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DATE: January 3, 2001

SUBJECT: Revisiting the Issue of Whether Tax and Insurance Reserves May be "Rolled-In" and Financed as Part of the Principal Amount of "Rate and Term" Refinance Home Loans in Texas

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In anticipation of lower long-term mortgage rates following the recent action of the Fed and the prospect of another refinance boom in 2001, it is appropriate and timely that we revisit with our clients the issue of whether tax and insurance reserves may be "rolled-in" and financed as part of the principal amount of "rate and term" refinance home loans in Texas. This memorandum summarizes the 1998 Texas law that has called into question whether, and under what circumstances, a lender's including of closing costs in the principal loan amount when refinancing a homestead lien may invalidate the refinance lien and examines how the risk of lien invalidity may be shifted to title insurance companies that are willing to insure the full loan amount of such loans, including amounts advanced to create escrow funds for the payment of property taxes and insurance, without exception to that particular risk.

BACKGROUND: HOW THE ISSUE IS RAISED

The financing of "closing costs" (including so-called *escrows*, *reserves*, or *impound accounts* for payment of property taxes, insurance, and other charges against the secured property during the loan term) when refinancing indebtedness secured by a homestead has been a traditional Texas practice that benefits the homeowner by making desired loan terms available to the homeowner even when the homeowner may not have adequate cash on hand to pay closing costs in connection with the loan or to deposit escrow reserves required by the lender to assure that property taxes and insurance are paid when due. Often the homeowner is required to establish a new escrow account before the balance of the old escrow account held by the lender being paid off with the refinancing proceeds is refunded to the homeowner – leaving the homeowner short of cash. The option of "rolling in" closing costs in these circumstances, while routinely offered by the traditional mortgage lender, is exclusively that of the homeowners. But an ambiguity in the 1997 constitutional amendment authorizing home equity loans in Texas cast an unintended shadow over the traditional Texas practice of including closing costs in the principal loan amount when refinancing a homestead lien.

The ambiguity arises out of the language of new Section 50(e), Article XVI of the Texas Constitution that went into effect on January 1, 1998:

"(e) A refinance of debt secured by a homestead and described by any subsection under Subsections (a)(1)-(a)(5) that includes the advance of additional funds may not be secured by a valid lien against the homestead unless:

(1) the refinance of the debt is an extension of credit described by Subsection (a)(6) of this section; or

(2) the advance of all the additional funds is for ***reasonable costs necessary to refinance such debt*** [emphasis added] or for a purpose described by Subsection (a)(2), (a)(3), or (a)(5) of this section."

While this amendment expressly authorizes the advance of additional funds "for reasonable costs necessary to refinance" an existing homestead debt, it also would appear to have the unintended consequence of invalidating the refinance lien in its entirety if the additional advance of funds were found to be for other than "costs" in connection with the transaction or other than costs that are both "reasonable" in amount and "necessary" to refinance the homestead debt. The terms "costs," "reasonable," or "necessary" in this context are not defined, and no interpretive guidance has yet been provided by Texas courts.

Texas title insurers have routinely issued mortgagee policies of title insurance for years in the combined amount of the outstanding principal balance of the existing loan and the accrued but unpaid interest on the loan, all mortgage discount points, the mortgage insurance premiums when rolled into the new loan amount, and ordinary closing costs, provided the sum of all such additional costs did not exceed 5-10% of the existing loan balance, depending on their respective underwriting policies. The title insurer assumed a business risk in indemnifying the insured mortgagee against partial invalidity of its lien to the extent of these excess amounts, of course, but hedged that risk in part by requiring that the deed of trust securing the refinancing loan contain a *partial invalidity clause*, under which payments made on the indebtedness would be first applied to reduction or discharge of any portion of the indebtedness deemed unsecured.

But the practice of rolling closing costs into the principal amount of homestead refinance loans must now be reexamined in light of the constitutional limitations of new Section 50(e)(2). Under traditional Texas practice before this Section 50(e) amendment, only the partial invalidity of the refinance lien (to the extent of these additional funds for closing costs) was at issue. Now a mortgage lender who includes closing costs in the principal loan amount arguably risks the possibility in any case that the lien in its entirety may be found invalid when later challenged by the borrower in a foreclosure or bankruptcy proceeding if the closing costs do not meet this vague "reasonable" and "necessary" costs standard.

THE PARTICULAR RISK OF FINANCING "PREPAIDS" OR "ESCROWS"

Whether so-called "prepaids" or "escrows" constitute "costs" within the meaning of new Section 50(e)(2) is particularly troublesome. "Prepaids" or "escrows," of course, are the amounts that are routinely collected at loan settlement and maintained by the lender, (together with monthly escrow installments paid by the borrower) to assure that adequate funds are in reserve and available to pay property taxes, casualty insurance premiums, and other charges on the property as they become due. While maintained by the lender as escrow agent in protection of its security interest, these reserves remain the property of the borrower and are earmarked for the future payment of specific legal obligations of the borrower when due. "Prepaids" is actually a misnomer because all amounts collected are held in reserve until a particular cost or charge that could affect the lender's security interest in the property actually becomes due and is then timely paid.

Although these reserves are "costs" in the broad sense that they are monies required by the lender as a condition of the loan, "prepaids" or "escrows" arguably are not closing costs in the narrower sense that they are not amounts paid for currently due lender charges or fees for settlement services provided by third parties in connection with closing the loan. Rather, they are reserves for future charges not yet due. These reserves differ from certain other charges collected at closing for future services, such as a tax service fee. Although a tax service fee in this example is compensation in part for future services to be performed over the life of the loan, the one-time fee nevertheless is due and payable at loan settlement under its contract terms.

The true character of “prepaids” or “escrows” is particularly problematic in light of new Section 50(e), therefore, when these reserves are rolled into the principal loan amount with other amounts for closing costs in refinancing a homestead debt – as has become common Texas practice in recent years. While the amounts collected for these reserves at loan settlement are regulated by federal law and therefore should necessarily be deemed “reasonable,” if a court in a proper case should find that “prepaids” or “escrows” included in the loan amount fail to satisfy the definition of “costs” within the meaning of Section 50(e)(2) or “necessary costs” to refinance the homestead debt, the underlying refinance lien may be voided as a matter of law. Texas courts have consistently held that a valid lien cannot be created on homestead property in any manner other than in strict compliance with the requirements of Texas statutes and its constitution.

Moreover, a compelling argument can be made that a lender’s advance to the borrower under these circumstances of amounts to be used to pay the borrower’s future legal obligations (which are the ordinary and usual costs incurred by any homeowner for property taxes and insurance regardless of whether the property is mortgaged) is tantamount to a “cash out” or equity disbursement. The lender in effect is disbursing additional funds purportedly secured by the homestead for the use of the borrower in meeting certain of the borrower’s household obligations in the first loan year, and the fact that the funds are earmarked and reserved for that purpose – rather than placed entirely at the borrower’s use and control – may not affect that fundamental analysis. This perception of funding escrow reserves as a “cash out” disbursement is further supported by the realization that, in addition to receiving the benefit of these additional escrow funds, the borrower typically will also be refunded the balance of her escrow account maintained by the existing lender whose loan is being repaid with refinance proceeds. While that refund in itself cannot rationally be regarded as a “cash-out” disbursement under the refinance loan, it does illustrate the economic reality that the borrower under these circumstances has benefited from both the additional funding of her new escrow account obligation and the cash refund of the equivalent balance, in most cases, of her old escrow account and that the homestead has been burdened with additional charges that the borrower would otherwise have to pay from other resources.

Shifting the Risk to the Title Insurer

Whether this extraordinary risk of lien invalidity may be transferred to a title insurer was the subject of Commissioner’s Bulletin No. B-0008-98, Title Bulletin No. 159, issued by the Texas Department of Insurance on April 24, 1998. There the Commissioner of Insurance advised all insurers and agents that, until more definitive guidance is provided by the Texas Legislature, the Attorney General, or a court of competent jurisdiction, the Department “will not object to a company’s utilizing an underwriting guideline which limits amounts included in the new loan for reasonable and necessary expenses of up to three percent (3%) of the amount of the loan being refinanced.” Because the amendment itself separately permits up to 3% in fees to be charged to the homeowner in connection with the making of a home equity loan, the Commissioner apparently reasoned that the Legislature must have considered this amount “reasonable” and, therefore, that three percent (3%) “might be a *safe harbor* for bona fide expenses connected with a refinance loan.”

> [**Note**: The Commissioner’s analysis would seem to ignore the important distinction that the so-called “3% fee cap” applicable to Equity Loans excludes *interest* and that, when adding in mortgage points, per diem interest, and other lender charges that may constitute interest under Texas law, the fee tolerance for even favored home equity loans would be greater than 3%. Furthermore, rather than intending to establish 3% in fees as a standard of *reasonableness*, the legislature is more likely to have

regarded 3% as a low-cost standard applicable to Equity Loans as a favored class entitled to this limitation as a special consumer protection.]

Interestingly, the Commissioner's Bulletin as issued is a significant departure from his widely circulated draft dated February 13, 1998, that cautioned insurers and agents against establishing underwriting policies in which "reasonable costs necessary to refinance" the insured loan are stated as a percentage of the original loan amount – because the meaning of those terms had not yet been defined by the "Attorney General or any court." Furthermore, representing to lenders that the mortgagee policy covers the full loan amount so long as closing costs do not exceed, for example, 5-7% of the loan amount could suggest that the insurer is waiving the exclusion from coverage under Paragraph 5 of the Exclusions from Coverage in the Texas Mortgagee Policy of Title Insurance (T-2), according to the Commissioner. Paragraph 5 of the Exclusions from Coverage is the so-called "consumer credit protection law exclusion," which excludes coverage because of the invalidity or unenforceability of the lien of the insured mortgage based upon usury, consumer credit protection, or truth in lending laws. The Commissioner's bulletin, in this draft form, admonished insurers and agents against promising or implying to any lender that the "consumer credit protection law exclusion" can be waived or that coverage in a mortgagee policy of title insurance would insure against a claim of lien invalidity arising out of a consumer credit protection law.

While the Commissioner's bulletin as issued omits this admonition against implied waiver, the Commissioner's reasoned analysis in his draft version nevertheless raises the specter that despite issuing a mortgagee policy of title insurance in which closing costs, including escrow reserves, are rolled into the insured loan amount, an insurer could attempt in any case to defend a claim of lien invalidity arising out of the "reasonable" and "necessary" costs limitations of Section 50(e) by invoking the "consumer credit protection law exclusion" of the promulgated form of mortgagee policy of title insurance. The prospects for success of such a defense, however, would seem to turn on the improbability (i) that a court in a proper case would find that Section 50(e) is so clearly a "consumer credit protection law" within the meaning of Paragraph 5 of the Exclusions from Coverage section of the mortgagee policy as to adequately put the lender on notice that the risk of lien invalidation under Section 50(e) was not covered; and, even so, that (ii) the court would find that the insurer had not waived the "consumer credit protection law exclusion" and consequently would not be estopped from asserting such a defense despite undertaking the coverage of the additional 5-10% in closing costs according to published underwriting standards without expressly excepting to the Section 50(e) risks (as is done in the case of an Equity Loan by attaching a T-42 endorsement to the policy that expressly excepts to Section (a)(6) conditions).

The reality is that lenders seem prepared to lend, and insurers prepared to insure their loans, on the terms they consider necessary to effectively compete in a Texas refinance market. Mortgage lenders believe they must offer refinance loans that include escrow reserves and closing costs both to be able to qualify their cash-short applicants for the loan under accepted underwriting standards and to counter the offers of aggressive competitors.

Despite the more conservative 3% "safe harbor" espoused in the Commissioner's Bulletin No. B-0008-98, therefore, most insurers and agencies remain steadfast in their willingness to insure homestead refinance liens in which both escrow reserves and other closing costs have been rolled into the insured loan amount, so long as the closing costs do not exceed a stipulated percentage of the loan amount as set out their respective underwriting bulletins. When these standards are exceeded, insurers are likely to insist on excepting to the Section 50(e) risk in Schedule B of the mortgagee policy by setting out a special exception that reads, in the case of one national insurer, as follows:

> *"Invalidity of the insured mortgage by reason of the inclusion of the advance of additional funds prohibited under Article XVI, Section 50(e) and/or Section 50(f) of the Texas Constitution."*

In any event, an informal poll of major title insurers in Texas indicates that none is presently adopting the conservative 3% cap "safe harbor" policy espoused in Commissioner's Opinion No. B-0008-98. The insurers believe competitive market conditions compel their continued underwriting of all usual and customary closing costs (including "prepaids" or "escrows") in connection with the refinancing of homestead debt. While all insurers have established varying underwriting standards limiting the additional funds advanced for "reasonable costs necessary to refinance" a homestead debt to a stipulated percentage of the loan amount, most are routinely insuring refinance mortgages containing additional amounts for all escrow reserves plus closing costs equal from 5% to 7% of the loan amount.

Until interpretive guidance is provided by Texas courts or the state legislature, the common Texas practice of including closing costs in the principal loan amount of a homestead refinance loan will continue to pose a significant potential risk to lenders that the refinance lien could be voided if a court in any case were to determine that the costs did not satisfy the Section 50(e) limitations of "reasonable costs necessary to refinance" the homestead debt. A particular risk is presented, furthermore, when so-called "pre-paids" or "escrows" are rolled into the loan amount with closing costs because of the possibility a court could find that these reserves do not constitute "costs" within the meaning of Section 50(e).

However, assuming that lenders operate within the title insurers' underwriting guidelines regarding costs that may be included within the insured loan amount, it appears that presently the risk of lien invalidity under Section 50(e) can be effectively transferred to the title insurer. Lenders must confirm in each case that, when applicable, escrow reserves are not excluded from coverage and that no special exception to the Section 50(e) risk of lien invalidity is taken by the title insurer. Because of the prospect that Section 50(e) lien invalidity issues could be challenged in one, or more, class action suits, with potentially large recoveries, the solvency and general reputation of the title insurer would now seem all the more important.