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US Court of Appeals Certifies an Important Question for the Texas Supreme Court Involving Home Equity Loans

On August 15, 2019, the United States Court of Appeals for the Fifth Circuit issued an opinion and certified a question to the Texas Supreme Court that could significantly impact lenders' rights in the face of an uncured, defective Texas home equity loan. In *Zepeda v. Federal Home Loan Mortgage Corporation*,² the Court examined whether a lender is entitled to either contractual or equitable subrogation where it failed to correct a curable constitutional defect to a home equity loan under Tex. Const. art XVI, § 50(a)(6).

What is Subrogation?

Subrogation is a legal doctrine that permits lenders to succeed to the rights of prior lenders in certain circumstances, and become entitled to the rights of the prior lender in relation to the debt. In general, subrogation works as follows: a homeowner receives a loan using the homestead as collateral. Thereafter, the homeowner takes out a second loan that pays off the balance of the first loan. The second lender is subrogated to the first lender's rights under the original lien. In other words, "whatever the terms of the original loan agreement, at a minimum the second lender stands in the shoes of the first lender."³

Texas law provides for both contractual and equitable subrogation. Contractual subrogation arises when "a person advances money to take up and extend indebtedness secured by a vendor's lien on land under an *agreement* that such person shall stand in the place of the original holder of the indebtedness."⁴ Equitable subrogation is governed by the principals of equity and occurs whenever a subsequent lender pays off an existing debt.

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² 2019 WL 3820019 (5th Cir. August 15, 2019), available [here](#).

³ *Id.* at 3 (citations omitted).

⁴ *Glasscock v. Travelers Ins. Co.*, 113 S.W.2d 1005, 1009 (Tex. Civ. App. –Austin 1938, writ ref'd) (emphasis added). A valid deed of trust executed by both the borrower and lender establishes contractual subrogation. *Vogel v. Veneman*, 276 F.3d 729, 735 (5th Cir. 2002); *Benchmark Bank v. Crowder*, 919 S.W.2d 657, 662 (Tex. 1996) (holding a bank that advances money to pay taxes owing is contractually subrogated to the government's tax lien).

The doctrine of equitable subrogation is vital for both homeowners and lenders: “Without equitable subrogation, lenders would be hesitant to refinance homestead property due to increased risk that they might be forced to forfeit their liens. The ability to refinance provides homeowners the flexibility to rearrange debt and avoid foreclosure.”⁵

The Facts in Zepeda

In *Zepeda*, the borrower obtained a home-equity loan under Section 50(a)(6) of the Texas Constitution. Per the agreement, the lender paid off the borrower’s existing purchase money loan secured by her homestead and released the remainder of the funds to her. The agreement also contained an express subrogation provision, which provided that the lender would be subrogated to all rights of any other holder of liens or debts outstanding before the agreement was executed.

Years after receiving the loan proceeds, the borrower notified the lender that the loan documents were constitutionally deficient because the lender’s signature did not appear on the acknowledgement of fair market value in violation of Section 50(a)(6)(Q)(ix). The lender did not sign the acknowledgment, and instead sent the borrower a new copy of the document with no explanation for the lack of signature. Freddie Mac thereafter acquired ownership of the loan and although received the notice to cure, did not attempt to cure it.

The borrower thereafter sued Freddie Mac to quiet title, claiming Freddie Mac did not possess a valid lien on her property due to its failure to cure the violation. In defense, Freddie Mac asserted that it was contractually and equitably subrogated to the original purchase-money lien that was paid off by the home equity loan. The district court ruled against Freddie Mac’s contractual subrogation defense because it did not have a valid contract, and denied its equitable subrogation defense because it found Freddie Mac negligent and unable to claim an equitable remedy.

Freddie Mac appealed the district Court’s decision to the Fifth Circuit.

The Zepeda Opinion and Certified Question

Unsurprisingly, the Fifth Circuit made quick work of Freddie Mac’s contractual subrogation argument. The Court cited longstanding Texas law that contractual subrogation requires a *valid* deed of trust. Because Freddie Mac failed to cure the constitutional deficiency, the deed of trust was invalid and precluded any contractual subrogation. As a result, the Court affirmed the district court’s ruling against Freddie Mac’s contractual subrogation defense.

Turning to the issue of equitable subrogation, the court noted that “[s]ince at least 1890, the Texas Supreme Court has applied equitable subrogation in the face of a constitutionally-invalid home-equity loan.”⁶ The Court distinguished these cases, however, noting that none of them “involve a constitutional defect that is exclusively the fault of the lender, as is the case here.”⁷ Accordingly, the Fifth Circuit certified the following question of law to the Supreme Court of Texas:

⁵ *LaSalle Bank Nat’l Ass’n v. White*, 246 S.W.3d 616, 620 (Tex. 2007) (citations omitted).

⁶ At 6 (citing *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)).

⁷ *Id.* at 6.

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?

Take-aways for Mortgage Lenders:

The answer to this question could affect lenders' ability to rely on the equitable subrogation doctrine in the face of a constitutionally defective home equity loan. Nonetheless, prudent lenders should take affirmative steps to ensure that reliance on this doctrine is not necessary.

To avoid the constitutional defect at issue in *Zepeda*, lenders should implement procedures that ensure the fair-market value acknowledgement is signed by the lender with all home equity loans on the date of closing. We will continue to monitor this case and provide updates when the Supreme Court answers the question certified.