BROWN, FOWLER & ALSUP

A Professional Corporation
Attorneys at Law

8955 Katy Freeway, Suite 305
Houston, Texas 77024

www.LoanLawyers.com

Telephone 713/468-0400
Facsimile 713/468-5235

DATE: May 8, 2000

FROM: J. Alton Alsup

SUBJECT: Texas Reverse Mortgage Law

ABOUT THIS ARTICLE

THIS ARTICLE IS ABSTRACTED FROM A LEGAL ARTICLE OF THE SAME OR SIMILAR TITLE THAT MR. ALSUP WILL PRESENT TO THE 16TH ANNUAL REAL ESTATE CONFERENCE SPONSORED BY THE SOUTH TEXAS COLLEGE OF LAW ON MAY 4TH; THE 22ND ANNUAL ADVANCED REAL ESTATE LAW COURSE SPONSORED BY THE STATE BAR OF TEXAS ON JUNE 28TH AND JULY 12TH; AND THE 34TH ANNUAL WILLIAM W. GIBSON MORTGAGE LENDING INSTITUTE SPONSORED BY THE UNIVERSITY OF TEXAS SCHOOL OF LAW ON SEPTEMBER 14TH AND 28TH

I. INTRODUCTION – *A HOME IN HECM*

More than two years after the *reverse mortgage* was first authorized by amendment to the Texas Constitution, there was as of May, 2000, not a single reverse mortgage loan transaction recorded in Texas. The failing of the Texas-style reverse mortgage to find market acceptance is found in the restrictive conditions under which lenders may accelerate reverse mortgage debt under the Texas Constitution and the failure of the 1997 reverse mortgage amendment to conform those default or acceleration conditions to the requirements of uniform programs of national secondary market makers, the United States Department of Housing and Urban Development, or HUD, and the Federal National Mortgage Association, or Fannie Mae, known respectively as the Home Equity Conversion Mortgage (HECM) and Home Keeper[SM] reverse mortgage loan programs.

Without eligibility for FHA insurance under the HECM program or for delivery of the loans for purchase by Fannie Mae in the secondary mortgage market, the Texas-style reverse mortgage has had no home, or source of funding, these past two years until recent passage of curative amendments to the Texas Constitution (proposed by S.J.R. 12 in the 76th Legislature and approved by voter referendum November 4, 1999) that promise to open up the Texas market for this particular form of home equity loan. Following these amendments, HUD on March 8, 2000, announced in its Mortgagee Letter 00-9 that, subject to the instructions outlined in the letter, FHA will immediately begin insuring reverse mortgages under its HECM program in the State of Texas. Fannie Mae, furthermore, is expected to follow suit not later than June, 2000, and announce the availability in Texas of its Home Keeper[SM] reverse mortgage program.

This article briefly examines the new Texas law authorizing reverse mortgage loans as found in Section 50(a)(7) and Sections 50 (k) – (r), inclusive, Article XVI, Texas Constitution, as amended, and reports on the status of related Texas rulemaking of (i) Procedural Rule P-45 and Form T-43 pending adoption by the Texas Commissioner of Insurance regarding the Reverse Mortgage Endorsement to the Texas form of Mortgagee Policy of Title Insurance, and (ii) recently adopted Texas Rules of Civil Procedure, Rules 735 and 736, regarding expedited foreclosure proceedings for certain Texas reverse mortgages.

II. CONCEPT OF THE REVERSE MORTGAGE – *GRANNY STAYS AND THE LENDER PAYS*

An overwhelming 85% of all homeowners in Texas over the age of 65 are thought to own their homes debt free, but many lack the resources to adequately maintain the property or comfortably pay the taxes, insurance, and utilities. Ironically, Texas homestead law, intended to protect homeowners, too often has forced our seniors in these circumstances from their homes when they must sell as the only means available to them to reach the equity in their homes needed to defray costs of living and medical care. A reverse mortgage, however, provides an alternative for elder Texas homeowners who may not otherwise qualify for a home equity loan.

So called because the mortgage's payment stream is said to flow in reverse, the *reverse mortgage* is a particular type of home equity loan intended to provide "house rich but cash poor" seniors, age 62 or older, the resources needed to remain in their homes for the rest of their lives, if they so desire, by effectively converting the homeowners' home equity into annuity-like periodic payments, or advances, that the lender makes to the homeowners over their remaining lives (or, if preferred, over a term of years) according to a payment plan. An initial advance typically is made to the homeowners at loan closing to cover closing costs and the payoff of any existing lien, and the balance of the credit is then advanced in scheduled periodic payments according to the plan. Homeowners are not restricted in their use of loan proceeds, although the advances are most often regarded as a supplement to Social Security benefits and used by elder homeowners to maintain their homes in a good state of repair, pay property taxes and insurance when due, or defray medical and other ordinary costs of living during their "Golden Years."

Interest accrues only on the amounts advanced by the lender (including compounding of interest on interest) over the term of the loan and homeowners have no obligation to repay any principal or interest on the loan during their lifetimes unless the homeowners earlier sell or transfer the home, permanently cease occupying the home as their principal residence, or breach their covenants to properly maintain the property, timely pay property taxes and insurance premiums, or maintain priority of the reverse mortgage lien. Reverse mortgages are non-recourse debt, and, when due, the lender may look only to the proceeds of the sale of the home for repayment of the reverse mortgage and neither a deceased homeowner's estate nor his heirs have any liability for payment of any deficiency that may result.

Reverse mortgages do not amortize, but are paid in full at maturity solely from sales proceeds, typically upon the death of the last of the homeowners to die or upon one of the other maturing events that permit the lender to accelerate the debt. In this fundamental way, reverse mortgages differ from traditional home mortgages, which are fully funded at loan settlement and are amortized by the homeowner in substantially equal, consecutive monthly payments over a typical term of 15 or 30 years. The homeowner under a traditional mortgage is funded the full principal amount of the loan to finance the purchase or refinance of the home at the beginning of the loan term and, at the end of years of amortization payments, owes the lender little or nothing at maturity. But in the case of the reverse mortgage, the homeowner begins owing the lender nothing, or very little in relation to the value of the secured property, and at maturity, having made no payments to the lender over the term of the loan, owes the lender the full principal loan amount (in the aggregate amount of all advances made by the lender over the loan term and accrued interest thereon), which is then satisfied from sales proceeds.

Unlike the traditional home mortgage loan, furthermore, a reverse mortgage is underwritten based on the appraised value of the home equity and the loan term or actuarial life expectancy of the homeowner, and not on the income or earning capacity of the homeowner, who is most often retired and living on a fixed income. Actuarial formulas are used to determine life expectancy rates for purposes of determining the principal loan limit, which cannot exceed the expected value of the home at loan maturity in any case. Generally, the younger the borrower, the lower the monthly payments for which the borrower qualifies because payments generally must be disbursed over a longer period than with an older borrower. Significantly, loan advances

made to the homeowner under a reverse mortgage generally are not taxable as income and do not affect the homeowner's eligibility for Social Security, Medicare, or Medicaid benefits.

III. THE REVERSE MORTGAGE – *TEXAS STYLE*

A. S.J.R. 12 – *Fixin' What's Broke*

The *reverse mortgage* was first authorized by Texas law as part of the celebrated home equity amendment to Section 50, Article XVI, of the Texas Constitution in November, 1997, but was regarded as fatally flawed in its terms by secondary market makers from the outset.

As proposed by H. J. R. 31 and approved by voters November 4, 1997, Section 50(k) defined a reverse mortgage in part as an extension of credit:

> …
> "(6) that requires no repayment of principal or interest until:
> (B) All borrowers cease occupying the homestead property as a principal residence for more than 180 consecutive days *and* (emphasis added) the location of the homestead property owner is unknown to the lender;"

This key acceleration provision was at odds with the debt acceleration provisions of national reverse mortgage loan products known as Home Keeper offered by Fannie Mae, a government sponsored enterprise, and the Home Equity Conversion Mortgage, or HECM, insured by the Department of Housing and Urban Development (HUD). Under the terms of each of these reverse mortgage products, the lender is permitted to require immediate payment in full of all outstanding principal and interest in any of four events if the borrower or, if more than one, the last of the borrowers (i) dies; (ii) conveys title to the property; (iii) for reasons other than death, fails to physically occupy the property for a period longer than 12 consecutive months (or the property otherwise ceases to be the principal residence of the borrower); or (iv) the borrower fails to perform some obligation under the loan terms, such as keeping the property maintained in good repair, insured, and free of tax liens.

The new Texas law, however, failed in particular to provide for the right of the lender to accelerate the debt in the event of the death of the last of the borrowers to die or in the event that the last of the borrowers ceases occupying the homestead *and*, in the terms of Section 50(k), " . . the location of the homestead property owner is unknown to the lender." Arguing that the conjunctive "and" preceding this phrase should instead have been the disjunctive "or", secondary market makers, Fannie Mae and HUD, were concerned that, unlike other reverse mortgage products nationwide, the Texas lender would be unable to call the loan in the event that the secured property were permanently vacated by the homeowner, *if* the lender was on actual or constructive notice that the homeowner was now residing at another location, such as at a convalescence home or hospice. William Apgar, FHA Housing Commissioner, in this regard observed in a March 20, 2000, interview with *Real Estate Finance Today*: " The Texas state Legislature produced a law that allowed reverse mortgages, but it didn't match with our guidelines, so we needed waivers to modify FHA's basic paperwork and develop an alternative way for the loans to be done in Texas." Fannie Mae expressed similar concerns, and the Texas reverse mortgage consequently has languished for the past two years until our biennial legislature could consider curative provisions needed to make the Texas reverse mortgage product acceptable to Fannie Mae, HUD and private secondary market makers.

S.J.R. 12 enacted in the 76th Legislature proposed curative amendments to Section 50(k), (p), and (r) to conform the reverse mortgage as defined and authorized by the Texas Constitution to the requirements of the secondary market, and in particular to the Home Keeper℠ and HECM reverse mortgage programs. These amendments were approved by voter referendum in the November, 1999, elections and became effective immediately upon canvassing of the vote. Notably, Section 50(k), as amended, now defines a "reverse mortgage"

in this regard as an extension of credit that is made to a person who is (or whose spouse is) 62 years old, or older, (formerly 55 years, or older) and that requires no payment of principal or interest until: (1) all borrowers have died; (2) the homestead property securing the loan is sold or otherwise transferred; (3) all borrowers cease occupying the homestead property for a period of longer than 12 consecutive months without prior written approval from the lender; (4) the borrower commits actual fraud in connection with the loan, or (5) the borrower defaults on an obligation specified in the loan documents to repair and maintain, pay taxes and assessments on, or insure the homestead property; or to maintain the reverse mortgage's lien priority.

These amendments and the other defining terms of the Texas reverse mortgage are discussed in some detail in Section III. B., which follows. On the strength of these amendments, the Department of Housing and Urban Development (HUD) issued its Mortgagee Letter 00-9 on March 8, 2000, announcing that, subject to instructions and modifications to certain of the model loan document forms set out in the letter, FHA would immediately begin insuring reverse mortgages under its Home Equity Conversion Mortgage (HECM) program in the State of Texas.

B. HUD ML 00-9 ANNOUNCES TEXAS HECM PROGRAM

The Federal Housing Commissioner announced the immediate availability of Home Equity Conversion Mortgages ("HECMs") in Texas in HUD Mortgagee Letter ML 00-9 on March 8, 2000. According to the Commissioner, the recent amendments to the Texas Constitution now enable FHA, with only minor modifications to the FHA HECM program described in the announcement, to insure Texas HECM loans without additional risk to the FHA insurance fund. Those modifications basically relate to two items: (i) Texas' constitutional limitations on permitted grounds for acceleration of reverse mortgage debt; and (ii) Texas' prohibition of lines of credit under a reverse mortgage. To address these two non-conforming items, revisions applicable to Texas loans only as announced in the Mortgagee Letter were made to the Model Forms for the (i) Home Equity Conversion Loan Agreement; and (ii) Repair Rider to the Loan Agreement. The Texas modifications addressed in these two documents were generally summarized as follows:

(i) *Non-Occupancy:* For Texas HECMs only, HUD will not grant permission to accelerate the reverse mortgage for reasons of non-occupancy until the homeowners have failed to occupy the property for more than 12 consecutive months;

(ii) *Inspection of Property*: For Texas HECMs only, HUD will not grant permission to accelerate the reverse mortgage for reasons of the homeowner's refusal to allow the lender to inspect the property;

(iii) *Escrows in Lieu of Set-Asides*: Because, according to HUD, the Texas Constitution does not permit a line of credit in connection with a reverse mortgage, FHA will permit the use of escrow accounts in place of set-asides that generally are disbursed as lines of credit. Escrow accounts must comply with state law and, for repairs that qualify for completion after loan closing, the escrow account must be funded in an amount equal to 150% of the estimated costs of repair. Any balance remaining after completion of repairs may, at the option of the homeowner, be added to the present payment plan or disbursed as a one-time lump sum payment from the escrow account.

FHA emphasizes that these model forms must be adapted to Texas law and lenders are advised to employ counsel to make any necessary changes to the model instruments to conform them to Texas law.

C. OVERVIEW: THE TEXAS REVERSE MORTGAGE DEFINED

The Texas reverse mortgage is a particular type of home equity loan that is authorized to be secured by a voluntary lien on homestead property by Section 50(a)(7) and in accordance with exacting requirements of Subsections (k) through (p), inclusive, of Article XVI of the Texas Constitution ("reverse mortgage"). Those constitutional provisions are briefly summarized as follows:

1. **Voluntary Homestead Lien**
   A valid reverse mortgage lien may be created only by written agreement between the lender and each owner of the homestead property and the spouse of each owner [§ 50(k)(l)]. Each owner and each owner's spouse must consent to the lien regardless of whether the spouse claims an ownership interest in the property or is an applicant for, or obligor on, the debt. Each owner or the owner's spouse must be at least 62 years of age [§ 50(k)(2)]. But this requirement varies from the requirements of the HECM and Home Keeper℠ loan programs that require the *youngest* borrower to be 62 years of age, or older. All homestead property, urban or rural, is eligible as security for a reverse mortgage (there being no "carve out" exceptions for homestead property "designated for agricultural use" as in the case of (a)(6) home equity loans).
2. **Non-recourse Debt**
   A reverse mortgage is non-recourse debt and must be made without recourse for personal liability against each owner and the spouse of each owner. A reverse mortgage is typically repaid from sales proceeds upon the sale of the homestead property by the borrower or the sale by the borrower's estate after the borrower, or the last of the borrowers, dies. If a reverse mortgage is not paid when due, the lender or noteholder must look only to recovery against the homestead property under its security interest as its exclusive remedy. The homeowner, therefore, will never owe more than the loan balance or the value of the homestead property, whichever is less, and no assets other than the homestead property must be used to repay the debt. Neither the borrower's estate nor the heirs of the estate have any liability for any deficiency that may result from the sale of the homestead property.
3. **Based on Equity in Homestead**
   A reverse mortgage is "needs based" financing, and the loan amounts or the borrower's eligibility for the loan must be based upon the borrower's age and the equity in the borrower's homestead property only. [§ 50(k)(4)] Accordingly, there must not be restrictions regarding the qualifications of the borrower for the loan based upon the borrower's income, assets, or intended use of the loan funds. For purposes of determining eligibility under any state statute relating to payments, allowances, benefits, or services on a "means-tested" basis (including expressly supplemental security income, low-income energy assistance, property tax relief, medical assistance, and general assistance), reverse mortgage advances made to the borrower are considered loan proceeds and not income; and undisbursed funds under a reverse mortgage loan are considered equity in the home and not loan proceeds. [§ 50(o)]
4. **Repayment; Acceleration; Default**
   The borrower must have no legal obligation to repay a reverse mortgage, furthermore, or any portion or principal or interest thereon, until the loan balance is due (i) upon the death of the last of the borrowers to die or, if earlier, (ii) upon the sale or transfer of the homestead property, or (iii) after 12 consecutive months in which all borrowers have ceased occupying the homestead property as their principal residence (without having obtained the lender's prior written approval). The lender may also accelerate the indebtedness and require payment of all principal and interest (iv) if the borrower commits actual fraud in connection with the loan or (v) defaults on an obligation provided for in the loan documents to repair and maintain, pay taxes and assessments on, or insure the homestead property or fails to maintain the priority of the lender's lien on the homestead property. [§ 50(k)(6)] In the latter case, the lender may accelerate the debt only if the borrower fails to promptly discharge any lien that has or may obtain priority over the reverse mortgage lien within 10 days after receiving notice from the lender, unless the borrower (i) reaches agreement in writing with the lender for borrower's payment of the obligation secured by the lien; (ii) contests in good faith the lien or its enforcement in legal proceedings so as to prevent enforcement of the lien; or (iii) obtains from the holder of the lien an agreement satisfactory to the reverse mortgage lender to subordinate the lien to that of the reverse mortgage.
5. **Consumer Notice; Counseling**
   The conditions under which the borrower is required to repay the reverse mortgage loan must be included in the written agreement, and the lender must additionally provide written notice of the

conditions to the borrower at loan closing. These conditions should also be covered in required counseling for the borrower regarding the "advisability and availability of reverse mortgages and other financial alternatives" [§ 50(k)(8)] required of borrowers before entering into a reverse mortgage loan. A reverse mortgage may not be made unless the owner of the homestead attests in writing that the owner has received counseling regarding these issues. Samples of suggested forms for these documents are set out as Appendices 4-10 and 8 to this article.

6. **Advances Per Payment Plan; Regular Intervals**

The proceeds of a reverse mortgage must be disbursed to the borrower in one, or more, payments of principal, generally referred to as "advances," according to an agreed payment plan. The total loan obligation, generally referred to as the "balance," is the sum of all advances due at loan maturity (including any amounts advanced to cover closing and other costs) plus accrued interest, including interest on interest, and other finance charges, such as mortgage insurance premiums and servicing fees.

If the payment plan established by the loan documents calls for more than one advance (i.e., a "lump sum" payment), the advances on a reverse mortgage must be made (i) at *regular intervals* or (ii) at regular intervals in which the amounts advanced may be *reduced* for one or more advances when requested by the borrower. [§ 50(p)(1), (2).] These requirements that advances be made at regular intervals and that they may be reduced in amount when requested by the borrower are generally construed to prohibit revolving *line of credit* terms popular in other states, under which any amounts repaid by the borrower are available to be drawn down again by the borrower when desired. In addition to regularly scheduled advances to the borrower, if the borrower fails to timely pay any of the following for which the borrower is obligated under the loan documents, the lender may at any time advance amounts on behalf of the borrower to pay: (i) property taxes, (ii) assessments, (iii) insurance, and (iv) costs of repairs and maintenance (when performed by persons who are not employed by or affiliated with the lender), or (v) any lien that has, or may obtain, priority over the reverse mortgage lien, to the extent necessary to protect the lender's interest in, or the value of, the homestead property. [§ 50(p)(3)]

7. **Lien Priority; Future Advances**

Advances made, and to be made, under a reverse mortgage, and interest on those advances have lien priority over any subsequently filed lien. Therefore, future advances under a reverse mortgage will have lien priority over any lien filed for record in the real property records of the county where the homestead property is located after the reverse mortgage instrument is filed in that county. [§ 50(l)]

8. **Interest; Shared Appreciation**

Interest may be charged on a reverse mortgage loan at any fixed- or adjustable-rate that the parties may agree upon(and which, if secured by other than a first lien, does not exceed the maximum lawful rate under the Texas Finance Code) and interest may accrue and be compounded during the term of the loan according to the agreed terms of the loan agreement. Interest, furthermore, expressly may be contingent upon appreciation in the fair market value of the homestead property, apparently allowing for lenders to charge "equity share" fees based upon the appreciation of appraised value of the homestead when the loan matures. Equity share terms generally reduce the lender's risk of loss and entitle the borrower to larger monthly advances over the term of the loan than under other options.

9. **Reducing or Failing to Make Advances; Forfeiture**

If an adjustable rate of interest is charged, the lender under a reverse mortgage expressly is prohibited from reducing the amount or number of advances made to the borrower because of an adjustment in the interest rate. [§ 50(k)(5).] The lender is obligated to make loan advances as required and set out in the loan documents under the penalty of forfeiture. If the lender fails for any reason to make loan advances according to the loan documents and, after notice from the borrower, fails to cure the default as required in the loan documents, the Constitution provides that

the lender forfeits all principal and interest on the reverse mortgage. [§ 50(k)(7).] However, this forfeiture provision does not apply when a governmental agency, such as FHA under its HECM reverse mortgage insurance, takes an assignment of the loan in order to cure the lender's default.

10. **Foreclosure; Grounds; Procedures**
    If proceeding to foreclosure of a reverse mortgage lien for any reason, the lender must first give written notice to the borrower that a ground for foreclosure exists and give the borrower an opportunity to cure the ground for foreclosure. [§ 50(k)(10).] The notice must be given in the same manner provided for a notice by mail related to the foreclosure of Section (a)(6) home equity loans. The borrower must be given at least 30 days (or 20 days if the ground is based upon the borrower's failure to maintain the priority of the lender's reverse mortgage lien) to either (i) remedy the condition creating the ground for foreclosure; (ii) pay the debt secured by the homestead property from proceeds of the sale of the homestead property (or from any other sources); or (iii) convey the homestead property to the lender by deed in lieu of foreclosure. If the ground for foreclosure is either (i) the death of the last of the borrowers to die or (ii) the sale or other transfer of the homestead property, foreclosure may be carried out under the power of sale under the terms of the deed of trust securing the loan and in accordance with applicable provisions of the Property Code related to the informal foreclosures.

    If foreclosure is for any other ground, the reverse mortgage lien may be foreclosed upon only by court order. [§ 50(k)(11).] In this regard, the Supreme Court of Texas was directed to promulgate rules of civil procedure for expedited foreclosure proceedings related to foreclosure of the reverse mortgage liens that require a court order. Section V. B. of this article reports on the adoption of revised Rules 735 and 736 for that purpose.

11. **Preemptive Authority**
    Texas reverse mortgage law as authorized and effected by the Texas Constitution expressly supercedes any statutes of this state, including the Texas Property Code, that purport to limit encumbrances that may be fixed on homestead property. [§ 50(q)] Furthermore, a reverse mortgage may be made without regard to any other conflicting state law, including any purported limitations on future advances; a requirement that a maximum loan amount be stated in the reverse mortgage loan documents or that a percentage of reverse mortgage proceeds be advanced before the assignment of the reverse mortgage; or a prohibition on balloon payments, compound interest or interest on interest, or contracting for, charging, or receiving any rate of interest authorized by Texas law. [§ 50(n)]

12. **(a)(6) Home Equity Provisions Inapplicable**
    Beyond these requirements, note that the numerous conditions imposed on home equity loans under Section 50(a)(6) are inapplicable to reverse mortgages authorized under Section 50(a)(7). Notably, the enumerated limitations under Section 50(a)(6)on permitted loan to value (80%), fees and charges (3%), foreclosure process, authorized lender's closing practices, promulgated consumer disclosures, or cooling off, and rescission rights, for example, are not carried over to the reverse mortgage provisions (although, with respect to the latter, reverse mortgages are subject to the federal right of rescission and other federal regulation under the federal Real Estate Settlement Procedures Act and the Truth in Lending Act noted in Section VI. C. of this article).

D. TEXAS' UNIQUELY PROTECTIVE HOMESTEAD LAWS

The Texas Constitution establishes and guarantees the right of homestead and, since amended in its modern form in the Convention of 1875, prescribed limitations for mortgaging the homestead that until amendments effective January 1, 1998, distinguished Texas as the only state in the nation in which homeowners could not contract for home equity or reverse mortgage loans secured by a lien against their homes.

Adopted at a time when Texas was largely a poor, agrarian society, the state's uniquely protective homestead law is based on public policy considerations and is intended to shield from general creditors a place for the family to live and for the family head to exercise a calling or business for the support of the family. Only by constitutional amendment as late as 1973 were these same homestead exemption rights extended to an unmarried adult person not the head of a household. And the homestead exemption concept itself was changed by constitutional amendment in 1983 – repealing the old money-valuation exemption in favor of the modern form in which then generally up to one acre of urban property or 200 acres of rural property, with a dwelling and other improvements thereon, can be protected as a *homestead.* (See 1999 amendments to the Constitution and Property Code expanding the urban homestead exemption to ten acres in Section III. E. of this article.)

Texas homestead rights today are derived both from the state's constitution and various state statutes, including its Property Code, enacted to carry out the purposes of the constitutional provisions. Beyond merely exempting the homestead from forced sale by general creditors, however, Texas recognizes homestead rights as being in the nature of an estate in land. Even a surviving spouse with no ownership interest in the homestead property itself, for example, generally has the right to remain in the homestead, unless abandoned, for the rest of his or her life — a kind of life estate by operation of law. The family homestead cannot be sold, mortgaged, or even abandoned, furthermore, without the consent of both spouses, even if the property is owned solely by one of them.

But even with their consent, a homestead may only be encumbered for the limited purposes set out as Section 50(a) (1) - (7) Art. XVI, of the Texas Constitution of purchasing, making improvements to, or paying taxes on the property and, since a 1995 constitutional amendment, for the additional purposes of an owelty of partition (imposed against the entirety of the property by a court order or by written agreement of the partitioning parties) and a refinancing of a lien, including a federal tax lien (resulting from tax debt of the owner or, in the case of a family homestead, both spouses) and, since the 1997 home equity amendment, for the additional purposes of an (a)(6) equity loan and an (a)(7) reverse mortgage.

D. APPLICABILITY OF STRICT COMPLIANCE STANDARDS

Section 50, Article XVI, Texas Constitution, embodies the constitutional protections of the homestead of a family or a single, adult person from forced sale and, in Section 50 (a)(7), expressly authorizes a reverse mortgage as a type of debt that may be secured by a valid lien against homestead property. A constitutional reverse mortgage is defined in terms of an extension of credit made in conformity with the certain provisions enumerated in Article XVI of the Texas Constitution as Sections 50(k) through (p), inclusive. This is significant because 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 the statutes and constitution. Section 50(c), which provides in pertinent part that "no mortgage, trust deed, or other lien on the homestead shall ever be valid *unless* it secures a debt described by this section," furthermore, would appear to leave little room for a notion of *substantial compliance* with these provisions as sufficient to satisfy the conditions to creation of a valid homestead lien. Because Texas homestead laws are liberally construed by the courts to effectuate the purposes of the constitutional protections, even the innocent failure to satisfy any one of these conditions could be found in a proper case to be fatal to the creation of a valid lien. Unlike a valid judgment lien that may subsequently attach to the real property constituting the homestead if the property loses its homestead character (e.g., through abandonment), a purported reverse mortgage loan that fails to satisfy any one of the constitutional conditions under this rationale would be void and could never constitute a valid lien on the real property. Moreover, the courts would be expected to find that none of these conditions could be waived by the homeowner because each is constitutionally vested. In any event, a constitutionally deficient lien cannot be estopped into existence, nor can the courts be expected to impose a constructive trust or equitable lien in any case in favor of the lender in absence of compliance with constitutional and statutory requirements for fixing a lien on homestead property.

E. RECENT CONSTITUTIONAL HOMESTEAD AMENDMENTS

Recent amendments to the Texas Constitution and the Property Code have increased the size of the urban homestead from one acre to ten acres and established defining criteria for distinguishing an urban homestead from a rural homestead, which exempts up to 200 acres of land as homestead, when the character of the homestead is ambiguous. Enacted as S.J.R. 22 and S.B. 496 by the 76th Legislature, these amendments appear to have the legal effect as of January 1, 2000, of instantaneously expanding the boundaries of even existing urban homesteads to include all contiguous land to the home site, not exceeding 10 acres in area (when combined with the area of the preexisting homestead property), that is owned by the homestead claimant and used or intended to be used for purposes of an urban home (or both an urban home and a place to carry on a business or profession). Subsection (d) of § 41.002 of the Property Code in this regard provides that the definition of a homestead set forth in the section "applies to all homesteads in this state *whenever created"* (emphasis added). If the contiguous acreage used for these purposes exceeds 10 acres, the homestead claimant is then authorized to voluntarily designate a particular area not exceeding 10 acres (and necessarily containing the dwelling used as a home and related improvements) as *homestead*. Any urban homestead created on or after the January 1, 2000, effective date of the Property Code amendments, of course, is governed by the new law and has the benefit of the new homestead exemption of up to 10 acres, while the validity of any voluntary or involuntary lien on any urban homestead created before that effective date is governed by the law in effect on the date the lien was created and prior law is continued in effect for that purpose. (Similarly, any rights under a writ of execution against a homestead property issued before that January 1, 2000, effective date or rights under the statutory exemption from seizure of the sale proceeds of a homestead property sold before that effective date are governed by the law in effect at the time and prior law is continued in effect for that purpose.)

Amendments to the Texas Property Code enacted by S.B. 496 include:

a. *Section 41.002(a) of the Property Code* was amended effective January 1, 2000, to define a homestead, when used for the purposes of an urban home ***or both*** an urban home and a place to exercise a calling or business (i.e., a business homestead), as consisting of ***not more than 10 acres*** of land, which may be in one or more ***contiguous*** *lots*, together with improvements thereon. When the urban home is part of one or more contiguous lots containing a total of more than 10 acres, Section 41.005 of the Property Code authorizes a homestead claimant to ***voluntarily designate*** not more than 10 acres of the property as *homestead*.

b. *Section 41.002(c) of the Property Code* was amended effective September 1, 1999, to provide a *bright line test* for distinguishing between urban and rural homesteads when the character of the homestead property is ambiguous and the property has characteristics of each. Under this test, a homestead is considered *urban* if, at the time the designation of homestead is made, the property is:

(i) Location: Located within the limits of a municipality, the extra territorial jurisdiction (ETJ) of a municipality, **or** a platted subdivision; **and**

(ii) Police & Fire Protection: Served by police protection **(and)** paid or volunteer fire protection; **and**

(iii) Municipal Services: Served by **at least three** of the following services that are provided by a municipality or (another party) under contract to a municipality: (i) Electric; (ii) Natural Gas; (iii) Sewer; (iv) Storm Sewer; and (v) Water.

c. *Section 5.042 of the Property Code* was amended effective September 1, 1999, to abolish the common law doctrine or rule prohibiting an existing lien on part of a homestead from being extended to another part of the homestead not already charged with the debts secured by that existing lien, thereby adding this common law rule to the junk heap with the earlier abolished Rule in Shelly's Case and the Doctrine of Worthier Title.

IV. TITLE INSURANCE COVERAGE – *SHIFTING COMPLIANCE RISK*

A. THE REVERSE MORTGAGE ENDORSEMENT

Texas mortgage lenders have traditionally shifted certain compliance risks to title insurance companies and agencies who act both as insurers against the invalidity or impairment of liens on the homestead property and as settlement agents responsible for closing the transaction. Title insurance in Texas, of course, is a contract of indemnity only — protecting the mortgage lender, in the case of a residential mortgage transaction, against loss suffered by reason of liens, encumbrances upon, or defects in the title to the real property and the invalidity or impairment of the lien created, or intended to be created, by the insured transaction. When securing a mortgage lien on homestead property, title insurers have been relied upon to investigate and make certain factual determinations incident to creation of a valid lien, such as confirmation of the true identity of the parties executing the debt and security instruments, the true character of the real property, the payment of all delinquent taxes on the property, and the passing of the consideration supporting the transaction. The title insurer as settlement agent, furthermore, routinely assures the proper execution, acknowledgment, and delivery of all conveyances, mortgage loan documents, or other instruments that may be necessary to consummation of the transaction, the proper disbursement of proceeds, and the filing in the public records of all appropriate instruments. Because creation of a valid reverse mortgage lien on homestead property is dependent as a matter of law on strict compliance by the lender with all constitutional conditions, the certitude of compliance that the title insurer can bring to the transaction through its insuring and closing services takes on particular importance.

But the title insurer does not undertake to indemnify the lender against the risk of lien invalidity resulting from claimed violations of constitutional conditions that are not a matter of public record, subject to open observation, or verifiable at a closing conducted by its own title agent. The title insurer generally is insulated from claims of lien invalidity based on violations of the federal Truth in Lending Act entitling the consumer to loan rescission in certain instances and other consumer credit protection laws. This "consumer credit protection law" exclusion is set out as Paragraph 5 under the *Exclusions From Coverage* section of the standard form of Mortgagee Policy of Title Insurance (Form T-2) promulgated by the Texas Department of Insurance as follows:

> "The following matters are expressly excluded from the coverage of this policy and the Company will not pay loss or damage, costs, attorney's fees or expenses that arise by reason of:
> …
> 5. *Invalidity or unenforceability of the lien of the insured mortgage, or claim thereof, which arises out of the transaction evidenced by the insured mortgage and is based upon usury or any consumer credit protection or truth in lending law*."

In undertaking to insure liens created under Section 50(a)(7), the Commissioner of Insurance, effective January 12, 1998, adopted a new form of Reverse Mortgage Endorsement (T-43) and a new related Procedural Rule (Rule P-45) regarding the use of the T-43 Endorsement that incorporates by reference this "consumer credit protection law" exclusion as it pertains to reverse mortgages. Essentially, the T-43 Endorsement expanded the definition of "consumer credit protection law" contained in Paragraph 5 of the Exclusions From Coverage section of the T-2 policy to expressly incorporate "the provisions of Subsections k(3) through k(11), inclusive, of Section 50, Article XVI, Texas Constitution, and any statutory or regulatory requirements for a mortgage made pursuant to Subsection (a)(7)." Claims of lien invalidity arising out of a failure to satisfy one, or more, of the conditions of Section 50(a)(7) or Subsections (k)(3) through (k)11, inclusive, (m) or (p), are excluded from title insurance coverage unless the claim is based on one of the conditions expressly covered under the 1998 version of the T-43 Endorsement, which included variously claims of lien invalidity based on future advances made under a reverse mortgage and failure of the insured mortgage to be created under a written agreement with the consent of each owner and each owner's spouse.

B. ADOPTION OF REVISED P-45 AND T-43 AMENDMENTS

Proposed amendments to the Texas Reverse Mortgage Endorsement (T-43) and Procedural Rule (P-45), *Basic Manual of Rules, Rates and Forms for Writing of Title Insurance in the State of Texas*, have been approved by the Commissioner of Insurance and following a required 30-day public comment period, the amendments are expected to be effective by June 12, 2000. The amendments are intended to insure against claims of lien invalidity of an insured reverse mortgage arising out of the failure to satisfy certain of the constitutional conditions contained in the 1999 amendments to the Texas Constitution as proposed by S.J.R. 12.

As amended, the Texas Reverse Mortgage Endorsement (T-43) to the Mortgagee Title Insurance Policy (T-2) would exclude from coverage any loss or damage based on usury or any consumer credit protection or truth in lending law "and/or violation of Subsections (k)(3), (k)(4), (k)(5), (k)(6), (k)(7), (k)(8), (k)(9). (k)(10), (k)(11), (m) or (p) of Section 50, Article XVI, Texas Constitution, and any regulatory or statutory requirements for a mortgage made pursuant to Subsection (a)(7), Section 50, Article XVI, Texas Constitution, *except as expressly provided in paragraph 3 of this endorsement*" (emphasis added).

Form T-43, as amended, in paragraphs 1 and 2, respectively, insures the validity of future advances made under a reverse mortgage up to the outstanding aggregate amount of loan proceeds actually disbursed and the amount of unpaid, accrued interest thereon as of the time a loss occurs under the policy (except as to (i) bankruptcies affecting the property prior to the date of any such disbursement or (ii) taxes or other obligations to the government secured by statutory liens recorded subsequent to the policy date); and in paragraph 3, Form T-43 expressly insures against loss sustained by the lender under the mortgagee policy because of invalidity or unenforceability of the reverse mortgage lien by reason of any of the following:

(i) *Written agreement:* the failure of the insured mortgage to be created under a written agreement with the consent of each owner of the insured homestead property and each owner's spouse [§ 50(k)(1)];

(ii) *Age 62:* the failure of the insured mortgage to be made to a person who is, or whose spouse is, 62 years of age or older [§ 50(k)(2)];

(iii) *Attestation of Counseling:* the failure of the written document purporting to be made pursuant to Subsection (k)(8) to be executed by the homeowner on the date that the insured mortgage and promissory note secured thereby are executed by the owner (provided that the policy does not insure that the document complies with Subsection (k)(8)) [Section 50(k)(8)]; or

(iv) *Notice of Repayment Obligation:* the failure of the title company or its agents to furnish the homeowner a copy of written notice purporting to be made pursuant to Subsection (k)(9) on the date that the owner executed the insured mortgage and promissory note secured thereby (provided that the policy does not insure that the written document complies with Subsection (k)(9)) [Section 50(k)(9)].

While attachment of the T-43 Endorsement to any mortgagee policy of title insurance issued in connection with a reverse mortgage loan is mandatory, under Procedural Rule P-45 the issuing agency may delete any of these four subdivisions of Paragraph 3 if it does not consider the additional risk insurable and must delete subdivisions (i) through (iv) if the promissory note and the insured mortgage instrument for the loan are not executed by the borrower at the office of the title company (which term includes variously the offices of the insurer, an insurer's direct operation, a title agency, or a fee attorney conducting business in the name of any of these where the attorney and its bona fide employees who close transactions are licensed as escrow officers under Art. 9.41C, Title Insurance Code). Furthermore, the insuring agency must delete subdivision (ii) of Paragraph 3 if the age of the owner or spouse is not verifiable "with government issued photographic identification" furnished the title agency and must delete subdivisions (iii) and/or (iv) if the related documents furnished by the insured are not executed by the homeowner at the office of the title company on the date that the insured mortgage and promissory note secured thereby are executed. Copies of the proposed

Form T-43 and Procedural Rule P-45 with proposed new language underlined and bracketed and proposed deletions stricken through are attached to this article as Appendix 6.

V. TEXAS REVERSE MORTGAGE DEFAULT AND FORECLOSURE PROCESS

A. CONSTITUTIONAL CONDITIONS TO FORECLOSURE

1. Acceleration of Debt:

A reverse mortgage is defined in part by Section 50(k)(6) as an extension of credit:

…

(6) that requires no payment of principal or interest until:
  (A) all borrowers have died;
  (B) the homestead property securing the loan is sold or otherwise transferred;
  (C) all borrowers cease occupying the homestead property for a period of longer than 12 consecutive months without prior written approval for the lender; or
  (D) the borrower:
    (i) defaults on an obligation specified in the loan documents to repair and maintain, pay taxes and assessments on, or insure the homestead property;
    (ii) commits actual fraud in connection with the loan; or
    (iii) fails to maintain the priority of the lender's lien on the homestead property, after the lender gives notice to the borrower, by promptly discharging any lien that has priority or may obtain priority over the lender's lien within 10 days after the date the borrower receives the notice, unless the borrower:
      (a) agrees in writing to the payment of the obligation secured by the lien in a manner acceptable to the lender;
      (b) contests in good faith the lien by, or defends against enforcement of the lien in, legal proceedings so as to prevent the enforcement of the lien or forfeiture of any part of the homestead property; or
      (c) secures from the holder of the lien an agreement satisfactory to the lender subordinating the lien to all amounts secured by the lender's lien on the homestead property;

Accordingly, so long as the borrower, or one of the borrowers, is alive and continues to occupy the homestead property as a principal residence, no loan default can occur unless, under the provisions of Subsection (k)(6)(D), the borrower commits actual fraud in connection with the loan or fails to repair and maintain, pay taxes and assessments on, or insure the homestead property or maintain the priority of the lender's reverse mortgage lien. Defaults under these obligations with respect to the homestead property rarely would be expected because homeowners typically have undertaken the reverse mortgage loan to provide for the resources just for these purposes to maintain and reside in their homes for the rest of their lives. Furthermore, Subsection (p)(3) and the terms of the loan documents provide the lender authority to make advances at any time on behalf of the borrower to pay just such items of delinquent taxes and assessments, insurance, costs of repair or maintenance, or any lien that has, or may obtain, priority over the reverse mortgage lender's lien, to the extent necessary in each case to protect the lender's interest in, or value of, the homestead property.

Before accelerating the debt and commencing foreclosure proceedings in any event, Subsection (k)(10) requires the lender to give notice to the borrower "in the manner provided for notice by mail related to the foreclosure of liens under Subsection (a)(6)" regarding home equity loans that

a ground for foreclosure exists and that the borrower is given a stated period of at least thirty (30) days in which to:

a. Remedy the condition creating the ground for foreclosure;
b. Sell the homestead property and pay the reverse mortgage debt from the proceeds of the sale, or pay the debt from other sources; or
c. Convey the homestead property to the lender by deed in lieu of foreclosure.

Only a cure period of at least 20 days must be given the borrower if the claimed default is a failure of the borrower to maintain the priority of the reverse mortgage lien under Subsection (k)(6)(D)(iii).

2. Methods of Foreclosure:

Foreclosure based upon the grounds under Subsections (k)(6)(A) or (B) either that all borrowers have died or that the homestead property securing the loan has been sold or otherwise transferred may be foreclosed upon under the power of sale contained in the deed of trust securing the loan and the requirements of the Section 51.002 of the Property Code, pertaining to informal foreclosure.

If the foreclosure is for a ground other than those stated in Subsections (k)(6)(A) and (k)(6)(B), however, a reverse mortgage lien may be foreclosed upon only by court order. Subsection 50(r) in this regard was amended by S.J.R. 12 to require the Texas Supreme Court to promulgate rules of civil procedure for expedited foreclosure proceedings related to both Subsection (a)(6) home equity loans and for those Subsection (a)(7) reverse mortgages that require a court order. Rule 735, recently adopted by the Supreme Court under that legislative directive, provides several judicial foreclosure options for a lender foreclosing a reverse mortgage on grounds other than under Subsection (k)(6)(A) and (k)(6)(B). Under Rule 735, the lender may file (i) a suit seeking judicial foreclosure; (ii) a suit or counterclaim seeking a final judgment that includes an order allowing foreclosure under the security instrument; or (iii) an application for an order allowing foreclosure under Rule 736 pertaining to expedited foreclosure proceedings.

B. THE REVISED EXPEDITED FORECLOSURE PROCEDURES – RULE 736

After administrative rulemaking procedures, Rules 735 and 736 of the Rules of Civil Procedure related to home equity loan foreclosure originally took effect May 15, 1998. Acting under the authority of amended Section 50(r), the Supreme Court approved revisions to Rules 735 and 736 on February 10, 2000, Misc. Docket No. 00-9019, published in Volume 63, *Texas Bar Journal* 293, March, 2000, and subject to any changes made after the public comment period, will take effect April 15, 2000.

As revised, Rule 736 sets out an *in rem* judicial procedure whereby a lender or other holder of a Section 50(a)(6) home equity loan or Section 50(a)(7) reverse mortgage may file a verified application in the district court of the county in which all, or any part, of the secured homestead property is located, seeking a court order allowing a foreclosure in accordance with Section 50(a)(6)(D) for a home equity loan or Section 50(k)(11) for a reverse mortgage under the security instrument and Tex. Prop. Code § 51.002. Service is accomplished by delivery of a promulgated form of Notice and a copy of the Application by certified and first class mail addressed to each party who is obligated to pay the debt and is deemed complete when mailed in a properly addressed, postage prepaid wrapper. A Certificate of Service must then be filed with the clerk of the court as *prima facie* evidence of service and must be on file at least ten days (exclusive of the date of filing) before a default order may be entered by the court. A Response by the parties so served is due by the Monday next after the expiration of 38 days from the date of service (i.e., the date of mailing of the Notice and Application), which response may set out as many matters, whether of law or fact, as the respondent thinks necessary or pertinent to contest the Application.

Under the rule, if no Response is timely made, the court must grant the Application without further notice or hearing if the Application complies in form and content with the requirements of the rule and a copy of the Notice and Certificate of Service has then been on file with the clerk of the court for at least ten days. If a Response is made, however, a hearing on the Application must be promptly set after reasonable notice to the parties and, in any case, not later than ten business days after a request for hearing by either party (unless the parties agree to an extension of time). The rule calls for a streamlined hearing in which no discovery is allowed and the court's action in granting or denying the order may not be appealed. The only issue before the court is the right of the applicant to obtain an order to proceed with foreclosure pursuant to a power of sale under the security instrument and Tex. Prop. Code § 51.002, which sets out the statutory scheme for required notice and procedures for conducting the sale of real property under a power of sale conferred by a deed of trust or other contract lien. The court must grant the Application and issue the order if it determines that the applicant has proved that a valid debt exists that is secured by a lien on the property created under Section 50(a)(6) or Section 50(a)(7); that a default under the security instrument securing that debt exists; and that the applicant has given all requisite notices to cure the default and accelerate the maturity of the debt under the security instrument and applicable law.

If the applicant has failed in that proof, the court must deny the application. In either event, the court's action does not constitute *res judicata* (or collateral or judicial estoppel in any other proceeding or suit) and is without prejudice to the right of either the applicant or respondent to seek relief at law or in equity in any other court of competent jurisdiction. In fact, if the respondent files a petition in the same court or any other district court of the same county contesting the right of applicant to foreclose and files a notice of such action with the clerk of the court before the court has signed an order granting the Application, the proceeding under Rule 736 is automatically abated and the Application dismissed. Once the order granting the Application has been entered, however, the homeowner would be put to the task of obtaining and serving a Temporary Restraining Order, or TRO, to forestall the foreclosure process. When entered, a copy of the Rule 736 order together with the notice of sale must be sent to the respondent and a certified copy of the order must be filed in the real property records of the county in which the property is located within ten days after entry of the order (although failure to timely record the order expressly does not affect the validity of the foreclosure). ❑