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Potential Pitfalls Face Texas Home Equity Lenders

In 1997, the 75th Texas Legislature passed HJR 31, setting the groundwork for amending Section 50(a), Article XVI of the Texas Constitution. Texas voters approved the constitutional amendment authorizing home equity lending for the first time in the state's 155-year history on November 4, 1997. In addition, new procedural rules passed regarding home improvement loans. Unlike many prior amendments, the rules are embedded in the constitution, not in enabling legislation.

The amendment dictates at least 25 requirements necessary to create a valid equity lien on homestead property (see "Home Equity Loans," pub. no. 1200 for details). Many of the requirements are vague and ambiguous, making absolute compliance difficult. With very few legal precedents, an innocent failure to comply could render a lender the holder of an unsecured, nonrecourse loan.

With the new law, many potential dangers and difficulties exist for both Texas lenders and borrowers. The lenders' failure to fully comply with all the requirements may not be apparent. Borrowers could raise the issue as a defense to foreclosure.

Lenders, as well as attorneys, question whether Texas courts will require **strict compliance** or regard **substantial compliance** as adequate for securing valid liens. Some legal scholars point to the case of *Toler v. Fertilla, 67 S.W. 2d 229* (1934), for the proposition that the courts will adhere to strict compliance. In the *Toler* case, the court states " . . . any attempt to create a lien or mortgage on a homestead to secure a debt, regardless of the method or form used, except for the things provided by the Constitution, is an utter nullity, and never becomes effective to any extent." The case involved a lender who neglected to get the owner's wife's signature on the mortgage.

One of the first difficulties lenders face is staying below the 3-percent cap placed on fees and charges to the borrower. Interestingly, the limitation is mentioned twice, once in the directive to lenders, and again in the required notice to borrowers. The amendment uses different language each time. In the first instance, the law places the cap on fees and charges, other than interest "necessary to originate, evaluate, maintain, record, insure, or service the **extension of credit**." In the second instance, the notice to the borrower states that, "Fees and charges **to make the loan** may not exceed 3 percent of the loan amount."

The question centers on which standard applies—the one for extending credit over the life of the loan or for making the loan? If the standard for extending credit applies where items such as maintaining, insuring and servicing costs are specifically mentioned, the escrowed casualty insurance premiums and property taxes could easily exceed the limit. If appraisal fees, title insurance, survey costs, credit reports and attorney document preparation fees are added, problems arise. Obviously, the barrier presents less of a problem with a $100,000 loan than a $2,500 loan.

The Office of the Consumer Credit Commissioner (OCCC), in conjunction with the state's departments of banking, savings and loans and credit unions issued regulatory commentaries on equity lending procedures in December 1997 and in January 1998. These state that the 3-percent limitation applies only to costs for making the loan (inception costs), not to costs for maintaining, insuring or servicing the loan. The opinion is not binding on the Texas courts.

Lenders encounter another potential problem when the urban homestead exceeds one acre and when the homestead is located in a fringe area. The amendment prohibiting lenders from using **additional property** as security creates the dilemma. Texas law limits an urban homestead to no more

than one acre. If more than one acre is used for security, the lien may be invalid.

Texas law limits a rural homestead to 100 or 200 acres depending on the familial status of the owner. When urban areas encroach on rural areas, rural homesteads may become urban even though outside the city limits. No definitive test exists to determine when a rural homestead becomes urban (see "Homestead Protection: For Whom and How Much?" pub. no. 1136). Lenders could mistakenly assume a rural homestead, use more than an acre as security and violate the prohibition.

The problem is formidable. Currently, mortgage lenders typically refuse to make equity loans secured on urban real property exceeding one acre. Title companies will not extend coverage and Fannie Mae refuses to purchase the loans. The problem is compounded when no survey is required to keep costs below the 3-percent threshold. The lender could unknowingly exceed the one-acre minimum.

Partitioning one acre for loan security is not a simple task. The procedure may conflict with many municipal ordinances regarding land use and possible restrictive covenants running with the land. The Texas Local Government Code requires a subdivision plat to be prepared prior to partitioning. To record the plat, the municipality or county must first approve it. This adds time, costs and uncertainty to the process.

Lenders may go afoul of the amendment simply by doing business as usual when refinancing. The amendment expressly authorizes the advancement of additional funds "for reasonable costs necessary to refinance" an existing homestead debt. The practice of including closing costs as part of the home equity loan package may violate this directive. The Texas courts may find the advancement not to be a "cost," not "reasonable" or not "necessary."

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The practice of refinancing "prepaids" or existing escrow accounts may violate the directive as well. However, insurers do not feel that it does. Title companies routinely insure the refinancing of these items as long as the closing costs do not exceed 5 - 7 percent of the loan value. In the future, Texas courts may find the prepaids and escrow accounts not to be a legitimate "cost" under the amendment.

Lenders may encounter another hidden problem when refinancing a home equity loan. The amendment requires lenders to repeat the 25 or more requirements necessary to validate the initial home equity loan. Lenders who refinance these loans in the traditional manner violate the amendment.

Similarly, lenders face a loss of security when consolidating a first lien with a home equity loan. According to the amendment, when consolidation occurs, the entire loan becomes an equity loan. This means the lender loses the right to nonjudicial foreclosure on the amount of the original lien, and the borrower sheds all personal liability.

Attorneys disagree on whether lenders have a chance to cure a procedural defect before the loan is lost. The amendment provides for the forfeiture of both principal and interest if the lender fails to comply with its obligations under the extension of credit within a reasonable time after being notified by the borrower.

Despite the language, attorneys argue the second-chance doctrine does not apply when the obligation is incurable. For example, how can a lender cure not having waited the required time before funding the loan? Also, giving the lender a second chance violates the rule of strict compliance set forth in the *Toler* case discussed earlier.

The amendment also changes the rules for home improvement loans. Owners now must wait at least 12 days after making a written loan application before executing the contract for work and materials. The contract must be signed by the owner and spouse in the offices of an attorney, a title company or a third-party lender extending credit. A three-day right of rescission without penalty or charge follows the signing.

The provisions present several troubling issues. First, if the owner has cash to pay for the improvements and will not make an application for a loan, how can the 12-day waiting period be

calculated, or does it still apply? The amendment does not address the question.

Second, how is a title company defined for purposes of the amendment? On March 16, 1998, an owner signed a contract for work and materials in the offices of AA Title Services of Fort Worth, a title abstract company. Later, Homeowners Mortgage & Equity, Inc. denied the loan because AA Title Services was not a "title company" as set forth in the amendment. Rooms with a View, Inc. (the contractor) filed suit against Homeowners Mortgage & Equity, Inc. requesting declaratory relief finding the amendment unconstitutionally vague because persons of reasonable intelligence can and do differ on what constitutes a title company under the amendment.

Third, as part of the same lawsuit, the plaintiffs attacked the place-of-signing requirements under the amendment. They contended the requirement violated the parties right to assemble, travel, due process and equal protection under the First and 14th Amendments to the U.S. Constitution. The plaintiffs alleged also that the amendment is preempted by federal law and is unenforceable under the supremacy clause of the U.S. Constitution.

Another issue concerning lenders who make home improvement loans is the type of improvements permitted. The amendment specifically refers to "work and material used in constructing **new improvements** thereon, if contracted for in writing, or work and material used to **repair or renovate** existing improvements," (emphasis added).

At first glance, the amendment appears to cover all types of home improvements. However, commentators on the subject and title companies hold that the amendment applies only to repairs, additions and renovations, not to new construction (see Alamo Title Insurance Agent Bulletin no. 98-3, dated February 6, 1998).

This means the procedures specified in the amendment must be followed for repairs, additions and renovation. The procedure in place before the amendment passed still applies to new construction. No reasons are given for the distinction, and no litigation is pending on the issue. Lenders, however, still assume a risk for noncompliance if title insurance is not secured.

To clarify some of the issues, six separate requests for official opinions on various equity issues were presented to the Texas Attorney General (AG). The AG declined to answer all inquiries, leaving the answers to the courts and legislators for resolution. (An AG opinion is not binding on Texas courts and will not protect lenders in a dispute.)

Presently, title companies insure five, and possibly six, of the 25 or more conditions required for a home equity loan. Title companies are being pressured by Fannie Mae to add at least six more.

Fannie Mae announced that it will continue to purchase home equity loans "only if new title insurance endorsements that provide additional coverage that is acceptable to [Fannie Mae] becomes available." The deadline was May 31, 1998, with a possible 90-day extension to allow for orderly rulemaking.

In response, the Texas Land Title Association petitioned for the adoption of rules by the Commissioner of Insurance to authorize additional coverage. Presently, Fannie Mae's mandate has been extended "until further notice."

This material is based on two articles that appeared in the 1998 Annual Advanced Real Estate Law Course sponsored by the State Bar of Texas and the Real Estate Probate and Trust Law Section. The first article, "Pitfalls (And Pratfalls) of Texas Home Equity Lending," was authored by J. Alton Alsup, a Houston attorney. Rhonda G. Jolley, a San Antonio attorney, authored the second article, "Changes in the Voluntary Homestead Mechanic's Lien Laws."

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