

Texas Home Equity Lending: A Brave New World

Impact of Texas Supreme Court Opinions

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Overview

- Background: Texas Constitution
- *Garofolo v. Ocwen Loan Servicing, L.L.C.* (Tex. May 2016)
- *Wood v. HSBC Bank USA, N.A.* (Tex. May 2016)
- Impact of the holdings
 - Statute of limitations
 - Availability of forfeiture as a remedy
 - UDAAP risks
- Future Litigation Implications
- Practical Considerations

Background: Texas Constitution

- **Texas Constitution, Article XVI, § 50**
 - Protects the homestead from forced sale for the payment of all debts with certain exceptions.
 - Limits types of loans that may be secured by homestead lien.
- **1997:** Constitutional Amendment to permit homestead liens to secure home-equity loans.

Background: Texas Constitution Limitations on Liens

- Liens on homestead only allowed if, among other things, loans made on condition that forfeiture of all principal and interest is available if loan is:
 - Constitutionally noncompliant; and
 - Lender fails to cure within 60 days of notice from borrower.

TEX. CONST. art. XVI, § 50(a)(6)(Q)(x)

- Intent: encourage lenders to correct loan infirmities under threat of forfeiture penalty.

Background: Texas Constitution

Compliant Loan Examples: art. XVI, § 50(a)(6)(A)-(P)

- **An extension of credit that:**

- Is of a principal amount that when added to the aggregate total of the outstanding principal balances of all other indebtedness secured by valid encumbrances of record against the homestead does not exceed 80% of the fair market value of the homestead on the date the extension of credit is made (6)(B)
- Is payable in advance without penalty or other charge (6)(G)
- Is made on the condition that ... within a reasonable time after termination and full payment of the extension of credit, the lender cancel and return the promissory note ... and give the owner, in recordable form, a release of the lien (6)(Q)(vii)

Background: Texas Constitution

6 Ways to Cure: art. XVI, § 50(a)(6)(Q)(x)(a)-(f)

1. Paying to the owner an amount equal to any overcharge paid by the owner under or related to the extension of credit ...
2. Sending the owner a written acknowledgement that the lien is valid only in the amount that the extension of credit does not exceed the percentage described [above]...
3. Sending the owner a written notice modifying any other amount, percentage, term, or other provision prohibited by this section to a permitted [one] and adjusting the account ... to ensure [proper payment and treatment]...

Background: Texas Constitution

6 Ways to Cure: art. XVI, § 50(a)(6)(Q)(x)(a)-(f)

4. Delivering the required documents to the borrower if the lender fails to comply ... or obtaining the appropriate signatures if the lender fails to comply ...
5. Sending the owner a written acknowledgement, if the failure to comply is prohibited ..., that the accrual of interest and all of the owner's obligations under the extension of credit are abated while any prior lien prohibited ... remains secured by the homestead; or
6. If the failure to comply cannot be cured under [1-5 above], curing the failure to comply by a refund or credit to the owner of \$1,000 and offering the owner the right to refinance ...at no cost...on same terms...with any modifications necessary to comply ...

Garofolo v. Ocwen Loan Servicing, L.L.C.

7-2 Decision

- **Facts:**

- Plaintiff obtains home equity loan in 2010.
 - Pays off loan in 2014.
 - Release of lien recorded within 27 days of payoff.
 - Plaintiff did not receive release of lien in recordable form as required by loan agreement and constitution.
 - Plaintiff notifies servicer; servicer does not provide document.
- Following passage of 60 days, Plaintiff sues servicer for purportedly violating Texas Constitution and contract.

Garofolo v. Ocwen Loan Servicing, L.L.C.
2 Questions for the Court:

1. Is there a constitutional right to forfeiture of principal and interest under these facts?
2. Is forfeiture available via a breach of contract claim under the facts of this case?

COURT ANSWERS “NO” TO BOTH QUESTIONS.

Garofolo v. Ocwen Loan Servicing, L.L.C. Constitutional Right to Forfeiture?

- **Plaintiff's argument:** failure to deliver release of lien = constitutional violation and remedy is forfeiture.
- **Court disagrees:**
 - Constitution does not create/allow/regulate home equity lending.
 - List of compliant loan requirements in § 50(a)(6)(A)-(P) are not constitutional rights by themselves—“[t]hey only assume constitutional significance when their absence in a loan’s terms is used as a shield from foreclosure.”
 - From constitutional view, compliance is measured by the loan as it exists at origination.

Garofolo v. Ocwen Loan Servicing, L.L.C. Constitutional Right to Forfeiture?

- **Court (continued):**
 - Just as terms and conditions in § 50(a)(6) “are not constitutional rights unto themselves, nor is the forfeiture remedy a constitutional remedy unto itself.”
 - Forfeiture remedy is just a term and condition a home equity loan must include to be foreclosure eligible.
- Ocwen never sought to foreclose; no constitutional remedy for failure to deliver a release of lien.
- § 50(a) has no applicability outside of foreclosure.
- Constitution does not address post-origination enforcement of loan’s provisions.

Garofolo v. Ocwen Loan Servicing, L.L.C. Forfeiture Available via Breach of Contract Claim?

- Loan agreement incorporates: (i) requirement to deliver release of lien; and (ii) forfeiture remedy.
- Plaintiff acknowledges she has not suffered damages for failure to deliver release of lien.
- **Court:**
 - “[I]f a lender fails to meet its obligations under the loan, forfeiture [of principal and interest] is an available remedy only if one of the six corrective measures can actually correct the underlying problem and the lender nonetheless fails to timely perform the relevant corrective measure.”

Garofolo v. Ocwen Loan Servicing, L.L.C. Forfeiture Available via Breach of Contract Claim?

- No breach of contract claim under these facts.
- Plaintiff must show actual damages to maintain breach of contract claim or seek some other remedy, such as specific performance.

Wood v. HSBC Bank USA, N.A.

6-3 Decision

- **Facts:**

- 2004 Plaintiffs obtain home equity loan.
 - 8 years later, plaintiffs provided note holder and servicer notice that loan did not comply with Texas Constitution in several ways, including that closing fees exceeded 3% of loan amount.
 - Neither note holder nor servicer cured defect after notice.
- Sued seeking to quiet title; asserting claims for breach of contract, fraud, and declaratory judgment that the lien securing the home equity loan is void, that all principal and interest be forfeited, and that borrowers have no further obligation to pay.

Wood v. HSBC Bank USA, N.A.

Court's Holding: Lien is Void, Not Voidable

- **Statute of limitations:** 4 years if instrument is voidable
- **Court:**
 - A lien securing a constitutionally non-compliant home equity loan is not valid before the defect is cured.
 - Therefore, no statute of limitations applies to cut off a homeowner's right to quiet title to real property encumbered by an invalid lien.
- **As applied to plaintiffs:**
 - If “allegation that [plaintiffs] were charged closing fees exceeding 3% of the loan's value is accurate, the lien on their homestead does not ‘secure a debt described by this section.’ As such lien may not be valid.”

Wood v. HSBC Bank USA, N.A.

Void Lien = Claims > Than 4 Years After Closing

- **Lenders' Concern:**

- Will be required to defend against constitutional noncompliance claims more than four years after closing.

- **Court:**

- “[L]enders ... should be encouraged, to cure constitutional noncompliance on their own, without notice from the borrower...”

Wood v. HSBC Bank USA, N.A.

Declaratory Judgment Action Foreclosed by *Garofolo*

- **Claims at issue:**

- Plaintiffs only appealed their causes of action for quiet title and for a declaratory judgment, not the breach of contract and fraud claims.

- **Court uses *Garofolo* holding:**

- § 50(a) does not create substantive rights beyond a defense to a foreclosure action on a home equity lien securing a constitutionally noncompliant loan.
- Foreclosure is not a constitutional remedy.

Impact of the *Wood* and *Garofolo* Holdings

- **Statute of limitations**

- Previously, most lower courts had held to a four-year limitations period applied to actions to quiet title or to void the lien.
- Because a non-compliant lien is void *ab initio*, no limitations period applies to an action to quiet title.

Impact of the *Wood* and *Garofolo* Holdings

- **Forfeiture**

- A constitutional violation will cause the lender to forfeit principal and interest only to the extent that the violation was curable and the lender or holder failed to cure.
- Forfeiture also may be available as a remedy for a breach of contract claim or some other cause of action.
- But in any event, equitable subrogation often will be available to limit the impact of the forfeiture remedy.
 - *LaSalle Bank National Assoc. v. White*, 246 S.W.3d 616 (Tex., 2007)

Impact of the *Wood* and *Garofolo* Holdings

- **UDAAP Risk**

- The lien securing a non-compliant home equity is void, rather than voidable.
- A home equity loan cannot provide for personal recourse against the debtor (absent actual fraud).
- Curing a violation can validate the lien, but *Garofolo* suggests that not all violations are curable.
- If the lien is irredeemably void and the debt only can be enforced against the property, further collection attempts arguably present UDAAP risk.

Future Litigation Implications

- **Potential Claims if Loan is Noncompliant:**
 - Breach of contract—must prove:
 - Actual damages
 - Specific performance
 - Fraud
 - Unfair and Deceptive Trade Practices
 - Wrongful foreclosure

Future Litigation Implications (continued)

- **Class Action Risks**

- Alleged noncompliance on large scale, e.g., policy does not require providing release of lien in recordable form to borrowers.
- Risk of broad class because no applicable statute of limitations on void lien.

- **Defenses**

- Individual issues predominate—still need to examine on loan-by-loan basis to determine whether there is a constitutional violation.
- Lien may not be void; therefore, statute of limitations applies.

Practical Considerations

- Increase in cure letters from borrowers and their attorneys.
 - Implement procedure and/or special team to review and correct, if necessary, following notice.
- Maintain complete and accurate records on home equity loans.
 - Review record retention policies.

Practical Considerations (continued)

- Extra steps in foreclosure review process.
 - Determine whether loan meets TX Constitution's requirements before proceeding.
 - If not, cure to start statute of limitations.
 - Even without notice from borrowers.
 - Proper cure will validate a homestead lien that may have violated TX Constitution at origination.
 - Consider full judicial foreclosure action.
 - Lenders typically foreclose through quasi-judicial process under TX Rules of Civil Procedure.

Practical Considerations (continued)

- Preemptive review of portfolio?
 - Non-performing loans?
 - Performing loans?
 - Systematic way to analyze?
- Consider impact on home equity lending.
 - Costs versus benefits analysis.