BLACK | MANN & GRAHAM L.L.P.

2905 Corporate Circle

Flower Mound, TX 75028

Phone: 972-353-4174

Fax: 972-221-9316

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To: Clients and Friends

From: Shawn P. Black and David F. Dulock

Subject: Will Equitable Subrogation be Prohibited for Uncured Home Equity Loans? *Zepeda v. Federal Home Loan Mortgage Corporation*, 2019 WL 3820019

In a decision filed August 15, 2019, the United States Court of Appeals for the Fifth Circuit certified a question to the Supreme Court of Texas, the answer to which may significantly impact a lender's ability to mitigate its losses on a constitutionally defective home equity loan. The case of *Zepeda v. Federal Home Loan Mortgage Corporation*, 2019 WL 3820019 (5th Cir. Aug. 2019) involved the application of Texas' long-standing doctrine of equitable subrogation to an invalid home equity loan under Tex. Const. art. XVI, § 50(a)(6).

Texas courts have long recognized that equitable subrogation benefits both lenders and homeowners. "Without equitable subrogation, lenders would be hesitant to refinance homestead property due to increased risk that they might be forced to forfeit their liens." *LaSalle Bank Nat. Ass'n v. White*, 246 S.W.3d 616, 620 (Tex. 2007). The doctrine of equitable subrogation provides that a "subsequent lender will succeed to the rights of prior lenders and become entitled to 'all rights of the prior creditors in relation to the debt.' " *Vogel v. Veneman*, 276 F.3d 729, 735 (5th Cir. 2002). With respect to homestead property, it applies when "A homeowner takes out a loan using the homestead as collateral. Later, the homeowner takes out a second loan, and asks the second lender to pay the balance on the first loan. The second lender is subrogated to the first lender's rights under the original lien. Whatever the terms of the original loan agreement, at a minimum, the second lender stands in the shoes of the first lender." *Zepeda* at *2. Even in instances where the requirements of the Texas Constitution are not met, Texas courts have allowed lenders to invoke the doctrine of equitable subrogation to obtain partial repayment of the loan. *See*, e.g., *Benchmark Bank v. Crowder*, 919 S.W.2d 657, 662 (Tex. 1996).

In *Zepeda*, the lender made a home equity loan under Tex. Const. art. XVI, § 50(a)(6) to Sylvia Zepeda, which was used, in part, to pay off the existing, purchase-money loan secured by her homestead. Years later, Zepeda notified the lender that the loan was constitutionally deficient because the lender's signature did not appear on the acknowledgement of fair market value in violation of §50(a)(6)(Q)(ix). In response, the lender did not sign the original acknowledgment, but instead sent a new copy of the acknowledgement to Zepeda, with no explanation for the lack of a signature. Freddie Mac subsequently acquired ownership of the loan and, although it was made aware of this violation, did not attempt to cure it. Zepeda sued Freddie Mac, claiming that the failure to cure the violation meant that Freddie Mac did not possess a valid lien on her homestead. In its defense, Freddie Mac asserted that it is equitably subrogated to the original purchase-money lien, because its predecessor-in-interest paid off the remainder of that loan. The district court, however, denied Freddie Mac's equitable subrogation defense because it found that Freddie Mac was negligent and, therefore, could not claim an equitable remedy.

Freddie Mac appealed the district court's decision to the Fifth Circuit. In its decision, the Fifth Circuit acknowledged Texas' historical recognition of equitable

subrogation. "Since at least 1890, the Supreme Court of Texas has applied equitable subrogation in the face of a constitutionally-invalid home-equity loan. *Texas Land & Loan Co. v. Blalock*, 76 Tex. 85, 13 S.W. 12, 13–14 (1890). *See also*, e.g., *LaSalle Bank*, 246 S.W.3d at 618 (applying equitable subrogation for a loan impermissibly secured on homestead property designated for agricultural use); *Benchmark Bank*, 919 S.W.2d at 662 (upholding equitable subrogation for a loan to pay taxes unconstitutionally secured by a lien on the homestead); *Farm & Home Sav. & Loan Ass'n v. Martin*, 126 Tex. 417, 88 S.W.2d 459, 469–70 (1935) (upholding equitable subrogation for a valid mechanic's lien when the second loan was unconstitutional)." However, the Fifth Circuit distinguished these cases from the facts in the Zepeda case. "None of these cases, however, involve a constitutional defect that is exclusively the fault of the lender, as is the case here. If the party seeking equitable subrogation could have satisfied the requirements of § 50(a)(6)(Q)(ix) but failed to do so, does that failure preclude it from invoking equitable subrogation? To our knowledge, the Supreme Court of Texas has never answered the question, and the parties cite no such decision".

Accordingly, the Fifth Circuit certified the following question of law to the Supreme Court of Texas:

> **Is a lender entitled to equitable subrogation, where it failed to correct a curable constitutional defect in the loan documents under § 50 of the Texas Constitution?**

Should the Supreme Court of Texas answer this question in the negative, lenders will no longer be able to rely on this long-standing doctrine of equitable subrogation to retain a lien on homestead property in order to recover a portion of a constitutionally defective home equity loan when they failed to properly cure a constitutional defect in the loan. Also unanswered, if this certified question is answered in the negative, is will the Texas Supreme Court's negative answer be retroactive? According to the Texas Supreme Court decision in *Bowen v. Aetna Cas. and Sur. Co.*, 837 S.W.2d 99, 100 (Tex. 1992), a decision of the Texas Supreme Court operates retroactively unless the Court exercises its discretion to modify that application, citing *Carrollton–Farmers Branch I.S.D., et al v. Edgewood I.S.D.*, et al, 826 S.W.2d 489, 514–522 (Tex.1992); *Reagan v. Vaughn*, 804 S.W.2d 463 (Tex.1990); *Sanchez v. Schindler*, 651 S.W.2d 249, 254 (Tex.1983).

We will continue to monitor this case. In the meantime, we recommend that lenders review their closing procedures and if they find that they are not including a lender-signed acknowledgment of fair market value with the closing package, that they revise those procedures to include a lender-signed acknowledgment of fair market value.