

Update on Mortgage-Related Litigation in Texas

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Larry Young is a Partner in the law firm of Hughes, Watters & Askanase, L.L.P. in Houston, Texas and is Chairman of the Governing Committee of the Conference on Consumer Finance Law. He is a fellow of both the American College of Consumer Financial Services Lawyers and the American College of Commercial Finance Lawyers. Larry is the Texas State Editor for both *CarLaw* and *HouseLaw* and is on the Advisory Board of the *Consumer Financial Services Law Report*. Further, he is the former Editor of the *Consumer Finance Law QUARTERLY REPORT* and has authored or co-authored over 100 articles and seminar papers, a book, two plays and a screenplay on a variety of legal subjects in the consumer finance, commercial finance and bankruptcy fields.

Larry recently served on the Committee established by the Texas Consumer Credit Commissioner to draft plain language consumer contracts. He currently serves on the Manufactured Housing Institute Finance Lawyers Committee, the American Bar Association (ABA) Business Law Section Task Force on Insolvency and the Federal Court Structure and the ABA Business Law Section Planning Committee. Larry is a past Chairman of the ABA Consumer Bankruptcy Committee, the ABA Consumer Financial Services Debt Collection Practices and Bankruptcy Subcommittee and the ABA Commercial Financial Services Interest and Usury Subcommittee.

Larry has defended numerous consumer class actions and has designed Texas home equity lending programs, national debt collection programs, and bankruptcy reaffirmation and post-discharge secured creditor programs. He originated several Bankruptcy Code provisions and wrote part of the Bankruptcy Code's legislative history. He initiated cases that held the bankruptcy court unconstitutional and was in-house bankruptcy counsel to the amicus curiae in *Northern Pipeline Company v. Marathon Pipeline Company*, the United States Supreme Court case that ultimately held the bankruptcy court unconstitutional. As in-house counsel, he further initiated *United States v. Security Industrial Bank*, the United States Supreme Court case that found retroactive lien avoidance under the Bankruptcy Code to be in violation of the Fifth Amendment Taking Clause of the United States Constitution.

Larry attended the University of Michigan Law School and is a former Marine officer.

LINDSAY L. LAMBERT

Lindsay L. Lambert is a 1991 graduate of South Texas College of Law, where he was a member of the South Texas Law Review and Order of the Lytae. He also interned for Justice Jack Hightower at the Texas Supreme Court.

Prior to law school, Mr. Lambert worked as a mortgage banker, where he focused primarily on residential and consumer lending and compliance issues. In his years since becoming an attorney, Mr. Lambert has defended numerous class action lawsuits involving alleged violations of state and federal consumer lending, debt collection and mortgage banking laws. He has also defended countless actions involving Texas home equity loans and other lending/debt collection lawsuits filed by individuals and class representatives. Mr. Lambert has extensive experience in analyzing procedures and advising clients with regard to avoiding credit/debt related litigation by identifying potential problems and solutions. His primary focus today is defense of consumer financial services litigation, with emphasis on mortgage-related issues.

Mr. Lambert is a partner in the law firm of Hughes, Watters & Askanase, L.L.P. He is an AV rated attorney, and is a member of the American, Texas and Houston Bar Associations. He is admitted in all state courts in Texas, Nebraska and Oklahoma, as well as all federal courts in Texas, and the Fifth and Ninth Circuit Courts of Appeal, as well as the United States Supreme Court.

Mr. Lambert is active in his Church in Bellaire, Texas. He is also a lieutenant in the Bellaire Volunteer Fire Department in the City of Bellaire, Texas. Mr. Lambert was selected as the Volunteer Firefighter of the Year in 2006. In addition, Mr. Lambert is an adult leader in the Boy Scouts of America.

Lindsay L. Lambert – representative cases of note:

LaSalle Bank, N.A. v. White, 246 S.W.3d 616 (Tex. 2007). Established, for the first time, a lender's right to equitable subrogation in those cases in which a home equity lien is declared invalid.

McMillen v. Drive Financial Serv., L.P., 172 Fed. Appx. 896 (10th Cir. 2006). Held that a creditor's reinstatement of a retail installment contract after buyer paid outstanding balance was not a "sale" under consumer protection laws.

Acceptance Ins. Co. v. Lifecare Corp., 89 S.W.3d 773 (Tex. App. – Corpus Christi 2002). Established that allegations of negligence for providing inaccurate information about a former employee is an "occurrence" within the comprehensive general liability insurance policy and such occurrence is not precluded by the "employment-related" exclusion in the policy.

Wilting v. Progressive County Mutual Insurance Company, - 227 F.3d 474 (5th Cir. 2000). Determined that evaluating a request for a premium quote for insurance is "underwriting" within the meaning of federal Fair Credit Reporting Act.

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I. HOME EQUITY LITIGATION

Mortgage related issues continue to find their way into the courts. Recent pronouncements by the Texas Supreme Court and the Texas Courts of Appeals help clarify important concerns. These decisions are briefly noted immediately below and then discussed in more detail beginning at Part II.

Case Law Summary of Holdings

- The Texas Supreme Court ruled that Section 50(e) does not abrogate the common law doctrine of equitable subrogation, which remains broadly available to lenders who pay off constitutionally permissible pre-existing liens.¹
- Following the Texas Supreme Court ruling on equitable subrogation, a district court held that a lender was entitled to equitable subrogation even where cure provisions under section 50(a)(6)(Q)(x)(b) provided an alternative remedy.²
- A Texas Court of Appeals and a bankruptcy court agreed that a timely and sufficient offer to cure is enough to cure loan defects, and a borrower may not refuse to cooperate.³
- Another Texas Court of Appeals granted summary judgment for the lender on the grounds that the statute of limitations barred an action based on constitutional violations four years after the date of the closing of the loan.⁴
- Several district courts addressing variable-rate loans granted summary judgment in favor of lenders based on 7 TEX. ADMIN. CODE § 153 *et seq.*
- A federal district court in Texas found that Texas law does not impose on lenders a duty of care to parties unrelated to the transaction.⁵

These recent cases are discussed further below.

A. Class Action cases in the Eastern District of Texas

Trahan and *Morehouse* are being discussed together because they involve similar issues.⁶ The plaintiffs argued that variable rate home equity loans (generally called an “adjustable rate mortgage” or ARM) are prohibited under the Texas Constitution. Among other things, the

¹ *LaSalle Bank N.A. v. White*, 246 S.W.3d 616 (Tex. 2008).

² *Cochran v. Ameriquest Mortgage Company*, No. 96-215111-05 (96th Dist. Ct., Tarrant County, Tex. May 20, 2008).

³ *Adams v. Ameriquest Mortgage Co.*, 307 B.R. 549 (Bankr. N.D. Tex. 2004); *Fix v. Flagstar Bank, FSB*, 242 S.W.3d 147 (Tex. App.—Fort Worth 2007, pet. denied).

⁴ *Rivera v. Countrywide Home Loans, Inc.*, 262 S.W.3d 834 (Tex. App.—Dallas 2008, no pet. hist.).

⁵ *Ray v. Carmax Auto Superstores, Inc.*, No. SA-06-CA-366-OG (W.D. Tex. Sep. 27, 2007).

⁶ *Trahan v. Long Beach Mortgage Co. and Washington Mutual Bank*, C.A. No. 9:05CV29 (E.D. Tex.); *Morehouse v. Ameriquest Mortgage Co.*, C.A. No. 05-00075-civ-TH (E.D. Tex.).

plaintiffs sought loan forfeiture under section 50(a)(6)(Q)(x), declaratory and injunctive relief, and recovery of attorney fees. The defendants, contending that the plaintiffs had no valid claims, relied on the text, construction, and reasonable interpretation of the Texas Constitution specifically authorizing variable rate equity loans.

Specifically, the plaintiffs asserted that: (1) the Texas Constitution mandates that equity loans are required to be repaid in substantially equal successive periodic installments; (2) ARM promissory notes allow for payments that are not substantially equal; (3) the Texas Constitution mandates, but that the notes do not provide for, the repayment of the extension of credit in substantially equal successive monthly installments; and (4) ARM notes allow the lenders to improperly modify the payments contrary to the Texas Constitution.

Accordingly, the summary judgment issues included: (1) whether the home equity amendment to the Texas Constitution authorizes variable rate equity loans; (2) whether the home equity amendment requires that payments for equity loans must all be equal or substantially so; and (3) whether the home equity amendment authorizes new schedules of payments for variable rate loans after interest rate adjustments. In their summary judgment motions, the defendants answered these issues by citing sections 50(a)(6)(L) (the repayment section) and 50(a)(6)(O) (the variable rate section) in Article XVI of the Texas Constitution and section 303.015 of the Texas Finance Code as unambiguously authorizing variable rate home equity loans, not requiring that all payments must be equal, and as not being in conflict with the terms of the promissory notes. The defendants' position recognized that, constitutionally, an equity loan is to provide an initial schedule of installments that are substantially equal and sufficient to pay accrued interest, but that the initial schedule is not set in stone. The defendants' arguments are consistent with the Constitutional provision that negative amortization is impermissible because each installment must be at least sufficient to discharge the interest accruing during the month preceding the payment.⁷

The *Morehouse* litigation was transferred pursuant to a MDL Conditional Transfer Order, but vacated and returned to the District Court. The court has yet to enter a new Docket Control Order. The *Morehouse* litigation remains pending while the courts await the resolution of the *Trahan* case. *Trahan* continues to wind its way through the courts. Class certification was granted; however, that issue is currently on appeal to the Fifth Circuit.⁸

B. Related Cases⁹

In a series of similar cases, plaintiffs sought forfeiture of the principal and interest on their home equity loans. The plaintiffs alleged several theories, including fraud, misrepresentation, inflated appraisal, and deceptive trade practices;¹⁰ however, the primary allegation was that the challenged loans violated the Texas Constitution because they were variable-rate home equity loans.

⁷ TEX. CONST. ART. XVI, §50(a)(6)(L).

⁸ Case No. 08-40874 (5th Cir.).

⁹ These cases are representative of variable-rate home equity litigation claims across Texas.

¹⁰ The plaintiffs DTPA failed because the extension of credit is not a "good or service." See, e.g., *Fix v. Flagstar Bank*, *supra*.

Plaintiffs argue that variable-rate loans are unconstitutional based on a reading of section 50(a)(6)(L)(i). That section requires that home equity loans be

scheduled to be repaid in substantially equal successive periodic installments, not more often than every 14 days and not less often than monthly, beginning no later than two months from the date the extension of credit is made, each of which equals or exceeds the amount of accrued interest as of the date of the scheduled installment.¹¹

Codification of regulatory interpretations now expressly permits variable-rate home equity loans. The Texas Administrative Code states

A lender may contract for and receive any fixed or variable rate of interest authorized under statute . . . the lender may contract to vary the scheduled installment amount when the interest rate adjusts on a variable rate equity loan. . . . The scheduled installment amounts of a variable rate equity loan must be: (A) substantially equal between each interest rate adjustment; and (B) sufficient to cover at least the amount of interest scheduled to accrue between each payment date and a portion of the principal.¹²

Therefore, as long as a loan is scheduled to be repaid in substantially equal installments over the remaining loan term after each interest adjustment, it is in compliance with the constitutional provisions, statutes, and regulatory interpretations. Section 153 of the Texas Administrative Code became effective Jan. 8, 2004, so variable-rate loans made prior to the effective date of section 153 are not equally insulated. However, the logic behind the interpretation codified by section 153 can be argued to apply with equal force for any variable-rate loan.

C. Marketic v. U.S. Bank Nat'l Ass'n¹³

Under the Texas Constitution, property designated for agricultural use is protected from foreclosure when the foreclosure is to satisfy outstanding debt on a home equity loan.¹⁴ Lenders therefore obviously proceed with caution when a property owner whose property is designated for agricultural use wishes to obtain a home equity loan. However, *Marketic v. U.S. Bank Nat'l Ass'n*, required a Constitutional amendment to be added for clarity. According to *Marketic*, lenders may not foreclose on property even if that property was not designated for agricultural use at the time of the closing as long as the property is designated for agricultural use prior to foreclosure.¹⁵

In *Marketic*, the property owner agreed to change the property tax designation to “non-agricultural use” in order to obtain the home equity loan. At the time of closing, the property

¹¹ TEX. CONST. art. XVI, § 50(a)(6)(L)(i).

¹² 7 TEX. ADMIN. CODE § 153.1 *et seq.* (effective Jan. 8, 2004).

¹³ 436 F. Supp.2d 842 (N.D. Tex. 2006).

¹⁴ Tex. Const. art. XVI, § 50(a)(6)(I).

¹⁵ *Marketic*, 436 F. Supp.2d at 849-51.

was not designated for agricultural use. After the property owner defaulted on the loan, the owner brought suit for injunctive relief to prevent the lender from foreclosing on the property. The basis for the injunction was that the property was now designated for agricultural use, thereby giving it protection from foreclosure under the Constitution.

The court agreed with the property owner and refused to accept the lender's argument that "the only relevant designation ... is the designation in effect at closing, when the lien is created."¹⁶ The court's interpretation would theoretically allow a property owner to obtain a loan on property not designated for agricultural use, and then subsequently designate the property for agricultural use in order to prevent foreclosure

The court based its conclusion on interpretations of the tax code. Other courts have interpreted the phrase "designated for agricultural use" when analyzing statutes governing property tax. Under these statutes, "a property's designation may vary from year-to-year."¹⁷ Therefore, the court reasoned, the designation for purposes of foreclosure should be able to vary from year to year as well. This interpretation places even greater "risk on the lender to ensure that any ... property that may be securitized as collateral for a loan will not be designated for agricultural use in the event of foreclosure."¹⁸ The lender may be required to "show that ... it did not have the means of knowing that [the] land was being used for agricultural purposes and was so designated or would be so designated at the time of possible foreclosure."¹⁹ One cannot imagine, however, that property never designated as agricultural could be deemed "lien free" by changing its designation to agricultural after closing a home equity loan. If so, Constitutional "taking" issues in violation of the Fifth Amendment of the United States Constitution are raised. This case must be confined to its facts: agriculture designation changed for the purpose of closing a home equity loan, then changed back.

In response to the Court's opinion in *Marketic*, the Texas Legislature adopted, and the voters approved, an amendment to the Texas Constitution clarifying that the provisions pertaining to agricultural property are determined as of the date the loan closes – not by subsequent designations or other subsequent events.²⁰

D. LaSalle v. White²¹

Lenders who find themselves in the position of the lender in *Marketic* may not be completely without remedy, however. *LaSalle v. White* reaffirmed the doctrine of equitable subrogation, holding that the doctrine continued to be applicable to homestead property, even in the face of TEX. CONST. art. XVI, § 50(e). In *White*, Lorae White took out a home-equity loan to refinance and cash out a portion of the equity in her homestead. At the time of the refinance, her homestead was designated for agricultural use. The Texas Constitution prohibits agricultural

¹⁶ *Id.* at 848.

¹⁷ *Id.* at 850.

¹⁸ *Id.* at 852.

¹⁹ *Id.* at 853.

²⁰ Tex. Const. Art. XVI, § 50(a)(6)(I) now provides that a home equity loan may "[n]ot [be] secured by homestead property that on the date of closing is designated for agricultural use as provided by statutes governing property tax, unless such homestead property is used primarily for the production of milk."

²¹ *LaSalle Bank N.A. v. White*, 246 S.W.3d 616 (Tex. 2008).

homesteads from being used to secure a home-equity loan.²² The homestead was burdened by constitutionally permissible purchase-money liens, as well as state property tax liens. When White refinanced her loan, LaSalle Bank paid off the \$185,011 purchase-money lien and \$9,411 property tax lien. White received \$57,519 in cash.

White failed to timely make payments on her loan, and LaSalle filed an application for home-equity foreclosure. White filed suit seeking a declaratory judgment on the basis that LaSalle had forfeited all principal and interest, and that its lien was invalid, because the loan violated the “agricultural homestead” provision of the Texas Constitution. The trial court and the court of appeals agreed with White, but the Texas Supreme Court reversed in part.

The Court found itself balancing the strong homestead protections in the Texas Constitution²³, and a lienholder’s long-standing common law right to equitable subrogation.²⁴ In the final analysis, the Court recognized that the two concepts were not entirely at odds, saying, “[w]ithout 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.”²⁵ Accordingly, the only question the Court faced was whether TEX. CONST. art. XVI, § 50(e), abrogated common law equitable subrogation.

TEX. CONST. art. XVI, § 50(e) states:

(e) A refinance of debt secured by a homestead and described by any subsection under Subsections (a)(1)-(a)(5) that includes the advance of additional funds may not be secured by a valid lien against the homestead unless:

- (1) the refinance of the debt is an extension of credit described by Subsection (a)(6) of this section; or
- (2) the advance of all the additional funds is for reasonable costs necessary to refinance such debt or for a purpose described by Subsection (a)(2), (a)(3), or (a)(5) of this section.²⁶

Looking at the plain language of § 50(e), the Court could not find any indication that there was any intent to displace equitable common law remedies. “[T]he legal forfeiture that article 50(e) imposes does not destroy the well-established principle of equitable subrogation.”²⁷ Thus, section 50(e) only invalidated LaSalle’s lien related to the cash-out portion of the loan, and to the extent that LaSalle’s refinance paid off constitutionally permissible liens, LaSalle was equitably subrogated to the prior lienholder’s position.²⁸

²² TEX. CONST. art. XVI, § 50(a)(6)(I).

²³ *White*, 246 S.W.3d at 618.

²⁴ *Id.*

²⁵ *Id.* at 620.

²⁶ TEX. CONST. art. XVI, § 50(e).

²⁷ *White*, 246 S.W.3d at 619.

²⁸ *Id.* at 620.

