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MEMORANDUM

TO: Clients and Friends of the Firm

FROM: J. Alton Alsup

DATE: March 1, 2002

SUBJECT: TEXAS HOME EQUITY LENDING LAW UPDATE

Recent judicial decisions should provide encouragement to mortgage lenders making home equity loans in Texas under the authority of Section 50(a)(6), Article XVI, Texas Constitution, that the courts may not necessarily enforce strict compliance with the exacting constitutional conditions of Section 50(a)(6) when a mortgage lender's good faith errors are capable of correction and, in fact, are corrected by the lender within a reasonable time after the lender is notified of its failure to comply with one or more of the constitutional requirements for the creation of a valid homestead lien. This memorandum reports on recent significant judicial decisions that provide interpretive guidance about whether, and under what conditions, (i) such charges as discount points, origination fees, and casualty insurance premiums constitute *fees* for purposes of the constitutional 3% fee cap limitation; (ii) mortgage lenders may cure innocent errors in meeting Section 50(a)(6) requirements and thereby validate a homestead lien, such as by refunding within a reasonable time fees collected that exceed the constitutional 3% fee cap; and (iii) mortgage lenders may require that home equity loan proceeds be used in part to pay indebtedness to other creditors despite ambiguous provisions of the promulgated form of consumer notice contradicting substantive provisions of the constitution permitting such requirements; and, finally, reports on a significant written opinion by joint state regulatory agencies that a home equity loan may be modified in certain respects, such as to reduce the contract interest rate, without following all the steps required under Section 50(a)(6) for a refinance of an equity loan.

TEXAS COURT OF APPEALS HOLDS THAT "POINTS" ARE PREPAID INTEREST AND NOT "FEES" FOR PURPOSES OF THE HOME EQUITY 3% FEE CAP

An equity loan may not require the owner or the owner's spouse to pay, *in addition to interest*, fees to any person "necessary to originate, evaluate, maintain, record, insure or service the extension of credit" that exceed three per cent (3%) of the original principal loan amount. This so-called "3% fee cap" applies to all fees *other than interest* that the borrower is required to pay to any person in connection with the loan, and not just to fees charged by the lender. [§ 50(a)(6)(E), art. XVI, Tex. Const.] Under Texas law, the concept of *interest* includes not just the nominal contract or note rate of interest, but a composite rate taking into account both the contract rate and all other charges by the lender in connection with the loan that constitute *interest*, as defined in § 341.002(4) of the Texas Finance Code in pertinent part to mean … "compensation for the use, forbearance, or detention of

money." Fees constituting *interest* under Texas law are excluded from the 3% fee cap by definition, and it has been assumed by most practitioners that mortgage discount points, each equal to 1% of the principal amount, charged by the lender in the nature of prepaid interest to reduce, or "buy-down," the stated note rate of interest would be excluded as interest.

This issue was recently tested as a matter of first impression to Texas courts in the recent case of *Tarver v. Sebring Capital Credit Corporation*, 2002 WL 122743 (Tex. App. – Waco 2002) decided January 30, 2002, wherein the Texas Tenth Court of Appeals concluded that by the plain meaning of § 50(a)(6)(E), as interpreted by reference to Texas statutes and administrative regulations defining interest, "points" are a form of interest and are not "fees" subject to the 3% fee cap under subsection (a)(6)(E). Sebring was granted a summary judgment on this issue, which the Tarvers appealed. That holding, of course, begs the question whether the 3% fee charged by Sebring in this case met the definition of "Points." The Tarvers' $112,800 home equity loan had a contract interest rate of 9.375% per annum, and, Sebring maintained by sworn pleadings that it initially offered the Tarvers a 12.375% rate and agreed to reduce to 9.375% conditioned on the Tarvers' agreement to pay discount points in the amount of 3%, or $3,384, at closing. Moreover, Sebring produced summary judgment evidence of (i) a "Discount Point Acknowledgment" form that the Tarvers signed at closing stating that they were "… electing to pay discount point(s) in this extension of credit in order to obtain a lesser interest rate" and that "… instead of paying any discount point(s) [they] could have obtained a higher interest rate without any discount point(s)" and (ii) Sebring's standard interest-rate pricing sheet, which described interest rates with and without the payment of points. The Tarvers disputed that they had ever been offered a lower rate in exchange for the payment of points and insisted they had learned of the charge for the first time at closing. However, the court gave great weight to the signed "Discount Point Acknowledgment" that the court found, without rebuttal evidence from the Tarvers, established that the Tarvers knew at the closing they were exchanging points for a lower interest rate. Moreover, the court found no evidence in the trial record that would explain why the three percent was charged if it was not points (an origination fee of $1,692 had already been paid to Mortgage Plus, a mortgage broker in the transaction). Finding no genuine issue of fact about whether the three percent charged in this case was points, the court affirmed the summary judgment awarding Sebring by the trial court.

[NOTE: Contrast the holding in *Tarver* with that of a federal district court case decided December 27, 2001, *Thomison v. Long Beach Mortgage Company*, 176 F. Supp. 2d 714, now on appeal to the Fifth Circuit Court of Appeals, in which the court held that a fee denominated by the lender as a "Loan Origination Fee" is a fee subject to the constitutional 3% fee cap and that the lender consequently was required to forfeit all principal and interest, both past and future, since it had failed to comply with the constitutional fee limitations and had failed to cure the violation within a reasonable amount of time after being notified by the borrower of the violation, in this case after a lapse of 21 months.]

TEXAS SUPREME COURT HOLDS BUSTING HOME EQUITY 3% FEE CAP AND OTHER FAILED CONSTITUTIONAL CONDITIONS CAN BE CURED

Of particular concern to wary lenders are the consequences at law if the 3% fee cap prescribed by Section 50(a)(6)(E) is inadvertently exceeded in any case and the validity of the lien is challenged. The fundamental question posed is whether the error can be cured by refunding any excess of fees collected, or whether the courts would find that the lien is void *ab initio* under the strict compliance standards historically enforced by the courts and the provisions of Section 50(c), Article XVI, Texas Constitution, a *voiding* provision which provides that no mortgage, deed of trust, or other lien on a homestead shall ever be valid unless it secures a debt described by Section 50. Moreover, if the courts do not permit an easy cure through refund of the excess of fees collected, the further question posed is whether the lender would be subject to draconian forfeiture of all principal and interest of the loan under the provisions of

Section 50(a)(6)(Q)(x) imposing such a forfeiture "if the lender or holder fails to comply with the lender's or holder's obligations under the extension of credit within a reasonable time after the lender or holder is notified by the borrower of the lender's failure to comply." These concerns, of course, extend to any of the many conditions to creation of a valid homestead lien under Section 50(a)(6).

The Texas Supreme Court in *Doody v. Ameriquest Mortgage Co*., 49 S.W.3d 342 (Tex. 2001) provided fence-sitting lenders hope that at least good faith errors in collecting excessive fees can be cured if discovered and refunded within a "reasonable time." The court was responding to two certified questions by the federal Fifth Circuit Court of Appeals in *Doody v. Ameriquest Mortgage Co*., 242 F.3d 286, 289 (5th Cir. 2001), which was a fundamental challenge to the validity of a purported homestead lien based on the claim of the plaintiff Doody that the lender had failed to strictly comply with constitutional requirements for its creation and that an attempt by Ameriquest to cure the error by refunding an excess of $641.88 over the amount of the 3% fee cap to the plaintiffs some three months after closing was ineffectual to breathe life into a void lien. Doody contended that because Ameriquest did not strictly comply with the constitutional requirements when it made the loan, the lien was never valid under section 50(c), and consequently Ameriquest's subsequent cure could not resurrect the void lien. Furthermore, Doody argued that the purported cure under section 50(a)(6)(Q)(x) did not validate the lien because that section is a forfeiture provision with a cure mechanism, and forfeiture was not being sought as an issue in this case.

Ameriquest argued to the contrary that the cure provision applies to the rest of section 50(a)(6), thus permitting a party to cure a constitutional defect and validate the lien under section 50(c). The cure provision allows a lender to comply with its constitutional obligations within a reasonable time after the borrower notifies the lender of a failure to comply, Ameriquest asserted, and the lender does not forfeit any rights, including its lien rights, if it corrects mistakes upon learning of their existence.

Specifically, the Texas Supreme Court was asked the following questions of state law:

- Under the Texas Constitution, if a lender charges closing costs in excess of three percent, but later refunds the overcharge, bringing the charge costs within the range allowed by section 50(a)(6)(E), is the lien held by the lender invalid under section 50(c)?
- If this question is reached, may the protections of section 50 of the Texas Constitution be waived by a buyer who accepts a refund of any overcharged amounts when the loan contract provides that accepting such refund waives any claims under section 50?

The Texas Supreme Court answered the first certified question no, and therefore did not reach the second of the certified questions. The court essentially concurred with the Ameriquest argument and concluded that under the Texas Constitution, if a lender extending home equity credit charges closing costs in excess of three percent, but refunds the overcharge within a reasonable time, bringing the costs down within the range allowed by section 50(a)(6)(E), that refund cures the error and validates the lien under section 50(c). In reaching this conclusion, the court relied on what it characterized the "cure provision" in section 50(a)(6)(Q)(x), which practitioners heretofore had regarded as a "forfeiture provision." Subsection (Q)(x) defines a home equity loan in part as one made on the condition that:

> (x) the lender or any holder of the note for the extension of credit shall forfeit all principal and interest of the extension of credit if the lender or holder fails to comply with the lender's or holder's obligations under the extension of credit within a reasonable time after the lender or holder is notified by the borrower of the lender's failure to comply.

The Texas Supreme Court held that this subsection (Q)(x) operates as authority for a lender to cure not only the particular obligation at issue under section 50(a)(6), but also to validate the lien. This cure provision applies to all the lender's obligations under the "extension of credit," the court reasoned, including section 50(c)'s requirements that to be valid a homestead lien must secure a debt described by section 50. Subsection (Q)(x) provides lenders authority and the means to correct mistakes within a reasonable time in order to validate a lien securing a section 50(a)(6) extension of credit, according to the court.

To reach this broad ranging conclusion, it was necessary for the Texas Supreme Court to first dispose of Doody's argument supported by mounds of precedents that because of Ameriquest's failure to strictly comply with the constitutional conditions to the creation of a valid homestead lien, the purported lien was void and could not be resurrected through subsequent corrective efforts (see discussion on the applicability by the courts of a strict compliance standard under A.2. of this section). These cases are all distinguishable for the case at bar, the court reasoned, because they all predated the 1997 constitutional home equity amendment establishing the subsection (Q)(x) cure provision and none of those cases involved a similar cure provision. Unlike the circumstances of those cases in which the court had denied subsequent attempted cures, the court said, "the 1997 home-equity loan amendment to our constitution includes a cure provision," and lenders have a reasonable opportunity to cure mistakes. The court offered no ideas of how a lender might cure mistakes that cannot be cured after closing through the rebating of money, however, such as a lender's failure to have provided the promulgated form of notice required by section 50(g) at least 12 days before closing.

FIFTH CIRCUIT RULES THAT CASUALTY INSURANCE PREMIUMS ARE NOT FEES FOR PURPOSES OF 3% FEE CAP

In *Doody v. Ameriquest Mortgage Co*., 242 F.3d 286, 289 (5th Cir. 2001), when certifying the two questions to the Texas Supreme Court discussed in B.2. above, the federal Fifth Circuit Court of Appeals first disposed of Doody's contention that Ameriquest had also exceeded the 3% fee cap by requiring the plaintiffs to take out hazard insurance at a premium cost far exceeding the 3% fee cap, and that none of the hazard insurance premiums had been refunded. The Fifth Circuit court held that hazard insurance does not constitute "fees … to originate" the loan in the sense that the lender required it. The standard of construction applied by the Texas Supreme Court in interpreting section 50 the court recognized is to "… avoid a construction that renders any provision meaningless or inoperative. Doody's construction that hazard insurance premiums are fees "necessary to originate" the loan would render "necessary to originate" redundant and therefore meaningless and inoperative, so said the court.

TEXAS SUPREME COURT HOLDS THAT OWNER MAY BE REQUIRED TO PAYOFF OTHER CREDITORS WITH HOME EQUITY LOAN PROCEEDS

An equity loan is defined in part as an extension of credit made on the condition that "the owner of the homestead is not required to apply the proceeds of the [loan] to repay another debt except debt secured by the homestead or debt to another lender." [§ 50(a)(6)(Q)(i), art. XVI, Tex. Const.] An equity loan, therefore, cannot be conditioned on a requirement that the loan proceeds be used wholly, or in part, to discharge or repay another indebtedness owed the same lender, *except* a debt that is already validly secured by the homestead property. An apparent purpose of this provision is to prevent an unsecured creditor from demanding that the creditor be granted a security interest in the debtor's homestead as a condition for granting a forbearance, rearrangement or recasting of the unsecured indebtedness. While the prohibition appears clear on reading that an equity loan may be conditioned on the requirement that loan proceeds be used in part to repay an indebtedness already secured on the homestead (even if owed the same lender) or an unsecured debt owed another lender or creditor, the

promulgated form of Notice Concerning Extensions of Credit that must be given loan applicants 12 days prior to loan settlement under the provisions of Section 50(g) appears to conflict with that clear meaning. Paragraph Q of the form of notice reads in pertinent part as follows:

> (Q) LOANS DESCRIBED BY SECTION 50(a)(6), ARTICLE XVI, OF THE TEXAS CONSTITUTION MUST:
>
> (1) NOT REQUIRE YOU TO APPLY THE PROCEEDS TO ANOTHER DEBT THAT IS NOT SECURED BY YOUR HOME OR TO ANOTHER DEBT TO THE SAME LENDER;
>
> . . .

The issue whether homestead owners may be required to use loan proceeds in part to pay other creditors as a condition to a home equity loan was raised squarely in a certified question to the Texas Supreme Court by the federal Fifth Circuit Court of Appeals in *Stringer v. Cendant Mortgage Corporation*, 23 S.W.3d 353 (Tex. 2000). The circuit court had under review a claim by plaintiff Stringer that they were unlawfully required to use a portion of their loan proceeds to pay off debts to creditors other than Cendant in contravention to the prohibition set out in paragraph Q of the promulgated form of notice given them 12 days prior to closing, and that any ambiguity between the provisions of the notice and the constitutional provision of Section 50(a)(6)(Q) should be resolved in favor of the notice, which Stringer contended "clearly and concisely" reflected the intent of the Texas Legislature. The question certified to the Texas Supreme Court by the circuit court at 199 F.3d 190, 192 (5th Cir. 1999) read as follows:

> Under the Texas Constitution, may a home-equity lender require the borrower to pay off third-party debt that is not secured by the homestead with the proceeds of the loan?

The Supreme Court answered the certified question yes and held "that under the Texas Constitution, a home equity lender may require a borrower to use loan proceeds to pay a third-party debt that is not secured by the homestead." The Supreme Court agreed with the Fifth Circuit court that the plain language of the constitutional provision and that of the notice conflict, but reasoned that the constitutional provisions of Section 50(a)(6)(Q)(i) establish the substantive rights and obligations of lenders and borrowers in this regard. The notice provisions set out in Section 50(g)(Q)(1) provide only the language of the mandatory notice to borrowers, the court held, and do not independently establish rights or obligations for the extension of the home equity credit. Based on this finding of state law, the Fifth Circuit thereupon affirmed the judgment of the trial court dismissing the case. In an unusual quasi-legislative initiative, the Supreme Court also sought to resolve the conflict between the substantive provisions of the constitution and the flawed notice summarizing those provisions that can mislead prospective home equity borrowers through the invention of an additional notice that the court stated lenders *should* provide in addition to the 50(g)(Q)(1) notice to identify the conflict between the two sections and explain the Section 50(a)(6)(Q)(i) substantive effect. This notice according to the Supreme Court should state:

> **The notice above states that your home-equity lender may not require you to apply the loan proceeds to another debt that is not secured by your home. Although the Texas Constitution requires that the notice include this statement, the statement conflicts with another provision of the Texas Constitution. That provision permits your home-equity lender to require you to apply the loan proceeds to a debt to another lender that is not secured by your home. This provision is controlling, and you should disregard the contrary statement in the notice.**

Assuming the legislature will correct the flawed Section 50(g)(Q)(1) notice in the 2003 legislative session (in this and in at least two other respects in which the notice provisions misstate the substantive provisions), the importance of the *Stringer* decision may be not so much the conclusion the Supreme Court reached as the fact that the Supreme Court showed deference in reaching its conclusion to the Regulatory Commentary on Equity Lending Procedures published January 6, 1998, by the Office of the Consumer Credit Commissioner, the Department of Banking, the Savings and Loan Department, and the Credit Union Department, which provides the industry informal interpretive guidance regarding home equity provisions. The Supreme Court both cites the Commentary in support of its own conclusions and shows it particular credence, considering that no constitutional or statutory authority exists for these agencies to interpret the Texas Constitution and that no protections from liability are afforded lenders who in good faith rely on these interpretations. The Supreme Court signals its willingness to look to the Commentary in future cases when it is called upon to interpret home equity provisions with the following praise: "Although the commentary is advisory and not authoritative, it represents four Texas administrative agencies' interpretation of the Home Equity Constitutional Amendment. These agencies are responsible for regulating the entities that make home equity loans. The Commentary's purpose is to provide guidance to lenders and consumers about the regulatory views on the meaning and effect of article XVI, section 50." The court then goes on to cite the Commentary three times, concluding with its supporting conclusion that the substantive requirements of section 50(a)(6) about a lender's responsibilities prevail over the notice requirements. The acid test, of course, will be whether the court will feel constrained in any future interpretations of section 50(a)(6) to refer to the Commentary and reconcile its holding with the interpretive views of these state regulatory agencies. Interestingly, the Tenth Court of Appeals in *Tarver v. Sebring Capital Credit Corporation*, discussed in B.1. above, also turned to the Commentary for support in its conclusion that "points" do not constitute "fees" subject to the 3% fee cap under subsection (a)(6)(E) and, citing *Stringer*, observes that "The Supreme Court has approved of the Commentary as an advisory from the four state agencies which regulate home equity loans."

JOINT STATE REGULATORY AGENCIES OPINE THAT A HOME EQUITY LOAN MAY BE MODIFIED WITHOUT FOLLOWING ALL THE STEPS REQUIRED UNDER SECTION 50(a)(6) FOR A REFINANCE OF AN EQUITY LOAN

Because of the exacting conditions to which a home equity loan must conform under the Texas Constitution, wary lenders have been concerned whether the interest rate and terms of payment of an (a)(6) equity loan can be lawfully modified by agreement with the borrower after loan closing without observing the constitutional conditions required to make the loan initially and, if so, whether the equity loan may be modified prior to the passage of the one-year period after closing that would be required under the constitution to refinance the loan. The concern had been raised in part because of the immediate need of many mortgage lenders and servicers to modify the interest rates of equity loans made to members of the United States Military Service called into active duty following the Attack on America of September 11 to comply with the requirements of the Soldiers and Sailors Civil Relief Act, discussed at Section VI of this article. Guidance on this issue was especially needed because under the provisions of Section 50(f) the refinance of a home equity loan may not be secured by a valid homestead lien unless the refinance of the debt is an extension of credit made under the authority and conditions of Section 50(a)(6). A *refinance* of a debt is generally regarded as a transaction in which the old debt is discharged and replaced with a new indebtedness evidenced by a new note or other debt instrument and is distinguished from a *modification,* which is a transaction in which the debt is not discharged and the existing debt and security instruments for a loan are merely amended.

Responding to an inquiry posing this question of interpretation by Karen M. Neely, General Counsel, Independent Bankers Association of Texas (IBAT), a joint opinion letter dated December 20, 2001,

(the "Joint Agency Letter") was issued by the four Texas financial regulators, Texas Department of Banking, Texas Savings and Loan Department, Office of the Consumer Credit Commissioner, and the Texas Credit Union Department, stating that a lender may modify a home equity loan by reducing its interest rate and changing the amounts and/or the number of monthly payments without going through all the steps required by the Texas Constitution for a loan refinance. Furthermore, the modification may be undertaken by agreement of the lender and borrower at any time, even if before the first anniversary of the loan.

The Joint Agency Letter observed that home equity loans, while governed by the Texas Constitution, may also be governed by other Texas law applicable to all mortgage lending, such as the Texas Finance Code, to the extent that provisions of the Texas Constitution may be reconciled with other law. Like other loans, therefore, a home equity loan may be modified provided the modification is not contrary to the express requirements of the constitution. Two examples were cited in the opinion: a home equity loan could not be modified to impose personal liability against any owner or spouse in conflict with constitutional prohibitions, and the principal loan amount could not be increased because such an additional advance would be in contravention of constitutional prohibitions against open-end accounts under which credit may be extended from time to time.

Though disclaiming the letter as an "interpretation" because no state agency is provided the authority to interpret the home equity provisions of the constitution, the guidance is useful at least as a statement of enforcement policy of these regulatory agencies and, as seen in the case of *Stringer v. Cendant Mortgage Corporation* discussed above may in a proper case be shown deference by the courts if reviewing a challenge to the validity of an equity loan modification.