Equitable Subrogation
A home equity lender's salvation

Equitable subrogation is an important legal principal under Texas law that allows a lender whose loan proceeds are used to pay off an existing lien to claim the lien priority of the lien being paid off by the new lender. In 2007, the Texas Supreme Court expressly held that common law subrogation applies in favor of a lender making a home equity loan made under Tex. Const. Art. XVI, Sec. 50(a).

In *LaSalle Bank Nat. Ass'n v. White.* 246 S.W.3d 616, (Tex. 2007) the Texas Supreme Court, was asked to reconcile the doctrine of common law subrogation with the Texas constitutional prohibition on a pledge of agricultural use to secure a home-equity loan. Because the Court ultimately determined that the home-equity mortgagee was equitably subrogated to the prior lienholders' interests, the Court found that the Texas Constitution did not require lien forfeiture to the extent the loan proceeds of the new home-equity loan were used to pay off constitutionally permissible pre-existing purchase-money and tax liens.

In a decision handed down on April 20, 2020, the Texas Supreme Court revisited the subrogation issue in a case where there was a defect in the origination of the new home equity loan AND the lender (after receiving notice of the infirmity) failed to cure the defect in the time allowed by the Texas Constitution. In *Fed. Home Loan Mortg. Corp. v. Zepeda*, the Texas Supreme Court outlined the facts straightforwardly:

> *In 2007, Sylvia Zepeda obtained a loan from CIT Group/Consumer Finance, Inc. to buy her homestead and secured the loan using her homestead as collateral. Neither party disputes the validity of the lien created by that transaction.*
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> *In 2011, Zepeda refinanced her debt with a home-equity loan from Embrace Home Loans, Inc. She also used her homestead as collateral in that transaction. Embrace paid the balance of Zepeda's debt to CIT Group, which then released its claim on the homestead.*
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> *In 2015, Zepeda, through an attorney, notified Embrace by letter that the loan documents did not comply with Article XVI, § 50 of the Texas Constitution[2] because Embrace had not signed a form acknowledging the homestead's fair market value. The letter requested that Embrace cure the defect within 60 days, as required by § 50. In response, Embrace sent Zepeda another copy of the fair-market-value acknowledgment but failed to sign it. Embrace later sold the loan to the Federal Home Loan Mortgage Corp., better known as Freddie Mac.*
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> *Zepeda sent a letter to Freddie Mac notifying it of the constitutional defect and offering an opportunity to cure. Freddie Mac did not respond, and Zepeda sued to quiet title. Her theory is that because Freddie Mac failed to cure the constitutional defect in the loan documents within 60 days of notification, Freddie Mac does not possess a valid lien on her property. Freddie Mac claims that it is subrogated to CIT Group's 2007 lien because its*

predecessor Embrace paid off the balance of CIT Group's loan to Zepeda. Both parties moved for summary judgment.

Fed. Home Loan Mortg. Corp. v. Zepeda, No. 19-0712, 2020 WL 1975169, at *1 (Tex. Apr. 24, 2020)

In a victory for mortgage lenders, the Texas Supreme Court found that the failure of the lender to cure a defect in the origination of the loan under Article XVI, Section 50(a)(6) did NOT prevent the lender from nevertheless receiving the benefits of equitable subrogation. The Court instead found that the doctrine of common law subrogation was alive and well and applied to a home equity loan for which a defect remained uncured, stating:

Common law subrogation has coexisted with this constitutional scheme for more than a century. In the mortgage context, the doctrine allows a lender who discharges a valid lien on the property of another to step into the prior lienholder's shoes and assume that lienholder's security interest in the property, even though the lender cannot foreclose on its own lien. This Court has recognized the doctrine in the § 50 context since at least 1890.

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Throughout our jurisprudence, we have stressed that the doctrine of equitable subrogation works to protect homestead property. 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.

Please note, however, that under *Zepeda*, the doctrine of equitable subrogation will not benefit a home equity lender with respect to loan proceeds used to provide cash to the borrower or to pay closing costs. Nevertheless, the Texas Supreme Court's decision in *Zepeda* recognizes and preserves the doctrine of equitable subrogation, an important protection for lenders making home equity loans in Texas to the extent that the loan proceeds are used to pay off an existing lien on the property.