule), and 153.84 (HELOC Convenience Check Rule). At its scheduled meeting on October 21, 2005, the Commissions took up the matter and resolved to recommend that the Attorney General of Texas timely move the district court for reconsideration of its order and vigorously represent the interests of the Commissions throughout a full appellate process.

- The Finance Commission after the issuance of the district court's October 7, 2005 letter forewarning of its intent to find these interpretive rule constitutionally invalid separately proposed on March 3, 2006 the repeal and substitution for rules 7 TAC §§153.13, .18, .20 and .22 (31 Tex. Reg. 1393) in an apparent effort to undermine ACORN's complaint of unconstitutionality of those interpretive rules, which the Commissions hope will make much of this order moot on appeal. The public comment period ended April 12, 2006 and the proposed substituted rules would be adopted as final rules at the next scheduled meeting of the Joint Financial Regulatory Agencies in June, 2006.

- On April 29, 2006, the long awaited formal judgment or order was signed by the district court in the form of the Final Summary Judgment and Temporary Stay Order, a copy of which is attached to this memorandum. The succinct order finding a number of the Commissions' interpretive rules constitutionally invalid, including specifically 7 TAC §§ 153.1(11) and 153.5(3) , (4), (6), (8), (9) and (12), 153.12(2) in part, 153.13(4), 153.18(3), .20 and .22, and .84(1), does state "It is further ORDERED that this judgment is stayed in all respects for thirty days, and the rules declared to be invalid by this judgment remain in effect during that time regardless of whether this judgment is superseded by the posting of a bond, filing notice of appeal or other action of a party."

- On May 2, 2006, the Commissions filed its Amended Notice of Appeal from the final judgment of the district court that was signed April 29, 2006. In fact, on April 12, 2006, prior to the judgment being signed, the Commissions prematurely filed a Notice of Appeal, which was deemed effective upon April 29, 2006, the date the judgment was signed.

SPECIFIC HOLDINGS OF THE *ACORN* TRIAL COURT

The Court in *ACORN* declared and ordered to be invalid the following interpretative rules adopted by the Commissions:

1. 7 TAC §153.1 (11), 153.5(3), (4), (6), (8), (9), and (12). The Court held these rules to be invalid thereby precluding the use of Texas usury law to interpret the Constitution's 3% cap in fees that may be charged to originate, evaluate, maintain, record, insure, or service the extension of home equity credit. Although the Court in its letter dated October 7, 2005 expressed that it would be reasonable to have a rule clarifying that discount points are interest and, therefore, not subject to the 3% cap, it held that utilization of the definition of interest under the 153.1(11), or Texas usury law that define points or charges as interest [153.5(3)(4)], including charges to originate [153.5(6)], charges to evaluate [153.5(8)], charges to maintain [153.5(9)], and charges to service [153.(12)], would render the 3% cap meaningless. In its letter, the Court stated that under the Commissions' rule, particularly, 153.5(3), a lender could charge a point to originate the loan, a point to evaluate the loan, a point to maintain the loan, and a point to service the loan, and because all of these charges or points may be considered interest under Texas usury law, they would not be subject to the 3% cap. Accordingly, the Court held such rules to be contrary to Constitution's express language and, therefore, invalid.
2. 7 TAC §153.12. In its letter of October 7, 2005, the Court stated that the language of the Constitution requires "submission of an application," and evinces a clear intent for a formal application process. Thus, the Court held oral loan applications, which are permitted by the rule, to be invalid; however, such invalidation does not extend to electronic submissions, which the Court, in its letter, stated to be substantially the same as applications submitted on paper.
3. 7 TAC §153.13(4). Under 153.13, with respect to preclosing disclosures, the lender may provide the required documentation or modify previously provided disclosures on the date of closing, if a

bona fide emergency or another good cause exists and the lender obtains the written consent of the owner. Under 153.13(4), a de minimis variance can be good cause at the owner's option; however, the Court held this provision to be invalid. In its letter of October 7, 2005, the Court stated that this portion of the rule was so poorly drafted as to allow dramatic increases in fees and charges, provided only one of the items decreases.

4. 7 TAC §153.18(3). Although expressly permitted by the rule, the Court held to be invalid debt consolidation loans in which the lender consolidates a non-homestead debt of the same lender in order to convert such non-homestead debt to a home equity loan secured by the owner's homestead.
5. 7 TAC §153.20. The rule states: "the blanks 'that are left to be filled in'" referenced in the Constitution refers to omitted contract terms in the equity loan agreement. The Court held that the language of such rule to be inconsistent with the requirements of the Constitution, which provides that a home equity loan may not be made on the condition that the owner of the homestead sign any instrument in which blanks are left to be filled in.
6. 7 TAC §153.22. Under 153.22, it is provided that, at closing, the lender must provide the owner with a copy of all documents signed at closing in connection with the equity loan; however, the lender is not required to give the owner copies of documents that were signed by the owner prior to closing. The Court held such language inconsistent with the requirements of the Constitution, which provides that at the time of extension of the credit, the lender must provide the owner with a copy of all documents signed by the owner related to the extension of the credit.
7. 7 TAC §153.84(1) The Court held the rule permitting "convenience checks" on HELOC transactions to be invalid.

CURRENT EFFECT OF THE *ACORN* TRIAL COURT DECISION

As stated above, the *ACORN* trial court additionally ordered its Final Summary Judgment, which was signed April 29, 2006, to be stayed for a period of 30 days. Further, as provided by Tex. R. App. P. 27.1(a), by prematurely filing its Notice of Appeal, the appeal by the Commissions of the Final Summary Judgment was perfected on April 29, 2006, the date the judgment was signed by the trial court. Based upon Tex. R. App. P. 24(g)(2) and Tex. Civ. Prac. & Rem. Code Ann. §6.001 (1987), the Commissions' perfection of the appeal supersedes the judgment of the trial court, and, during the appellate period, the interpretative rules declared to be invalid by such judgment shall remain in full force and effect. Additionally, with regard to loan transactions that have either previously closed or that will close during the appellate period, lenders that have relied or that will rely upon interpretative rules declared to be invalid by the *ACORN* trial court shall have protection from liability or financial exposure based upon the safe harbor provisions of Tex. Const., art. XVI, Sec. 50(u).

PRACTICAL CONSIDERATIONS

On March 3, 2006, in an effort to resolve complaints of unconstitutionality by ACORN, the Commissions have separately proposed the repeal and substitution of interpretative rules 7 TAC §§153.13, 153.18, 153.20, and 153.22, the adoption of which would render moot the portions of the *ACORN* decision pertaining to such rules. The proposed substituted rules may be adopted as early as the next scheduled meeting of the Joint Financial Regulatory Agencies in June, 2006. For your further information and reference, attached to this memorandum is a copy of such Proposed Interpretations.

However, please note that the Commissions have not proposed any substitution of interpretative rules 7 TAC §§153.1(11), 153.5(3), (4), (6), (8), (9), and (12) or 7 TAC §153.12(2) that have been declared invalid by the *ACORN* trial court; therefore, unless the *ACORN* holding is reversed upon appeal: (i) other than per diem interest and true loan discount (in which the fees paid are in reduction of the

interest rate), lenders must include within the 3% cap all other points and fees paid to originate, evaluate, maintain, record, insure or service the loan, and (ii) for the purposes of compliance with constitutional requirements upon home equity loans, loan applications may not be taken orally.

We would encourage the review of the attached Proposed Interpretations. Even if the substituted rules are adopted, we would anticipate that each lender may have to revise current practices and procedures pertaining to such rules. For example, under proposed rule 7 TAC §153.13, the "de minims variance" standard for good cause permitting the lender to provide pre-closing disclosure documentation or modification of such documentation on the date of closing is much more restrictive than the existing rule. The proposed substituted §153.13 requires both that the modification at closing does not create a material adverse financial consequence to owner and also that a delay in closing would create an adverse consequence to the owner. Further, under the proposed substituted §153.13, the modification must result from either (i) an accidental or bona fide error, such as a mathematical computation, despite control systems that are in place to detect and prevent that type of error; or (ii) an unanticipated fee that is to be paid only to a third party and not to the lender or the mortgage originator. We would submit that some of the additional requirements of proposed substituted §153.13 are subjective in nature, thus diminishing a lender's comfort in reliance upon such rule.

Additionally, under proposed rule 7 TAC §153.22, rather than just providing to the owner copies of documents signed at closing as required by existing §153.22, the lender would be required to provide to the owner at loan closing copies of documents signed by the owner as a condition to the loan and used by the lender: (i) in the process of evaluating and underwriting the home equity loan; and (ii) creation of a legal obligation of the owner in favor of the lender. Presumably, this could include at closing copies of such documents as the original Form 1003 Loan Application, authorizations for verifications and earlier acknowledged receipts of consumer disclosures.

At this time, we would not encourage our clients to revise any current practices or procedures based upon the Proposed Interpretations. Although the comment period upon the Proposed Interpretations has expired and the Commissions have concluded a public hearing upon the Proposed Interpretations, prior to adoption by the Commissions, the content of the Proposed Interpretations is subject to change, which may occur as early as June 9, 2006, the date of the next scheduled meeting of the Joint Regulatory Financial Agencies.

On April 11, 2006, Al Alsup of our firm submitted written comments upon the Proposed Interpretations to the Office of the Consumer Credit Commissioner of Texas. For your further reference, a copy of our letter of comments is attached to this memorandum.

Please contact us if you have any questions or comments regarding these matters.

Attachments