

MORTGAGE BANKING ALERT

AKIN

GUMP

STRAUSS

HAUER &

FELD, L.L.P.

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SPOTLIGHT ON TEXAS

TEXAS SUPREME COURT FAVORABLY INTERPRETS CONSTITUTIONAL "CURE" PROVISION: DOODY V. AMERIQUEST MORTGAGE COMPANY

On June 7, 2001, the Texas Supreme Court issued its opinion in the case of Doody et al. v. Ameriquest Mortgage Company. The case was presented to the Texas Supreme Court by the United States Court of Appeals for the Fifth Circuit (the Federal Court) which asked the Texas Supreme Court to interpret the Texas Constitution and answer two questions. Those questions were:

1. Under the Texas Constitution, if a lender charges closing costs in excess of three percent, but later refunds the overcharge, bringing the charged costs within the range allowed by section 50(a)(6)(E), is the lien held by the lender invalid under section 50(c)?

2. If this question is reached, may the protections of section 50 of the Texas Constitution be waived by a buyer who accepts a refund of any overcharged amounts when the loan contract provides that accepting such refund waives any claims under section 50.

The Court answered the first question by saying "no." And because they did so, they did not need to answer the second question.

While the court was only asked to address whether a violation of section 50(a)(6)(E) (the 3% limit on fees in connection with home equity loans), invalidates the lender's lien even though the lender later refunds the excess fees (i.e., cures the violation) its opinion has far greater reach.

The facts surrounding the loan, which is the subject of this case, are as follows. Ameriquest made a \$45,500 home equity loan to the homeowners (Doody and Carrington). The closing costs covered by the 3% limitation exceeded the maximum allowable by Section 50(a)(6)(E) of the Constitution. About three months after closing, Ameriquest discovered the error during an internal audit. Subsequently, they refunded the excess to the homeowners, in order to reduce the closing costs to the allowable 3%. Soon thereafter, Doody and Carrington sued Ameriquest claiming that the violation invalidated Ameriquest's lien, and that Ameriquest should forfeit principal and interest for failing to comply with the constitution. Doody and Carrington also claimed that the hazard insurance required by Ameriquest should also count toward the 3% cap on fees and charges. [Before sending its questions to the Texas Supreme Court, the Federal Court held that hazard insurance does not count against the cap].

Applicable Constitutional Provisions:

§ 50. Homestead; protection from forced sale; mortgages; trust deeds and liens

(a) The homestead of a family, or of a single adult person, shall be, and is hereby protected from forced sale, for the payment of all debts except for:

(6) An extension of credit that:

(E) does not require the owner or the owner's spouse to pay, in addition to any interest, fees to any person that are necessary to originate, evaluate, maintain, record, insure, or service the extension of credit that exceed, in the aggregate, three percent of the original principal amount of the extension of credit;

(Q) is made on the condition that:

(x) the lender or any holder of the note for the extension of credit shall forfeit all principal and interest of the extension of credit if the lender or holder fails to comply with the lender's or holder's obligations under the extension of credit within a reasonable time after the lender or holder is notified by the borrower of the lender's failure to comply[.]

(c) No mortgage, trust deed, or other lien on the homestead shall ever be valid unless it secures a debt described by this section, whether such mortgage, trust deed, or other lien, shall have been created by the owner alone, or together with his or her spouse, in case the owner is married. All pretended sales of the homestead involving any condition of defeasance shall be void.

TEX. CONST. art. XVI, § 50.

Arguments:

Essentially, Doody and Carrington argued that because Ameriquest did not comply with 50(a)(6)(E), its lien was

never valid, and that a subsequent "cure" under 50(a)(6)(Q)(x) could not validate the lien.

Ameriquest, on the other hand, argued that the cure provision in section 50(a)(6)(Q)(x) applies not just to the forfeiture remedy, but to all obligations under Section 50(a)(6).

The Court's Analysis and Holding

The court said "We conclude that the cure provision in section 50(a)(6)(Q)(x) applies to all the lender's obligations under the "extension of credit" including Section 50(c)'s requirements that to be valid a homestead lien must secure a debt described by this section." The court reached this conclusion by reading all of the constitution's provisions together, considering them in light of each other. Specifically, they noted that to be valid, a home equity loan under 50(a)(6) must be made without personal recourse. If the cure provision only applied to the forfeiture remedy and did not validate the lien, then the lender would be left with an unsecured, no personal liability loan and no method for recovering any sums extended to the borrower.

Improved Landscape:

The Doody case is a milestone in home equity lending in Texas because it gives lenders some comfort that if they make errors that result in inadvertent violations of the Texas Constitution, they will not immediately be subject to an invalid lien and the forfeiture of principal and interest. The case clearly stands for the proposition that if mistakes are made, the lender has a reasonable opportunity to cure resulting violations of the constitution and should only be subject to the harsh remedies of forfeiture and lien invalidity if they fail to cure.

Additional points to consider when reading the Doody case include the following:

1. In the Doody case, the borrower had not notified Lender of the violation (Lender discovered it on its own). The question certified by the Federal Court did not ask the Supreme Court to address whether it mattered if the lender or borrower discovered the violation. The cure provision however clearly states that lenders are permitted to cure within a reasonable time frame “after the lender or holder is notified by the borrower of the lender’s failure to comply” (emphasis added). Query whether a lender who discovers violations on their own but does nothing to cure can avail themselves of the “borrower notification” requirement.
2. The Court did not just address whether the cure provision permits a lender to cure a 3% violation, but instead concluded that the cure provision applies to all of the section 50(a) requirements pertaining to 50(a)(6) loans, and to the 50(c) lien validity provision.
3. The Texas Legislature failed to pass legislation to fix any of the inconsistencies, ambiguities, and/or illogical provisions of the Texas Constitution as it pertains to home equity loans. Fortunately this case favorably addresses one of the most important issues—that of a lender’s ability to cure inadvertent violations, in order to avoid the “death penalty.” Borrowers and Lenders alike will benefit from the more stable, predictable playing field created by this case.

THE TEXAS LEGISLATURE PASSES PREDATORY LENDING LAW TO BE EFFECTIVE SEPTEMBER 1, 2001

Texas becomes the most recent copycat, joining the ever growing list of states to pass “predatory lending” legislation. Fortunately for lenders and borrowers alike, Texas legislators ultimately chose not to emulate some of the more stringent, ill conceived predatory lending initiatives

going on around the country. Instead, after meetings with lender and consumer groups, the primary sponsor redrafted the bill, editing out some of the more onerous provisions originally proposed.

The bill – SB1581 - adds a new Chapter 343 to the Texas Finance Code. Several new definitions and/or classifications are added by the bill, including “Home Loan,” “High Cost Home Loan” and “Low Rate Home Loan.” There is also a section that applies to “Home Loans with an interest rate of greater than 12%.” Each classification is affected by the Predatory Lending Bill.

Provisions that apply to “Home Loans” Generally:

- Home Loan is defined as a loan made to one or more individuals for personal, family, or household purposes; and is secured in whole or part by the borrower’s principal residence which consists of a manufactured home or real property improved by a 1-4 family dwelling.
- Reverse mortgages and open-end accounts are exempt.
- A Low Rate Home Loan is one that at its inception carries an interest rate two percentage points or more below the yield on treasury securities having comparable maturities, except that if the loan has a discounted introductory rate, then the fully indexed rate shall be used to determine whether the loan is a Low Rate loan.
- Low Rate Home Loans made by the government or a non-profit lender may not be replaced before their seventh anniversary, unless the new loan “has a lower interest rate and requires payment of a lesser amount of points and fees than the original loan or is a restructure to avoid foreclosure.”

Comments: The legislature apparently did not see the wisdom of using a definable standard to distinguish whether a proposed loan is eligible to refinance a Low Rate

Loan. For example, it could have used the APR, which is a uniform standard that takes into account not only a loan's nominal interest rate, but points and fees as well. Rather, they said that the refinancing loan has to have a lower rate and lower points and fees. Of course it is easy to see the ridiculous scenarios likely to arise from this provision, i.e., a Low Rate Home Loan that required no points or fees arguably cannot be refinanced by a lower rate loan with 1 point, even though the proposed loan could be economically better for the borrower. Also, there is no definition of "fees" or whether the test is based on an aggregate of the so-called fees, or if it is a fee-by-fee test. Certainly the legislature is considering an aggregation of the fees, but be prepared for plaintiffs to argue the opposite, when it would benefit them to do so. The only good thing about this provision is that it is not likely to affect a large amount of loans.

Provisions that apply to Home Loans with an interest rate of 12% or greater per year:

[Since the first distribution of this article, the Finance Commission of Texas has proposed a new rule (7 TAC §5.1 – "Rule 5.1") concerning these provisions, as well as a model notice. Though imperfect, Rule 5.1 imposes some sanity upon this portion of SB1581, codified as Section 343.102 of the Texas Finance Code. Rule 5.1 provides that an adjustable rate loan is a "Home Loan with an interest rate of 12% or greater" if it has a maximum specified rate of interest, whether based upon a formula or index value, that may result in an interest rate of 12% or greater a year; or has a maximum variable rate of interest that when calculated upon the index's value at the time of application plus maximum periodic increases may result in an interest rate of 12% or greater a year. This definition could be troublesome, given that the current average for one year ARM rates is approximately 5.72% and many of the conventional Fannie Mae ARM programs provide for 6

percentage point life caps. Consequently, under Rule 5.1, an adjustable rate mortgage made to a prime credit customer today (in an historically low rate market) would be just 28 basis points under the trigger for this notice. In a slightly higher rate market, this notice could be required for virtually all adjustable rate loans. Conversely, portfolio lenders could avoid application of these provisions by capping ARMs at 11.99%].

Along with the good faith estimate (or if RESPA doesn't apply, then within 3 business days after the application is made), a lender making a Home Loan with an interest rate of 12% or greater per year shall provide:

- A statement regarding the value of mortgage counseling before taking out a home loan.
- A list of the nearest housing counseling agencies approved by HUD.

Comment: Rule 5.1 provides that a lender must provide the applicant with either a list of the Texas-located housing counseling agencies approved by HUD; or a list of at least five HUD-approved housing counseling agencies nearest the applicant's residence. The list must contain housing counseling agency information that is not more than 90 days old or if more than 90 days old, is the most recent information available from HUD.

- A list of other resources where mortgage information can be found, including toll-free telephone numbers and on-line resources.

Comment: The legislature has failed to tell us what they mean by "mortgage information." Do they mean that lenders should provide lists of toll free numbers and websites of competitors? regulators? counseling agencies? Rule 5.1 does not give lenders any guidance on this issue. However, the proposed notice attempts to comply with this requirement by providing a toll-free Texas Finance Commission Home Loan Hotline number and the names

and websites of the Texas Department of Banking, Texas Office of Consumer Credit Commissioner, Texas Savings & Loan Department; U.S. Consumer Gateway; HUD; Fannie Mae and the Federal Reserve Bank.

- Other disclosures required by the finance commission, including an official notice regarding high cost home loans.

Penalties for failure to comply with these provisions include: actual damages caused by the violation; punitive damages not to exceed \$10,000 in an action brought by the aggrieved borrower; and court costs.

Comments (to the Notice provisions generally): The disclosure requirements are imposed on lenders, without mention of brokers; however Rule 5.1 indicates that a mortgage broker may deliver the notice for the lender. For what it is worth, these disclosure and penalty provisions expire September 1, 2003.

Provisions Relating to High Cost Loans:

- “High Cost Home Loan” is defined as a Home Loan that (i) has a principal amount equal to or less than one-half the maximum conventional loan amount for first mortgages as established by FNMA, (ii) is not a reverse mortgage or open end account, AND is a credit transaction described by Regulation Z, Section 226.32, as amended, except that the term includes a residential mortgage transaction if the total loan amount is \$20,000 or more. The only difference between this and the Section 32 classification is that residential mortgage transactions are not exempt from the Texas definition of High Cost Home Loan.

Comment: It is important to note that a Home Loan can be both a Home Loan with an interest rate of 12% or greater per year, and a High Cost Home Loan.

- High Cost Home Loans may not contain a provision for a balloon payment – defined as a scheduled payment that is “more than twice as large as the average of the earlier scheduled monthly payments.” Balloon payments are permitted if scheduled 60 or more months after the date of the loan. The balloon prohibition does not apply if the payment schedule is adjusted to account for the seasonal or other irregular income of the borrower, or if the loan is a bridge loan in connection with the acquisition or construction of a dwelling intended to become the borrower’s principal residence.

Comment: The Section 32 prohibition on balloons is effected through a requirement that a loan with a term of less than 60 months must be fully amortized through “regular periodic payments” – a payment is a regular periodic payment if it is “not more than twice the amount **of other payments.**” The Texas prohibition defines a balloon payment as one that is “more than twice as large as the **average of the earlier scheduled monthly payments.**”

- The payment schedule of a High Cost Home Loan may not cause the principal balance to increase, except that negative amortization is not prohibited as a consequence of a temporary forbearance, bridge loan, or restructure sought by the borrower.
- Lenders may not engage in a pattern or practice of extending credit to consumers under High Cost Home Loans based on the value of collateral without regard to the obligors’ repayment ability – including current and expected income, current obligations, employment status and other financial resources other than the obligors’ equity in the dwelling that secures the loan.
- Prepayment penalties are prohibited for High Cost Home Loans.

Comment: While the Texas provision is a complete prohibition of ppp's with respect to High Cost Home Loans, ppp's are permitted for Section 32 loans if the borrowers' debt to income ratio is less than 50%.

Restrictions on Single Premium Credit Insurance:

- Prepaid single premium credit life, disability, or involuntary unemployment insurance may not be offered without providing each applicant a specified notice within three days of receiving an application.

The provisions of this law apply to loans closed on or after September 1, 2001, except that the provisions relating to Home Loans with an interest rate of greater than 12% apply to applications received on or after September 1, 2001, and the provisions with respect to credit insurance apply only to loans closed on or after the later of January 1, 2002 or the date the Texas Department of Insurance approves a credit insurance product that complies with this new law and certifies to the Finance Commission that such coverage is available.

TEXAS ENACTS NEW PROVISIONS APPLICABLE TO MANUFACTURED HOME SALES AND FINANCING

The Texas Legislature has enacted provisions – effective January 1, 2002 – that will significantly improve the ability of lenders to finance or refinance the purchase of a manufactured home and the purchase of the homestead lot on which it is to be placed on security of the homestead.

These new provisions change the procedure by which a manufactured home is converted from personal property to real property. They also attempt to characterize a debt for purchase of a manufactured home placed on a homestead as a debt for work and materials used in constructing new improvements on the homestead, in an attempt to bring it within the existing class of debts permitted to be secured by the homestead. The legislature also framed a proposed

amendment to the Texas Constitution that, if approved by the electorate on November 6, 2001, would *add* to the class of constitutionally permitted debts secured by the homestead a debt created by the purchase of a manufactured home (while it is personal property) that is placed on real estate owned by the consumer.

The new legislation also provides that, on and after January 1, 2002, the retailer and a non-exempt person making a loan to a consumer to fund acquisition of a manufactured home must make certain prescribed written disclosures before the consumer signs documents related to the closing of the loan. However, a federally insured financial institution or a HUD-approved lender with direct endorsement underwriting authority is exempt from these disclosure requirements if Regulation Z disclosures are made.

Currently (since January 1, 1996 and prior to January 1, 2002) a manufactured home can become real property only when (1) the home is permanently attached to real property and (2) the manufacturer's certificate of origin or the original document of title is surrendered for cancellation and a certificate of attachment is filed in the real property records of the county in which the home is located. Until the occurrence of these two events, the manufactured home is personal property – a circumstance that historically has caused great difficulty for lenders where the purchase of the lot is other than concurrent with the creation of the debt for the manufactured home and its conversion to real property. In that instance Texas lenders have been unable to finance or refinance both the purchase of the manufactured home that is personal property and the purchase of the lot on which it is to be placed on security of both the manufactured home and the homestead lot. This problem arises because historically, until it is permanently affixed to the lot as a legal part of the realty, the manufactured home is not a part of the homestead. A homestead comprises

only real property, including fixtures that are a part of that real property. The Texas constitution permits the homestead to be security for a mortgage lien securing the debt for purchase of the homestead, but when the manufactured home is not a part of the homestead at the time its purchase-debt is created, that debt is not a debt for purchase of *the homestead*, and thus does not support a lien on the homestead.

In 1997, the legislature attempted to alleviate this problem by declaring that “[w]hen the manufactured home converts to real property..., the lien on the property ... is converted to a purchase money lien on real property by operation of law.” Understandably, when the question was presented to him, the Texas Attorney General took a dim view of this attempt of the legislature to expand the constitution’s limit on a permissible purchase money debt secured by the homestead. The legislature has no power not expressly given it by the constitution to expand or limit its provisions. The AG expressed the opinion that the constitution clearly confines the permissible purchase money debt to the purchase price of the land and the fixtures attached to it, and does not include the purchase money debt applicable to a yet-unattached manufactured home – which is personal property.

New Procedures for Conversion from Personalty to Real Property.

Under the new provisions, a manufactured home becomes real property when it is placed on a lot that is titled in the name of the purchaser of the home under a deed or contract of sale. (A manufactured home is considered permanently attached to real property for taxation purposes when the home is secured to a foundation and connected to a utility, including a utility providing water, electric, natural gas, propane or butane gas, or wastewater services.) Conversion to real property does not await the filing of a certificate of attachment.

Nevertheless, on the sale or resale of a manufactured home by a retailer or a financial institution, if the home is to be permanently installed directly on realty titled in the name of the purchaser under a deed or contract of sale, the retailer, or the title company or attorney conducting the closing, is required to file a Notice of Installation in the county real estate records within 30 working days after the installation has been completed. A copy of the Notice of Installation must be forwarded to the Texas Department of Housing and Community Affairs (TDHCA) together with a copy of the Notice of Installation and the manufacturer’s certificate of origin (on a first retail sale) or document of title (on a resale). After January 1, 2002, no document of title will be issued and exist for a manufactured home on its first retail sale - only a manufacturer’s certificate of origin. The Notice of Installation serves as a completed cancellation application.

A Notice of Installation must be notarized; be on a TDHCA form; contain a description of the home, including its make, model, dimensions, federal label number, state seal number, and ID or serial number; include a verification of the installation of the manufactured home; include the wind zone designation of the county in which it is to be installed; and be signed by the retailer or, if a resale, the installer. In addition, a title company filing a Notice of Installation must include a statement in the notice that the manufacturer’s certificate or the original document of title has been surrendered for cancellation and that a request has been made for the issuance of a certificate of attachment. That Notice must include a legal description or the appropriate tract or parcel number of the real property on which the home is placed. The Notice of Installation is valid for all purposes until the certificate of attachment is issued and filed in the real property records of the appropriate county.

New Options for Financing the Debt for Purchase of a Manufactured Home Placed on Homestead Property

Undoubtedly in response to the Attorney General's opinion, rejecting as unconstitutional the legislature's 1997 provisions which purported to convert the purchase debt for a manufactured home to a purchase-money debt on the homestead realty, the legislature now seeks the approval of the people to change the constitution. HJR 5 proposes to add to the class of debts permitted to be secured by a Texas homestead the following: "the conversion and refinance of a personal property lien secured by a manufactured home to a lien on real property, including the refinance of the purchase price of the manufactured home, the cost of installing the manufactured home on the real property, and the refinance of the purchase price of the real property." This change will be voted on by the people on November 6, 2001.

In addition, since the constitution has long permitted a lien on the homestead to secure the debt for work and materials furnished in construction of new improvements on the homestead (if certain requirements of the constitution and the statutes are complied with), the legislature has declared that the installation of a manufactured home on a homestead lot is the furnishing of work and materials in construction of new improvements on the homestead. This characterization probably does no violence to the constitutional provisions. Thus, even if the people should reject the constitutional amendment proposed by HJR 5, the legislature has sanctioned an effective means by which the purchase money debt for a manufactured home may be secured by the homestead. Once the home is installed, assuming that the legislature's characterization holds, the separate debt for the "work and material, " (i.e., the installation of the manufactured home,) and the debt for purchase of the homestead lot may be refinanced into one single debt secured by a valid lien on the

homestead, which includes both the lot and the installed manufactured home.

**FEDERAL DISTRICT COURT
INTERPRETS THE 3% LIMIT ON "FEES"
IN HOME EQUITY LOANS**

On March 13, 2001, the U.S. District Court in Houston, Texas issued summary judgment on behalf of Bankers Trust Company in the case of Breaux, et ux. v. United Companies Lending Corporation. (Bankers Trust was the Trustee under the United Companies Loan Trust which owned the subject loan).

Plaintiffs obtained a home equity loan (an extension of credit subject to Article XVI, Section 50(a)(6) of the Texas Constitution) from Arkansas Fidelity Mortgage Corporation. The loan was subsequently assigned to United Companies Lending Corporation (UCLC). At some point after obtaining the home equity loan, plaintiffs accepted an offer to sell their home, and requested UCLC to release its lien on the homestead in order to facilitate the sale. UCLC denied the request, insisting on full repayment before it would agree to release the lien. Plaintiffs brought suit seeking invalidity of the Loan. During the pendency of the lawsuit, Plaintiffs paid off the loan and UCLC released the lien.

The Plaintiffs argued, among other things, that the 3% limit on fees in connection with Texas home equity loans was violated. Plaintiffs argued that items such as hazard insurance, a processing fee, a mortgage lenders fee (origination fee) and a lender loan fee should have been included as fees subject to the 3% cap. Defendants, on the other hand, argued that hazard insurance was not included within the 3% limit as confirmed by the Fifth Circuit in Doody v. Ameriquest, 242 F. 3d 286 (5th Cir. 2001). Additionally, they argued that all of the other fees and charges that plaintiffs complained of were paid to the lender, and accordingly they constituted "interest" under

Texas law. Defendants correctly pointed out that the 3% limit on fees does not apply to fees that constitute “interest.”

The court noted that plaintiffs’ action was moot since they had paid off the loan, but nevertheless addressed the substantive issues. First, citing the Doody case, the court held that there was not a 3% violation - because hazard insurance is not covered by the 3% limitation of fees (the court noted that removal of the hazard insurance charge alone brought the aggregate of all other fees and charges

below the 3% limit). It also concluded that “lender retained fees or charges that are not supported by separate and distinct consideration for the loan and the lender’s ordinary overhead and expenses” are interest and are therefore excluded from the 3% cap.

While the decision is unpublished, it is still instructive in that it indicates the thought process courts are going through to determine compliance with the 3% cap on fees. Fortunately, this court chose to follow long-standing Texas law on what constitutes interest.

AKIN, GUMP, STRAUSS, HAUER & FELD, L.L.P.
ATTORNEYS AT LAW

AUSTIN
(512) 499-6200

HOUSTON
(713) 220-5800

NEW YORK
(212) 872-1000

BRUSSELS
(011) 322-535-2911

LONDON
(011) 44-20-7726-9600

NORTHERN VIRGINIA
(703) 891-7500

DALLAS
(214) 969-2800

LOS ANGELES
(310) 229-1000

PHILADELPHIA
(215) 965-1200

DENVER
(303) 825-7000

MOSCOW
(011) 7-095-974-2411

SAN ANTONIO
(210) 281-7000

WASHINGTON
(202) 887-4000

IF YOU HAVE ANY QUESTIONS OR COMMENTS ABOUT ANY OF THE FOREGOING, PLEASE CONTACT:

SHERWIN F. ROOT
PHONE: (310) 728-3383
E-MAIL: SR00T@AKINGUMP.COM

RONALD M BENDALIN
PHONE: (214) 969-2740
E-MAIL: RBENDALIN@AKINGUMP.COM

DAVID H. SANDS
PHONE: (310) 728-3226
E-MAIL: DSANDS@AKINGUMP.COM

JOSEPH V. GATTI
PHONE: (202) 887-4008
E-MAIL: JGATTI@AKINGUMP.COM

ELDON L. YOUNGBLOOD
PHONE: (214) 969-2851
E-MAIL: EYOUNGBLOOD@AKINGUMP.COM

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