# POAs: DRAFTING RULES FOR REASONABLENESS

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**CHAPTER 15**

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One of Roberts Markel Weinberg Butler Hailey's founding partners, Marc Markel has been practicing law for over thirty years. Marc heads the firm's real estate section; he is experienced in handling all aspects of real estate transactions, litigation and community association representation. Marc is Board Certified in Residential Real Estate and Commercial Real Estate by the Texas Board of Legal Specialization and a charter member of the College of Community Association Lawyers (CCAL). He is AV-rated by *Martindale-Hubbell*, the highest possible peer rating for both competence and ethics.

Mr. Markel has authored master deed restrictions for numerous large residential, commercial and mixed-use projects. He has actively defended community associations and their volunteers in litigation and frequently assists developers through their due diligence process and acquisition of title. His representation of developers, builders and associations involves litigation avoidance techniques in which he conducts a thorough risk analysis program.

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"*An HOA Lawyer's Insights on Board Duties, Deed Restriction Enforcement and Small Claim Collections*" Speaker, Friendswood Homeowner Association Education Forum (January 29, 2011)
*"Property Tax Foreclosure Suit - The Good News for Associations"* Austin Chapter Community Association Institute, Community Association Living, 2014
*"Top 5 Things Every Manager Needs to Know"* The Essentials of Community Risk Management, Roberts Markel Weinberg, 2013
*"2011 Legislative Changes Revisited"* Greater Houston Chapter of Community Association Institute, Legal Seminar, 2013
*"2006 – 2013 Supplement to Survey of Texas Case Law Affecting Property Owners Associations"* 36th Annual Advanced Real Estate Law Course, 2014
*"Avoiding Wrongful Foreclosure,"* Handling Your First (or Next) HOA Assessment Lien Foreclosure for Condos and Subdivisions, 2014
*"Lawsuits and your HOA"* Greater Houston Chapter of Community Association Institute, Legal Seminar, 2014
*"Analyzing Leasing Rules, Regulations and Restrictions for Condominium Associations"* 26th Annual Advanced Real Estate Drafting Course, 2015

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## I. INTRODUCTION

When representing communities that are twenty or thirty years old, they are more than likely strapped with dedicatory instruments, especially restrictive covenants, that are either outdated or ones that fail to address common problems that may not have existed at the time they were drafted. Whether it is due to the creation of PODS (portable on demand storage) or the rise of extended families, property owners associations must deal with present-day issues affecting subdivisions as a result of the constantly changing landscape of community association living. Unfortunately, an amendment to a community's restrictive covenants may require approval by sixty-seven percent (67%) of the total votes in an association.[1] This hurdle, although achievable, is difficult and requires considerable time, money, and resources, which associations may not have. A potential solution to this frustrating issue is for the board of directors of a property owners association to adopt rules, regulations, policies, or resolutions (collectively hereinafter referred to as "rules and regulations") to address the foregoing types of problems. When drafting rules and regulations, practitioners must create provisions which are reasonable and avoid conflict with the more senior dedicatory instruments. These more senior dedicatory instruments generally include any restrictive covenants found on the plat, the declaration as well as the bylaws. The enforceability of rules and regulations will largely depend on their reasonableness as well as avoiding the perception that the association is enlarging its powers beyond the scope of the restrictions or its own limitations.

Section 202.004(a) of the Texas Property Code gives associations the benefit of the doubt in the enforcement of rules. It states,

> [a]n exercise of discretionary authority by a property owners' association or other representative designated by an owner of real property concerning a restrictive covenant is presumed reasonable unless the court determines by a preponderance of the evidence that the exercise of discretionary authority was arbitrary, capricious or discriminatory.

Therefore, reasonableness is presumed and may only be defeated if the association is acting in a manner which destroys that presumption. Arbitrary means "not supported by fair, solid, and substantial cause, and without reason given."[2] Capricious means "given to sudden and unaccountable changes of mood or behavior."[3] Discriminatory means making or showing "an unfair or prejudicial distinction between different categories of people or things."[4] Associations may need to adopt rules and regulations regarding the collection of assessments, architectural controls and/or modifications, implementation of fines, swimming pool rules, parking, and for a variety of other issues. Ensuring that rules and regulations are reasonable and can be enforced uniformly is imperative.

## II. POWER TO ADOPT RULES

The power to adopt rules and regulations must be contained in the association's dedicatory instruments or state law. Most often, either the declaration or the bylaws give the board of directors of an association the authority to adopt rules and regulations. There are also various statutes regarding the adoption of rules. In single family communities located in Harris, Montgomery, or Galveston counties, Section 204.010(a)(6) of the Texas Property Code gives a board the power to "regulate the use, maintenance, repair, replacement, modification, and appearance of the subdivision."[5] Absent explicit authority in the restrictions or bylaws, this provision has been interpreted to give a board the authority to adopt rules and regulations within a subdivision. In addition, Texas Property Code Section 82.102(a) gives the board of a condominium association the authority to adopt rules regarding a variety of issues, including the use, occupancy, leasing or sale, maintenance, repair, modification and appearance of the unit and the common elements.[6]

Many restrictions also give the association the authority to establish an architectural control committee. Either the committee or the board will often have the power to adopt architectural control guidelines regarding the repair, replacement or modification of existing or new construction. If an association wants to impose fines for violations of the dedicatory instruments based on Texas Property Code Sections 209.006 or 82.102, a fine policy should be adopted which sets out the schedule of fines (i.e. how

[1] Tex. Prop. Code §209.0041

[2] Black's Law Dictionary

[3] *Id.*

[4] Oxford Dictionary

[5] See Tex. Prop. Code §204.002 for applicability

[6] Additional sections of Tex. Prop. Code Section 82.102(a) give the board power to adopt rules regarding the: (a) imposition of interest, late charges, returned check charges and the imposition of fines if notice and opportunity to be heard are given (12); (b) collection of delinquent assessment and the application of payments (13); and (c) termination of utility service to a unit (14).

much and how often a fine is assessed as well as the amount) and the right of the owner to request a hearing prior to the imposition of the fine. The policy and the fine amount must be reasonable. A rule or regulation will be of no value to the association if it is unreasonable because it will fail to withstand judicial scrutiny when it is challenged.[7]

The process of adopting rules is laden with pitfalls if the proper procedure is not followed by an association. For example, an amendment to a rule in a condominium association may be adopted at a board meeting only after notice is given to members.[8] For single family associations, the board must give written notice to all owners of the date, time and general subject of an open board meeting.[9] If rules or regulations are being adopted during the development period, the meeting at which they are adopted must be an open board meeting, after proper notice to the members.[10] Therefore, it is important for practitioners to be involved in all stages of rule creation, drafting, adoption and implementation. Board adopted rules and regulations are useless if they are unenforceable due to errors in any of these stages.

Depending on the type of rule and the type of association, rules and regulations have various procedures that must be followed for adoption. If an association is contemplating the adoption of a comprehensive set of rules and regulations, allowing the owners to be involved in the process, although not required by law, may provide buy-in and owners who will comply with the rules they helped create. Even if the problem which the board wants to address is pervasive, holding town hall meetings in which the proposed rules are discussed in detail should garner an understanding from the community of their need. For example, a townhome community with private streets and short driveways may decide to adopt a parking policy in order to address parking issues. Owners might be upset if they believe the board is limiting their rights or affecting their ability to park on their driveways. Holding meetings to explain and even provide pictures or testimony of owners dealing with issues related to the existing parking problem, however, should help owners understand the need for such a policy. Asking owners to provide input in the process may help promote a better understanding and the need for the policy.

## III. PURPOSE OF RULES

As previously stated, boards may decide to adopt rules to deal with issues that are not covered by the dedicatory instruments or to provide an enforcement process for the implementation of rules. Most rules attempt to prevent an action from happening, prohibit an action that is occurring, or require specific conduct. Regardless of the purpose, the rule should not conflict with the other more senior dedicatory instruments and it should be limited in its scope. Too many rules may dilute the purpose of a rule. Rules which are either too detailed or ambiguous may be difficult to understand and enforce. In addition, there is very little gained by adopting rules for the sake of having rules. Instead, recommend that boards only adopt rules as to behavior of owners that is warranted.

When adopting rules, it is important to be mindful of their enforceability, including due process and/or the owner's right to an appeal. Even when the association has the power to adopt rules, drafting rules that clarify restrictions is an excellent way to avoid potential conflict. If the restrictions gives owners the right to lease, adopting leasing rules that limit the term of leases, the number of properties that may be leased, or require that a copy of the lease be provided to the association, is a great way to regulate the right to lease.[11]

## IV. CREATION

Lawyers should assist associations interested in creating rules in order to ensure compliance with laws, avoid conflict with senior dedicatory instruments, and aid with drafting. The process of creating rules may be limited to input from the board or involve the membership. Depending on the type of rules desired, limited membership involvement may help with buy-in the event a membership vote is needed for an amendment to the restrictions.

Whenever possible, rules should be permissive instead of prohibitive in order to keep the overall content positive instead of negative. Owners may be less willing to abide by the rules if they believe the association is constantly forbidding them from taken certain actions or limiting perceived ownership rights. Couching rules in "dos" instead of "don'ts" may be less antagonizing for owners, allowing for more buy-in during adoption and implementation.[12]

## V. HOW CASE LAW IMPACTS THE DRAFTING AND ENFORCEMENT OF RULES

Although reasonableness is presumed when an association exercises its discretion, rules should be

[7] Tex. Prop. Code §202.004
[8] Tex. Prop. Code §82.070
[9] Tex. Prop. Code §209.0051
[10] Tex. Prop. Code §209.0051(e) and (i)

[11] Pending legislation, HB 2489, if adopted, may restrict a property owner's association right to request or demand a copy of the lease.
[12] Please see Appendix A for examples of how rules may be modified at the drafting stage from being negative to positive.

reasonable as written as well.[13] The following section discusses a variety of cases in which associations were involved with the creation, implementation or enforcement of rules. Many of the decisions from these cases impact how practitioners should draft rules and advise associations about their enforcement.

## A. Clarifying restrictions

Associations can benefit from rules which further clarify restrictions that may not be defined. The Heathlake Community Association, Inc. attempted to apply a 24-hour rule to the storage of boats on a lot.[14] The restrictions stated that "No . . . boat . . . shall be semipermanently or permanently store in the public street right-of-way or on driveways. Storage of such items must be screened away from public view." Wiese challenged the application of the 24-hour rule as arbitrary because it was unsupported by the declaration which neither defined "semipermanent" nor contained an explicit 24-hour time limit. Although the court found the provision to be ambiguous, the lack of evidence from Heathlake resulted in a reversal of the trial court's finding in favor of the association. In this case, the board, if rulemaking authority existed, would have benefitted by adopting rules and regulations regarding the storage of boats by defining the term "semipermanent." This way, the association may be able to rely on a written policy to defend an allegation of arbitrariness.

Clarifying restrictions or providing explicit examples of property use or conduct that is prohibited is also an excellent way to use rules and regulations. For example, rules and regulations may be adopted to limit the use of property in which restrictions provide that only one single-family dwelling used for residential purposes may be constructed on a lot and further prohibiting a commercial or business use of the property. The Kingsbridge Park Community Association prevailed in a case in which an entity attempted to use a single family home for worship services.[15] Although the court relied on the specific wording contained in the restrictions to prohibit the use of the home as a church, a rule and regulation explicitly providing that the use of a property as a church is considered a violation of the single family dwelling used for residential purposes provision may have avoided litigation over the interpretation of "residential purposes."

Owners may routinely use their homes for business or commercial use even when such use is prohibited if such use is incidental to the use of the property as a residence. Therefore, adopting rules which place limitations on such incidental business or commercial use may help prevent substantial violations. Case law in this area indicates a preference for allowing limited commercial use when such use: (1) is not detectable by sight, sound or smell; or (2) does not increase traffic due to visitors, clients, customers, or deliveries.[16] Giving owners specific examples of allowed uses should promote compliance and avoid confusion. Practitioners should be mindful, however, that particular uses which may appear to violate the single family use and residential purpose restrictions such as group homes for the mentally disabled, are in fact protected.[17] Even periodic worship services or prayer meetings may be akin to social gatherings rather than a violation of the single family residential use provision. There is a recent trial court decision regarding religious services in the Dallas area which may be appealed. A homeowner filed suit against Congregation Toras Chaim, Inc. and the owners of a house, complaining that it was being used as a synagogue in violation the restrictions. The lawsuit is grounded in secular complaints: traffic, parking, residential-only deed restrictions. However, the trial court dismissed the suit concluding that the use of the property is protected under both the Texas Religious Freedom Restoration Act and the federal Religious Land Use and Institutionalized Persons Act.[18]

Providing specific terms for leasing is another example in which rules and regulations are beneficial in the context of regulating residential use or purposes. In order to avoid short-term leasing of properties resulting in excessive transient or vacation rental use, practitioners should recommend the adoption of a leasing policy with minimum lease terms (i.e. leases shall be more than ninety days) and requiring owners to submit tenant information.[19] Even if the restrictions give an owner the absolute right to lease his property, this right may be subject to limitations by the adoption of a leasing policy. The Gulf Shores Council of Co-Owners, Inc. charged owners a fee for going outside of the rental pool by way of a board enacted policy which then later prohibited owners from using outside leasing agents.[20] The relevant provision in the declaration

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[13] Tex. Prop. Code §202.004

[14] *Wiese v. Heathlake Cmty. Ass'n, Inc.*, 384 S.W.3d 395, 405 (Tex. App. 2012)

[15] *Tao Ass'n v. Kingsbridge Park Cmty. Ass'n*, 953 S.W.2d 525 (Tex.App.—Houston [1st Dist.] 1998, no pet.)

[16] *Mills v. Kubena*, 685 W.W.2d 395 (Tex.App.—Houston [1st Dist.] 1985, writ ref'd n.r.e.)

[17] *Deep E. Texas Regional Mental Health & Mental Retardation Servs. V. Kinnear*, 877 S.W.2d 550 (Tex.App.—Beaumont 1994, no writ)

[18] *Schneider v. Gothelf, Judith D., et.al.*, No. 429-04998-2013 (429th Dist. Ct., Collin County, Tex. Feb. 12, 2015)

[19] *Benard v. Humble*, 990 S.W.2d 929 (Tex.App.—Beaumont 1999, pet. denied)

[20] *Gulf Shores Council of Co–Owners, Inc. v. Raul Cantu No. 3 Family Ltd. Pship.*, 985 S.W.2d 667, 670 (Tex.App.-Corpus Christi 1999, pet. denied)

stated, "[e]ach Apartment [unit] owner shall have an absolute right to lease or rent his apartment upon such terms as he shall approve, subject to all provisions and restrictions applicable to the Project." An owner filed suit arguing that the policy was arbitrary, discriminatory, and capricious. Reviewing the evidence under a reasonableness standard, the court found that the absolute right to lease was subject to any restrictions as well as the dedicatory instruments for the condominium. The restrictions gave the board wide latitude to adopt rules and regulations regarding leasing. Therefore, even an absolute right to lease may not be unfettered if the board has authority to adopt rules and regulations regarding a particular restriction.[21]

### B. Avoiding conflicts and limiting scope

It is also important to avoid creating conflicts with provisions in other senior dedicatory instruments or adopting amendments because it is easier to amend one particular dedicatory instrument over another in order to enlarge the association's powers. When the restrictive covenants for a condominium failed to grant an association the power of sale to non-judicially foreclose on a unit, the board opted to amend the bylaws to provide for this.[22] An amendment to the bylaws needed a simple majority as opposed to seventy-five percent (75%) of votes needed for an amendment to the restrictive covenants. Although the court of appeals upheld the association's ability to foreclose non-judicially, it could have easily struck down the amendment as an unreasonable attempt to increase the association's power to foreclose. Instead, the court of appeals opined that although the restrictive covenants did not contain the words "power of sale" or set forth procedures conducting the sale, there was no authority requiring this language in the restrictive covenants rather than the bylaws.

The Mission Trace Homeowners Association adopted a regulation prohibiting owners from parking their vehicles on their driveways and requiring all vehicles to be stored in the garage.[23] The bylaws of Mission Trace Homeowners Association provides that the board has the power to "(a) adopt and publish rules and regulations governing the use of the Common Area and facilities, and the personal conduct of the members and their guests thereon, and to establish penalties for the infraction thereof . ." Although the court found that the association had authority to adopt the regulation, after the Hollemans provided proof that they owned the driveway in fee simple, the thirteen (13) feet of driveway owned by the Hollemans was excluded from the trial court's judgment enjoining them from parking any vehicle overnight on the driveway leading to the owners garages. If the restrictions limit the adoption of rules to common areas, enlarging the scope to include rules involving use of an owner's lot will be considered unreasonable.

### C. Architectural control

An architectural control committee's ("ACC") reliance on a provision which allows for an approval or denial of an ACC application on the basis of harmony and conformity with the aesthetics of the subdivision has more support if ACC guidelines establish specific provisions regarding paint colors, materials, dimensions, height, etc. If the subdivision has adopted a general plan or scheme of development, adopting ACC guidelines will help protect the scheme and hopefully avoid an accusation of unreasonableness if an association disapproves an application or files suit against owner for making a modification outside the desired scheme. The restrictive covenants in Village of Pheasant Run Homeowners Association, Inc. gave the association the power to establish an ACC which could promulgate architectural guidelines, including color scheme standards which prohibited painting houses in bright blue colors.[24] When Kastor painted his house a bright blue color without approval, the court of appeals reversed the trial court's decision which was in favor of Kastor, stating that the association had authority to regulate the paint color of houses by establishing minimum guidelines as provided by the restrictions. In fact, the court said the restrictive covenants gave the ACC the ability to establish independent standards to effectuate the intent of the restrictions. Being clear and succinct is a great way to avoid ambiguity. If the association wants to limit paint colors to earthtones, the association may benefit by including a pallet of acceptable or prohibited colors to avoid confusion. Architectural control guidelines are an excellent way to regulate the appearance and maintenance of a subdivision.

ACC guidelines may also be an appropriate place to add limitations on the ACC's ability to grant variances from the restrictive covenants. The ACC approval process often gets associations in hot water if applications are not uniformly handled and approved/denied. Generally, restrictive covenants give an association the ability to adopt ACC guidelines as well as the authority to approve variances for various reasons in particular circumstances. In addition to

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[21] Currently pending legislation, HB 2489, if adopted, would prevent certain lease rules and regulations from being adopted or enforced.

[22] *Dickerson v. Debarbieris*, 964 S.W.2d 680 (Tex.App.—Houston [14th Dist.] 1998, no pet.)

[23] *Holleman v. Mission Trace Homeowners Ass'n*, 556 S.W.2d 632, 636 (Tex. Civ. App. 1977)

[24] *Village of Pheasant Run Homeowners Ass'n, Inc. v. Kastor*, 47 S.W.3d 747 (Tex.App—Houston [14th Dist.] 2001, pet. denied)

providing specifics about the ACC application submittal and approval process, the guidelines may give examples of situations in which granting a variance may be appropriate. Approving an application in one circumstance may not necessitate the same approval in a different circumstance. However, varying decisions on applications may provide a sufficient basis on which to establish a claim of unreasonableness or arbitrariness. The Supreme Court upheld an ACC's waiver of a restriction which prohibited the use of composition-type roof shingles.[25] When the Pilarciks found that their home could not structurally support non-wood shingle alternatives, the ACC decided to approve a composition roof, which the Supreme Court found was not a complete waiver of a restriction prohibiting wood shingles but reasonable in light of the specific circumstances in this case. Although variances should only be granted in extreme situations and used sparingly by boards or the ACC, having ACC guidelines which provide flexibility in the application of restrictions should go a long way to support a presumption of reasonableness.

The court did not find that the ACC for the La Ventana Ranch Owners' Association, Inc. acted arbitrarily and capriciously after it granted variances to owners requesting propane tanks because the ACC had the "sole and absolute discretion to determine whether the necessary conditions for granting a variance have been met" even though the restrictions prohibited the installation of propone storage tanks.[26] Therefore, the court found that Section 202.004(a) was inapplicable. It is extremely important that the board or committee enforcing any rules and regulations acts within its bounds and the discretion provided in the restrictions.[27]

Another important caveat regarding ACCs are restrictive covenants which often state that the ACC must either approve or deny an ACC application within thirty (30) days after it is submitted or the application will be deemed approved. The ACC must act accordingly if the association intends to pursue a violation involving an ACC application or risk losing on a technicality for failing to act timely and reasonably. When the Greenway Improvement Association failed to approve an ACC application for a sign within the sixty (60) day limitation provided in the restrictive covenants, the court found that the association's failure to act resulted in an approval even though the restrictions prohibited the installation of signs without written approval from the ACC.[28]

**D. Fees**

Adopting a policy establishing late fees, interest, or fines is another area in which reasonableness is important. If the restrictive covenants give the association the power to charge late fees for delinquent assessments, a board should adopt a policy to establish a reasonable late fee. The amount of the late fee will often depend on the amount of the assessment. Although a late fee of $25 a month may seem reasonable for a $500 annual assessment, it may be considered unreasonable for a $100 annual assessment. Similarly, charging interest at a rate of 10% percent is reasonable unless the restrictive covenants provide for a higher interest rate.[29] Adopting a policy will give owners notice of the amount that will be charged and provide the process for the imposition of those charges. Texas Property Code Section 204.010(a)(10) gives a board the authority to charge late fees for unpaid assessments. However, case law clearly provides that unless the charge is secured by a lien in the restrictions, an association cannot foreclose on property for the late fee if it is established using Texas Property Code Section 204.010(a)(10).[30]

**E. Using definitions**

A large part of being reasonable or having reasonable rules and regulations means using the simple and plain meaning of words. When drafting rules and regulations which clarify restrictive covenants, providing definitions often helps to avoid misinterpretation. Several cases in this area rely on common dictionary definitions if a word is ambiguous. However, a disagreement about a provision's interpretation does not mean it is ambiguous.[31] Many associations struggle with terms such as structure or improvement when determining if architectural approval is required for a fence or a driveway. Courts often rely on Texas Property Code Section 202.003(a) which states that "[a] restrictive covenant shall be construed liberally to give effect to its purposes and intent."

The court of appeals used dictionary definitions when the Morans claimed the terms "fence, wall, and hedge" were ambiguous in connection with an issue regarding the installation of a fence within the set-back line.[32] The court also relied on the plain meaning of the terms to find the restriction unambiguously required the placement of a "boundary or barrier"

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[25] *Pilarcik v. Emmons*, 966 S.W.2d 474 (Tex. 1998)

[26] *La Ventana Ranch Owners' Ass'n, Inc. v. Davis*, 363 S.W.3d 632 (Tex.App.—Austin 2011, pet denied)

[27] Currently pending legislation, HB 748, if adopted, would affect an association's ability to regulate propane tanks.

[28] *Bank United v. Greenway Improvement Ass'n*, 6 S.W.3d 705 (Tex. App.—Houston [1st Dist.] 1999, pet. denied)

[29] *Lee v. Braeburn Valley W. Civic Ass'n*, 794 S.W.2d 44 (Tex.App.—Eastland 1990, write denied)

[30] *Brooks v. Northglen Ass'n*, 141 S.W.3d 158 (Tex. 2004); *See* Tex. Prop. Code §204.002 for applicability

[31] *Moran v. Memorial Point Property Owners Ass'n, Inc.*, 410 S.W.3d 397 (Tex.App.—Houston [14th Dist.] 2013, no pet.)

[32] *Id.*

within twenty-five (25) feet of the edge of a platted street regardless whether the boundary was made of "masonry, boards, wire, or densely planted shrubbery."

Similarly, the Jamisons were sued after choosing "HarpdiPlank" for siding on their home. The Allens alleged that HardiPlank could not be used for the construction of exterior walls.[33] The definition of "exterior walls" became the issue when the Jamisons, claiming a quasi-estoppel defense, alleged the Allens had used HardiPlaink on their gables. The court of appeals used several dictionary definitions to determine that the everyday use of the word "wall" includes "gables." Therefore, the Allens could not complain about the Jamisons use of HardiPlank.

### F. Pets

Many condominium or townhomes associations may benefit by adopting rules regarding limitations for pets. The board of the Post Oak Lane Townhome Owners Association, Phase II adopted a rule limiting the height of small house pets to 18 inches.[34] McGuire, who owned a 24-inch tall dog, filed suit arguing that the rule was unenforceable for many reasons. He alleged that the rule was arbitrary, capricious, discriminatorily applied, and improperly adopted. The court reviewed the restriction which contained provisions limiting house-hold pets and subjecting them to rules and regulations adopted by the board. Although McGuire was challenging the adoption on the grounds that the board was not made up of owners in the townhome, the court relied on the restrictive covenants and Texas Property Code Section 81.102(b) to find that the developer and its agents could be on the board even if they were not owners. Similarly, in the single family context providing examples of allowed domestic animals may help avoid disagreements about unusual pets, such as pot belly pigs. However, associations must make modifications in rules if an owner requests an accommodation for a comfort pet or one based on a disability of the owner.[35]

### G. Grandfathering

When considering enforcement of rules and regulations, determining whether to grandfather existing violations is an important factor to consider during the drafting process. Substantial changes to current situations may require a grandfather provision either until the sale of the property or for some reasonable time frame after adoption. Expecting owners to immediately comply with rules and regulations may seem unreasonable if the rule requires a major change.

## VI. FAIR HOUSING

The Fair Housing Amendments Act of 1988 ("FHA") prohibits discrimination in the sale, transfer or lease of a property as it relates to a protected class.[36] Rules which appear to be discriminatory on their face or have a discriminatory impact on a protected class will not pass scrutiny under the FHA. The FHA protects against discrimination in housing on the basis of race, color, religion, sex, national origin, familial status, and disability.[37] The FHA greatly affects the ability of associations to adopt and enforce certain rules. The Texas legislature adopted a fair housing law which is substantially similar to the FHA which became effective on January 1, 1990.[38]

Familial status is included in the class of protected people under the FHA.[39] The FHA prohibits discrimination against families in which one or more children under the age of 18 live with: (1) a parent; (2) a person with legal custody of the child or children; or (3) the designee of a parent or legal guardian, with the parent's or custodian's written permission. It also applies to pregnant women and anyone trying to obtain legal custody of a child under 18. Associations must be mindful of rules which limit the type of family that may lease or occupy a property. Also covered by the FHA is discrimination based on age and persons with disabilities. If a rule has the effect of restricting the rights of the disabled or children, the association will not prevail if it is challenged under the FHA.

In addition, if a disabled person makes a request for a reasonable accommodation, the association may subject itself to liability for being unreasonable if it refuses to modify a rule, practice or policy.[40] Requests

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[33] *Jamison v. Allen*, 377 S.W.3d 819 (Tex.App.—Dallas 2012, no pet.)

[34] *McGuire v. Post Oak Lane Townhome Owners Ass'n, Phase II*, No. 01-88-00813-CV, 1989 WL 91519 (Tex.App.—Houston [1st] 1989, writ denied)

[35] 42 U.S.C. § 3604(f)(3)(B); 24 C.F.R. § 100.204(a); Tex. Prop. Code § 301.025(c)(2); 40 Tex. Admin. Code § 819.134. The DOJ and TWC's interpretive regulations expand this nondiscrimination norm beyond dwellings to "public and common areas." 24 C.F.R. § 100.204(a); 40 Tex. Admin. Code § 819.134

[36] *See* Section 1, 41 U.S.C.A Section 3601 et seq (West 1988)

[37] The FFHA uses the term "handicap" instead of the term "disability." Both terms have the same legal meaning. See *Bragdon v. Abbott*, 524 U.S. 624, 631 (noting that the definition of "disability" in the Americans with Disabilities Act is drawn almost verbatim "from the definition of 'handicap' contained in the Fair Housing Amendments Act of 1988"). This document uses the term "disability" which is more generally accepted.

[38] *See* Tex. Prop. Code §301

[39] 42 U.S.C.A. Section 3602(k) (West 1988)

[40] 42 U.S.C. § 3604(f)(3)(B); 24 C.F.R. § 100.204(a); Tex. Prop. Code § 301.025(c)(2); 40 Tex. Admin. Code § 819.134. The DOJ and TWC's interpretive regulations expand this nondiscrimination norm beyond dwellings to

for reasonable modifications may also affect the enforceability of rules if architectural or aesthetic guidelines limit the size and/or shape of a modification, making it unavailable to a person with a disability. In addition, comfort pets or pets for a disability may have to be allowed even if a rule prohibits pets.

Another area that results in problems for associations in the fair housing context are rules regarding recreational facilities and swimming pools. Rules requiring adult supervision for children, swim diapers for children, or adult only swim may be discriminatory on the basis of familial status.[41] Ensuring that rules regarding the use of common areas and recreational facilities are reasonable and uniformly applied are important issues to consider during the drafting process. [42]

Another federal law which prevents associations from adopting certain rules deals with the placement of satellite dishes. The Telecommunications Act of 1996 prohibits rules which require architectural control approval prior to the installation of a satellite dish. In addition, no rule or regulation may unreasonably delay or add unreasonable costs to an owner's right to receive a signal. Associations may adopt guidelines suggesting desired locations for satellite dishes but they can in no way impede an owner's right and ability to use satellite dishes. However, condominium associations may prohibit placement of satellite dishes on common areas.[43]

Using a savings clause is a beneficial way to avoid unintended violations of statutory law. The following example of a savings clause may help protect an association from such an accusation or a perceived unreasonable action in enforcement.

> It is not the intent of this policy to discriminate against any individual subject to protection under any state or federal law; if it is found that any provision of this policy is in violation of any law, then that provision shall be interpreted to be as restrictive as possible to preserve as much of the original provision as allowed by law.

## VII. AMENDMENTS

One benefit of having board adopted rules and regulations is that the board can also amend them later without needing a vote of the membership. This is of great value if it is later determined that the wording of a previously adopted rule is difficult to enforce due to its ambiguity. It is also easier for a board to amend a rule if it becomes obsolete as a result of a change in the law or simply due to time. For example, a rule regarding a specific weight or type of roofing shingles may more easily be amended as a result of the industry change over time in the way they are weighed. Historically shingles used to be measured according to their weight in pounds per one hundred square feet. This later changed to the manufacturer's warranty. Shingles weighing 300 pounds per 100 square feet in 1990s were classified in 2000 as 40 year shingles. Now they are measured in bundles. It is much easier to amend the rules and regulations regarding the weight of a shingle without having to amend the restrictions as

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"public and common areas." 24 C.F.R. § 100.204(a); 40 Tex. Admin. Code § 819.134

[41] There are three California cases supporting the idea that discriminatory pool rules are unlawful under the FHA. *See Landesman v. The Keys Condominium Owners Association*, No. C 04-2685 PJH, 2004 WL 2370638 (N.D. Cal. Oct. 19, 2004); *United States v. Plaza Mobile Estates*, 273 F. Supp. 2d 1084 (C.D. Cal. 2003); *Llanos v. Estate of Anthony Coehlo*, 24 F. Supp. 2d 1052 (E.D. Cal. 1998).

[42] Please see Appendix A for examples of how to draft rules to avoid an allegation of discrimination under the FHA in this area.

[43] The following is a brief summary of rulings by the FCC regarding their Over-the-Air Reception Devices Rule ("OTARD"):

- OTARD preempts a city ordinance that requires prior approval requirements and permit fees for installation of a satellite because the ordinance causes an unreasonable delay in antenna installation and results in unreasonable cost to the consumer. (7/22/97)
- OTARD preempts a POA restriction because the association had not met its burden of proof by testing and establishing the reception signal quality from the Petitioner's lot. (10/10/97)
- FCC dismissed, without prejudice, a petition when the homeowner informed the FCC that they had decided to move their antenna to a location approved by the association and that the association had adopted new antenna regulations. (11/28/97)
- POA must adopt OTARD's meaning of the term "reasonable." (10/10/97)
- OTARD invalidated a POA penalty provision for violation of antenna rules on the basis that the rules "are likely to deter installation." (10/10/97)
- OTARD preempts POA screening requirements on the basis that it did not provide exceptions for cases in which the screening would "unreasonably delay installation, or unreasonably increase the cost of installation, maintenance or use of the antenna, or preclude reception of an acceptable quality signal." (10/10/97)
- OTARD preempts association's prior approval processes and antenna prohibition. (11/28/97)
- OTARD preempts association's prohibitions on the basis that the homeowner is entitled to exercise exclusive use over the property even though the association provides maintenance. (10/30/97)

a result of the change in the industry standard over the years.

Architectural guidelines requiring a specific color palette may also change over time due to the landscape of the neighborhood. Creating a policy which gives the board flexibility to allow for these types of changes is best left in a board adopted rule.

## VIII. ENFORCEMENT

Once an association has adopted rules and regulations, the way in which they are enforced is also important. Notice of any approved rules should be sent to the members. In fact, as of January 1, 2000, all dedicatory instruments, including rules, must be filed of record in the real property records of each county in which the property to which the dedicatory instruments relate are located.[44] As of January 1, 2012, if the dedicatory instruments are not recorded, they are not enforceable.[45] Although recording is a vital step, sending copies of the actual rules or publishing them in the association's newsletter or website helps provide actual notice of the rules to owners. If an association has a publicly accessible website, all dedicatory instruments must be posted on its website.[46]

Creating an enforcement procedure either within the rules or as a separate policy will assist in increasing compliance. The policy should describe the process the association intends to utilize in the event of a violation. Typically, the association should send at least two to three notices to an owner requesting compliance. It is recommended that the association maintain a positive and friendly tone in the first notice and maybe even in the second notice before becoming slightly more aggressive in later notices. If compliance is still an issue, the association must consider turning the owner over to the association's attorney. Prior to doing this and in order to recover the attorneys' fees that will be incurred by the association for compliance, any requisite statutory notices must be sent to the owner.[47] Depending on the violation and penalty (i.e. fine or suspension of privileges), the owner may be entitled to a hearing in front of the board. Reasonableness is also extremely important at this stage and the board should be mindful of situations or hardship exceptions that need to be considered when enforcing the rules.

If the association has the authority to assess fines, a fine policy and schedule should be adopted to establish the process and amount of fines to be assessed for each violation. Fines should be reasonable. For example, a $1,000 for failing to regularly mow will not be considered reasonable if a homeowner challenges such a fine. Similarly, if the association is entitled to revoke privileges to the use of common areas, adopting a policy outlining the process will be helpful in guiding boards towards reasonableness. Before an association can levy a fine or suspend an owner's privileges for a deed restriction violation, it must send written notice via certified mail return receipt requested giving the owner certain rights.[48] Under Texas Property Code Section 209.006, the notice must: (1) describe the violation which is the basis for the fine or suspension; (2) inform the owner that he/she is entitled to a reasonable period to cure the violation before the fine can be assessed or privileges may be revoked; (3) inform the owner that he/she has thirty (30) days from the date the notice is received to request a hearing in front of the board; and (4) inform the owner that he/she may have special rights under the Servicemembers Civil Relief Act if the owner is serving in active military duty. The Texas Uniform Condominium Act has a similar provision in Texas Property Code Section 82.102 (d).

Section 209.007 of the Texas Property Code provides some information about this hearing. The hearing must be requested in writing by the owner as provided in the notice. The hearing must be held not later than the 30th day after the owner requests a hearing and the association must notify the owner in writing about the date, time and location of the hearing at least ten days before the hearing. The hearing may occur in front of the board or a committee of the board. The owner will have a right to appeal a hearing in front of a committee to the board. Section 209.007 also deals with postponements of the hearing as well as situations in which such notice is not necessary. If the association fails to act accordingly, a presumption of reasonableness may be easily rebutted. Having rules and regulations which clearly outline the violation process, including details of what can be expected at the hearing, will help associations act within their rights as well as give owners notice of their rights. This should assist in adopting a uniform and consistent plan which supports a presumption of reasonableness.

The association must send written notice as discussed in the foregoing, in order to recover attorneys' fees for enforcement of dedicatory instrument violations. Section 209.008 of the Texas Property Code provides that an association may recover reasonable attorneys' fees and costs for the enforcement of the restrictive covenants of the

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[44] Tex. Prop. Code §202.006

[45] *Id.*

[46] Tex. Prop. Code §207.006; Currently pending legislation, HB 2797 and SB 1168, if adopted, will clarify whether this provision applies to condominium associations. Regardless, posting all dedicatory instruments on the association's website is a best practice for all associations.

[47] Tex. Prop. Code §209.006 and Tex. Prop Code §82.102(d)

[48] Currently pending legislation, SB 1168, if adopted, eliminates the requirement to send this notice for certain uncurable violations.

association only after the owner is provided written notice that attorneys' fees and costs will be charged to the owner if the violation continues after a date certain. If notice is not properly sent or if the Board fails to follow the hearing procedure, recovery of attorneys' fees will be at risk.

Another area in which the association may easily encounter an allegation of arbitrariness is when exercising its right to self-help. Self-help should be contained within an association's restrictive covenants. It gives an association the right, without liability in trespass, to enter onto an owner's property to remedy a violation. Generally, this right is limited to trash removal, lawn maintenance, and other exterior issues. Rules and regulations provide a beneficial tool to provide the process and limitations for self-help. Providing a notice and hearing process as well as examples in which exercising self-help is appropriate may also provide a certain level of protection against an allegation of unreasonableness. The clearer the association's dedicatory instruments are in delineating its rights, the easier it will be for a court to find in favor of the association.

## IX. CONCLUSION

In disputes regarding the enforcement of restrictive covenants and other dedicatory instruments, community associations are most often accused of acting unreasonably. Although the law presumes reasonableness, this presumption may easily be rebutted by a preponderance of the evidence. If an association has rules and regulations it can rely on which clearly address common issues, clarify restrictions, and provide enforcement procedures, the potential for a finding of arbitrariness, capriciousness, or discrimination should be greatly reduced.

It is vital for attorneys to be involved in each stage of the development of rules and regulations. Lawyers should rely on case law to guide them during the drafting process. Ensuring compliance with state and federal laws, avoiding conflict with other senior dedicatory instruments, and being mindful to not enlarge powers of the association established by the senior dedicatory instruments are important considerations.

In addition, attorneys should consider advising associations early in the enforcement process by suggesting involvement at the hearing with the board, if one is requested by the owner, in order to provide guidance on the appropriateness of actions and suggestions for moving forward. Once an association decides to pursue litigation or if an association is sued, all actions taken by the board or the ACC will be reviewed in detail without an ability to modify past behavior. If reasonableness is established at the drafting phase, it can then be fostered through the enforcement phase in order to limit conflict and potential liability.

# APPENDIX A

**DISCLAIMER**

The examples provided herein are not Texas Real Estate Commission or State Bar of Texas forms, and are being provided for illustrative purposes only. They are the work product of the author and are constantly being revised. The provisions in these forms have not been tested by any court of law. Use of these forms or the provisions contained within are at your own risk. The author in no way assumes liability or responsibility for litigation or damages incurred in connection with the use of these forms.

**Negative vs. Positive Rules**

| Negative | Positive |
|---|---|
| No trash cans shall be placed in front of the home for pick up before 6pm on the night before scheduled trash pick up. | Owners are permitted to place trash cans in front of the home for pick up after 6pm on the night before scheduled trash pick up. |
| No inoperable vehicles shall be parked on the driveway or in public view. | Any vehicle parked on a lot or in public view must be operable, with a current registration and inspection sticker. |
| No pets without leases shall be allowed in Common Elements. | All pets must be leashed or carried while in Common Elements. |

**FHA Safe Rules**

| Possibly discriminatory | Recommend wording |
|---|---|
| No person under the age of 18 years may be permitted in or around the swimming pool unless accompanied by a parent or legal guardian. | Non-swimmers must be accompanied by responsible adults. [or] Children under the age of 14 must be accompanied by an adult.[49] |
| Children who are not toilet-trained are not permitted in the swimming pool. | Incontinent swimmers and swimmers who are not toilet-trained must use swim diapers when in swimming pool. |

[49] *Landesman v. The Keys Condominium Owners Association,* 2004 WL 2370638 (U. S. Dist. Ct. N.D. Cal, Oct. 19, 2004).

# ISSUES IN HOME EQUITY FINANCING

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**37th ANNUAL**
**ADVANCED REAL ESTATE LAW**
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San Antonio

**CHAPTER 16**

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Morton has lived most of his life in San Antonio. He is a graduate of San Antonio MacArthur High School, the University of Texas @ Austin(Plan II 1971) and the University of Texas School of Law (JD 1974) and was admitted to practice in Texas in 1975.

Morton is married, has four grown children and 8 grandchildren. His son, Michael Fritz Baird, is a recent University of Texas School of Law graduate and is co-author of this paper.

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# ISSUES IN HOME EQUITY FINANCING

## I. INTRODUCTION

When Texas incorporated homestead protection into the Constitution of 1845, it was the first state to do so. In 1988, when Texas legalized Home Equity financing, it was the last state to do so. The one hundred and fifty three year gap between the creation of the Homestead protection and the legalization of Home Equity financing underscores Texas' long-standing commitment to protecting Texans' homes from the reach of creditors.

Since Texas' adoption of Home Equity financing seventeen years ago, the legislature, regulators and courts have responded to a variety of issues but new ones continue to emerge. This paper will discuss some of these issues within the context of Constitutional requirements, regulatory interpretations and the historical evolution of the homestead.

## II. EVOLUTION OF THE TEXAS HOMESTEAD

### A. Texas Colonization (1821-1836)

After Mexico gained its independence from Spain in 1821, Texas and Coahuila were combined to create the Mexican state of Coahuila y Tejas. To encourage colonization of Texas, Mexico granted *empresarios* the right to bring colonists to Texas. One *empresario*, Stephen F. Austin, understood that many of the immigrants were fleeing creditors from their former states. Austin encouraged the legislature of Coahuila y Tejas to create a legal refuge that would protect the colonists' homes from seizure by foreign creditors.

> "*Many Americans who settled in Texas in the early nineteenth century were pursued by their creditors, and for their protection Stephen F. Austin recommended a moratorium on the collection of the colonists' foreign debts. In response to that recommendation, the legislature of Coahuila and Texas enacted Decree No. 70 of 1829 to exempt from creditors' claims lands received from the sovereign as well as certain movable property."*[1]

The **Cohuila y Tejas Decree No. 70** provided:

> "*The lands acquired by virtue of colonization law … shall not be subject to the payment of debts contracted previous to the acquisition of said lands, from whatever source the said debts originate or proceed*."[2]

Though Decree No. 70 was repealed in 1831, the principle of protecting the home from seizure by creditors had been expressed and would remain in the minds of Texans when they declared their independence from Mexico in 1836.

### B. Republic of Texas (1836-1845)

The Texas Act of 1839 revived the homestead protection created by Coahuila y Tejas Decree No. 70.

> *"Be it enacted by…the Republic of Texas…there shall be reserved to every citizen or head of a family in this Republic, free and independent of the power of the writ…or other execution.. his or her homestead…"*[3]

### C. Annexation and Statehood (1845-1861)

As a prerequisite to Texas' annexation by the United States, Texans approved the Constitution of 1845, which reiterated Texas' commitment to protect the homestead from seizure by creditors.

**The Constitution of 1845**

Article 12, Section 22 provided:

> *"The legislature shall have power to protect by law, from forced sale, a certain portion of the property of all heads of families. The homestead of a family… shall not be subject to forced sale for any debts hereafter contracted…"*[4]

Members of the Texas Constitutional Convention of 1845 chose to permanently inscribe homestead protection constitutionally rather than legislatively because they did not want to subject this fundamental right "*to the whim and caprice of the Legislature*."[5]

Protection of the homestead has been included in every Texas Constitution since 1845.

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[1] McKnight, Joseph W., *Homestead Law*, http://www.tshaonlinge.org/handbook/online/articles/mhc04 (accessed May 19, 2015).

[2] McKnight, Joseph W. *Protection of the Family Home from Seizure by Creditors: The Sources and Evolution of a Legal Principle*, 86 S.W. Historical Quarterly 369 (1983).

[3] Wilkinson, A. E. *The Author of the Texas Homestead Exemption Law*. 20 S.W. Historical Quarterly 35 (1916).

[4] www.tarlton.law.utexas.edu/constitutions/texas1845 (accessed May 12, 2015).

[5] Thomas J. Rusk, Speech, *Debates of the Texas Convention* (Austin, August 5, 1845).

### D. Confederate States of America (1861-1865)

**Constitution of 1861**

The Constitution adopted by Texas after its succession from the United States restated the homestead protections set out in the Constitution of 1845.[6]

### E. Post-Civil War and Reconstruction (1865-1870)

**Constitution of 1866**

Texas' first post war Constitution again restated the homestead protections set out in the Constitution of 1845.[7]

**Constitution of 1869**

Texas' next Constitution included provisions mandated by the U.S. Congress for readmission into the United States but it also restated homestead protections set out in the previous two state constitutions.[8]

In addition to the general protection of the homestead from seizure by creditors, the 1869 Constitution introduced specific debts that could be enforceable against the homestead: purchase money, taxes and improvements.

Article XII, Section XV of the Constitution of 1869 provided:

> *"…The homestead of a family…shall not be subject to forced sale for debts, except for the purchase thereof, for the taxes assessed thereon, or for labor and materials expended thereon…"*[9]

### F. Readmission to the United States and Modern-day Texas (1870-present)

**Constitution of 1876**

After Texas was readmitted into the United States in 1870, Texans sought to repeal and replace the Constitution of 1869, which had been adopted during Texas' period of military occupation and rule.

The resulting Constitution of 1876 remains the underlying organic law of Texas. It is also one of the lengthiest state Constitutions. Since 1876, the legislature has proposed 666 constitutional amendments of which 484 have been approved by Texas voters.

Article 16, Section 50(a) of the 1876 Constitution, which delineates Texas' homestead law, has been amended ten times since 1876.

The list of debts enforceable against the homestead has grown to reflect an evolving Texas but the fundamental protection of the homestead remains intact.[10]

The Constitution of 1876, Article 16, Section 50(a) provides:

> *"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 the following*":
>
> *(1) Purchase money;*
> *(2) Taxes;*
> *(3) Owelty of partition;*
> *(4) Refinance of lien against the homestead;*
> *(5) Work and materials for new improvements or repair and renovation for existing improvements;*
> *(6) Home Equity financing*
> *(7) Reverse Mortgages*
> *(8) Conversion of personal property lien secured by manufactured home to real estate lien*

## III. HOME EQUITY FINANCING UNDER ARTICLE 16, SECTION 50(A)(6)

### A. Texas Voters Approve Home Equity Financing

In 1997, the 75th Texas legislature passed HJR 31 to permit Home Equity financing. On November 4th, 1997, 59.6% of Texas voters approved HJR 31 and the following January 1st, 1998, Article 50(a)(6) became part of Texas law.

The comprehensive consumer protections incorporated into Section 50(a)(6) make Texas' Home Equity financing the most consumer-protective in the nation. "*Texas is the only state with a regulation limiting home equity lending…Rules governing home equity borrowing are not uniform across the U.S. and Texas' rules are significantly more stringent.*[11]

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[6] Buenger, Walter L. *Constitution of 1861,* Handbook of Texas Online. http://www.tshaonline.org/handbook/online/articles/mhc04 (accessed May 7, 2015).

[7] McKay, S. S. *Constitution of 1866,* Handbook of Texas Online. http://www.tshaonline.org/handbook/online/articles/mhc06 (accessed May 7, 2015).

[8] McKay, *S. S. Constitution of 1869.* Handbook of Texas Online. http://www.tshaonline.org/handbook/online/articles/mhc06 (accessed May 7, 2015).

[9] www.tarlton.law.utexas.edu/constitutions/texas1869 (accessed May 7, 2015).

[10] "*Amendments to the Texas Constitution Since 1876,* Texas Legislative Council, www.tlc.state.tx.us/pubsconamend/constamend1876.pdf (accessed May 3, 2015).

[11] Kumar, Anil and Skelton, Edward. *Did Home Equity Restrictions Help Keep Texas Mortgages from Going Underwater?* Southwest Economy, Federal Reserve Bank of Dallas (3Q 2013).

Lenders who fail to cure their 50(a)(6) violations within 60 days notice from the borrower face a potentially catastrophic result: termination of the lien and forfeiture of all principal and interest.

### B. Regulatory Interpretations Authorized

The initial 50(a)(6) which went into effect in 1998 did not delegate interpretive authority to a state agency though the Office of Consumer Credit Commissioner issued a non-binding set of interpretations. These initial interpretations were helpful but lenders and consumer groups required a more definitive, binding interpretive rulebook.

In 2003, Texas voters approved a new Section 50(u) to the Constitution.

> *"The legislature may by statute appoint one or more state agencies with the power to interpret subsection a(5)-(7)…"* [12]

The legislature amended the Finance Code to authorize the Finance Commission and Credit Union Commission to issue interpretations of 50(a)(6).[13]

## IV. SECTION 50(A)(6) HOME EQUITY FINANCING REQUIREMENTS WITH SELECTED REGULATORY COMMENTARY

### A. Texas Constitution, Article 16, Section 50(a)(6) provides:

> "*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 the following…*
>
> *(6) an extension of credit that:*

**1. 50(a)(6)(A)**
is secured by a "*voluntary lien on the homestead created under a written agreement with the consent of each owner and each owner's spouse;*

**Regulatory Commentary**:

**7 Texas Administrative Code (TAC) Rule 153.2(1)**
"*The consent of each owner and each owner's spouse must be obtained, regardless of whether any owner's spouse has a community property interest or other interest in the homestead."*

**2. 50(a)(6)(B)**
is an amount that when added to aggregate of all debts against homestead does not exceed 80% of the fair market value of the homestead at the time of closing;

**3. 15.41350(a)(6)(C)**
is without personal recourse except for fraud;

**4. 50(a)(6)(D)**
is secured by lien that may only be foreclosed by Court order;

**5. 50(a)(6)(E)**
does not require owner or spouse to pay, in addition to interest, fees that exceed 3% of original principal amount;

**Regulatory Commentary:**

**7 TAC Rule 153.5 (3) (B)** "*Legitimate discount points are interest and are not subject to the three percent limitation. Discount points are legitimate if the discount points truly correspond to a reduced interest rate…"*

**7 TAC Rule 153.1 (11)** *"Interest- As used in Section50(a)(6)(E), "interest" means the amount determined by multiplying the loan principal by the interest rate over a period of time."*

**6. 50(a)(6)(F)**
if the loan is an open end account, it must be a Home Equity Line of Credit;

**7. 50(a)(6)(G)**
is payable in advance without penalty or charge;

**8. 50(a)(6)(H)**
is not secured by any additional real or personal property other only than the homestead;

**9. 50(a)(6)(I)**
is not secured by property with Agricultural property tax designation (unless property used primarily for milk production);

**10. 50(a)(6)(J)**
may not be accelerated because of decrease in market value or default in other debt not secured by prior lien on homestead;

**11. 50(a)(6)(K)**
is the only Home Equity loan on the property;

**Regulatory Commentary**

**7 TAC Rule 153.10(1)** "*Number of Equity loans. An owner may have only one equity loan at any time,*

[12] Tex. Const. art. XVI, §50(u).
[13] Tex. Fin. Code §11.308 and §15.413.

*regardless of the aggregate total outstanding debt against the homestead."*

**12. 50(a)(6)(L)(i)**
is scheduled to be repaid: in "*substantially equal successive periodic payments*" not more often than every two weeks and not less often than monthly, beginning no later than two months from closing, "*each of which equals or exceeds the amount of accrued interest as of the date of the scheduled installment";*

**Regulatory Commentary**

**7 TAC Rule 153.11 (3)** "*For a closed-end equity loan to have substantially equal successive periodic installments, some amount of principal must be reduced with each installment. This requirement prohibits balloon payments."*

**7 TAC Rule 153.11 (4)** *"Section 50(a)(6)(L)(i) does not preclude a lender's recovery of payments as necessary for other amounts such as taxes, adverse liens, insurance premiums, collection costs, and similar items."*

**7 TAC Rule 153.1 (1)** *"Balloon- an installment that is more than an amount equal to twice the average of all installments scheduled before that installment."*

**13. 50(a)(6)(L)(ii)**
if it is a Home Equity line of credit, the periodic payments also must be regular periodic installments payable not more often than every 14 days and not less often than monthly, beginning not later than 2 months from closing;

**14. 50(a)(6)(M)(i)**
is not closed before 12th day after owner submits loan application and lender provides Home Equity Notice;

**15. 50(a)(6)(M)(ii)**
is not closed for at least one business day after owner receives copy of loan application (if not previously received) and a final itemized closing statement;

**Regulatory Commentary:**

**7 TAC Rule 153.13(3)** *"A lender may satisfy the disclosure requirement of providing a final itemized disclosure of the actual fees, points, interest, costs, and charges …by delivering to the borrower a properly completed …HUD-1 or HUD-1A."*

**16. 50(a)(6)(M)(ii)**
if owner has "*bona fide emergency or other good cause"* and of "*lender obtains written consent owner*", lender may provide copy of loan application and final itemized closing statement on the date of closing;

**17. 50(a)(6)(M)(iii)**
is not closed before at least one year since last Home Equity loan on the same property;

**Regulatory Commentary**

**7 TAC Rule 153.14(2) "***Section 50(a) (6) (M) (iii) does not prohibit modification of an equity loan before one year has elapsed since the loan's closing date. A modification of a Home Equity loan occurs when one or more terms of an existing equity loan is modified, but the note is not satisfied and replaced. …"*

**7 TAC Rule 153.14(2) (A)** *"A modification of an equity loan must be agreed to in writing by the borrower and lender, unless otherwise required by law…"*

**7 TAC Rule 153.14(2) (B)** "*The advance of additional funds to a borrower is not permitted by modification of the equity loan."*

**7 TAC Rule 153.14(2) (C)** *"The modification of an equity loan may not provide for new terms that would not have been permitted by applicable law at the date of closing of the extension of credit."*

**7 TAC Rule 153.14(2) (D)** *"The 3% cap required by Section 50(a) (6) (E) applies to the original Home Equity loan and any subsequent modification as a single transaction."*

**18. 50(a)(6)(M)(iii)**
may be closed within one year of previous Home Equity loan on the property if state of emergency has been declared by the President or Governor for the area where the homestead is located;

**19. 50(a)(6)(N)**
is closed only at the office of the lender, an attorney or a title company;

**Regulatory Commentary:**

**7 TAC Rule 153.15(1)** *"An equity loan may be closed at the permanent physical address of the office of branch office of the lender, attorney at law, or title company. The closing office must be a permanent physical address so that the closing occurs at an authorized physical location other than the homestead."*

**7 TAC Rule 153.15(2)** *"Any power of attorney allowing an attorney-in-fact to execute closing*

*documents of behalf of the owner or the owner's spouse must be signed by the owner or the owner's spouse at an office of the lender, an attorney at law, or a title company. A lender may rely on an established system of verifiable procedures to evidence compliance with this paragraph…"*

**20. 50(a)(6)(O)**
permits a fixed or variable rate of interest;

**Regulatory Commentary:**

**7 TAC Rule 153.16(2)** *"An equity loan must amortize and contribute to amortization of principal."*

**21. 50(a)(6)(P):**
is made only by a qualified Home Equity Lender:

- bank, savings and loan or credit union doing business under Texas or federal law;
- federally chartered lender or person federally approved to make federally insured loans;
- a person licensed in Texas to make regulated loans;
- a person who sold the homestead to the owner and provided financing for the purchase;
- a person related to the owner within the second degree of affinity or consanguinity;
- a person regulated by Texas as a mortgage broker;

**22. 50(a)(6)(Q)(i)-**
owner is not required to use loan proceeds to pay non-Homestead debt to Home Equity lender;

**23. 50(a)(6)(Q)(ii)**
owner has not assigned wages as security;

**24. 50(a)(6)(Q)(iii)**
owner has not signed document with blanks of "substantive terms";

**25. 50(a)(6)(Q)(iv)**
owner has not signed confession of judgment or power of attorney to lender or third party to confess judgment or appear for owner in judicial proceeding;

**26. 50(a)(6)(Q)(v)**
at closing, owner receives copy of final loan application and all executed documents;

**27. 50(a)(6)(Q)(vi)**
Deed of Trust discloses that it is a Home Equity loan;

**28. 50(a)(6)(Q)(vii)**
within "*reasonable time"* after loan is paid off, lender must cancel and return Note and provide recordable release of lien to owner or copy of assignment of the lien to lender who is refinancing the Home Equity loan;

**29. 50(a)(6)(Q)(viii)**
owner and "*any spouse of the owner"* may rescind loan within 3 days after closing *without penalty or charge;*

**30. 50(a)(6)(Q)(ix)**
owner and lender sign a written acknowledgement of fair market value of the homestead property on the closing date;

**50(a)(6)(h)**
*A lender …may conclusively rely on the written acknowledgement as to the fair market value….if:*

1. *the value acknowledged …is an appraisal or evaluation prepared in accordance with a state or federal requirements…"*
2. *the lender…does not have actual knowledge…that the fair market value stated in the written acknowledgement is incorrect."*

**31. 50(a)(6)(Q)(x)**
lender and any holder of the Note "*shall forfeit all principal and interest*" of the Home Equity loan "*if the lender or holder fails …to correct the failure to comply not later than the 60th day after the date the lender or holder is notified by the borrower of the lender's failure to comply by:"*

**Regulatory Commentary**

**7 TAC Rule 153.91 (a)** *"A borrower notifies a lender or holder of its alleged failure to comply with an obligation by taking reasonable steps to notify the lender or holder of the alleged failure to comply. The notification must include:*

*(1) Identification of the borrower;*
*(2) Identification of the loan; and*
*(3) Description of the alleged failure to comply.*
*(b) A borrower is not required to cite in the notification the section of the Constitution that the lender or holder allegedly violated."*

**7 TAC Rule 153.94**
*"(a) (T)he day after the lender or holder receives the borrower's notification is day one of the 60-day period. …*

*(b) If the borrower provides the lender or holder inadequate notice, the 60-day period does not begin to run."*

**7 TAC Rule 153.93**

"*(a) at closing, the lender or holder may make a reasonable conspicuous designation in writing of the location where the borrower may deliver a written or oral notice of a violation…*

*(d) If the lender or holder does not designate a location where the borrower may deliver a notice of violation, the borrower may deliver the notice to any physical address or mailing address of the lender or holder.*

**7 TAC Rule 153.94**

"*(a) the lender or holder may correct a failure to comply… on or before the 60th day …if the lender or holder delivers required documents, notices, acknowledgements, or pays funds by:*

*(1) placing in the mail, placing with other delivery carrier, or delivering in person the required documents, notices, acknowledgements, or funds;*

*(2) crediting the amount to the borrower's account;*

*(3) using any other delivery method that the borrower agrees to in writing…"*

**7 TAC Rule 153.95**

"*(a) If the lender or holder timely corrects the violation…then the violation does not invalidate the lien."*

*(b) A lender or holder who complies…to cure a violation before receiving notice…receives the same protection as if the lender had timely cured after receiving notice.*

*(c) A borrower's refusal to cooperate fully with an offer that complies …to modify or refinance an equity loan does not invalidate the lender's protection for correcting a failure to comply."*

**32. 50(a)(6)(Q)(x)(a)**

lender pays owner any overcharge;

**33. 50(a)(6)(Q)(x)(b)**

lender sends owner written notice that lien is valid only in the amount that the loan does not exceed 80% limit or is secured by ineligible property;

**34. 50(a)(6)(Q)(x)(c)**

lender sends owner written notice modifying any prohibited provision and adjusts borrower's account to be compliant

**35. 50(a)(6)(Q)(x)(d)**

lender delivers required documents to borrower or obtains required signatures;

**36. 50(a)(6)(Q)(x)(e)**

if there is another Home Equity loan already on the property, lender sends owner written notice that interest and other obligations are "*abated"* until the other Home Equity lien is released;

**37. 50(a)(6)(Q)(x)(f)**

if violations cannot be cured under the previous provisions, lender sends/credits owner with $1000 and offers to refinance loan with the same rate and at no cost to owner in order to comply with the law;

**Regulatory Commentary**

**7 TAC Rule 153.96**

*"(b) To correct a failure to comply…:(1) the lender or holder has the option to either refund or credit $1000 ; and (A) modify the equity loan without completing the requirements of refinance; or (B) refinance the extension of credit that complies with 50(a)(6).*

*(d) After a borrower accepts an offer to modify or refinance, the lender must make a good faith attempt to modify or refinance within a reasonable time not to exceed 90 days."*

**38. 50(a)(6)(Q)(xi)**

the lender and any holder "*shall forfeit all principal and interest"* if the lender is not an authorized Home Equity lender or if the lien was created without the consent of all owners and all owners spouses (unless all owners and spouses subsequently consent)

## V. SOME UNRESOLVED HOME EQUITY FINANCING ISSUES

### A. Are Home Equity Claims Subject to a Four-Year Statute of Limitations?

1. Background

Although 50(a)(6) contains many details for a compliant 50(a)(6) loan, it is silent on a limitations period for filing claims/lawsuits based on violations.

Texas law provides a residual four-year Statute of Limitations for laws that do not contain a limitations period.

> "*Every action for which there is no express limitations period, except an action for the recovery of real property, must be brought not later than four years after the day the cause of action accrues."*[14]

A majority of Texas courts have applied this residual four-year statute of limitations to 50(a)(6) cases filed more than four years after loan closing. A few courts have refused to apply the four-year statute of limitations.

The Texas Supreme Court has not addressed this issue, but a petition for review is currently before the Court.[15]

This issue first emerged in 2008 when the Dallas Court of Appeals in the case of *Rivera v. Countrywide Home Loans, Inc* applied the four-year statute of limitations to bar the plaintiff's 50(a)(6) claims.[16]

In 2001, the Riveras obtained a Home Equity loan from Countrywide Home Loans. As part of their loan documentation, the Riveras and Countrywide signed an acknowledgement of fair market value that the home was worth $350,000.

The appraisal obtained by Countrywide indicated that the property was worth between $261,040 and $293,580, not $350,000. Rivera was given a copy of the appraisal at closing.

Five years after closing, the Riveras fell behind in their payments and Countrywide initiated foreclosure proceedings.

The Riveras filed suit in state court, claiming Countrywide violated the requirements of 50(a)(6)(B) by lending more than 80% of the home's value at the time of closing. Countrywide filed for summary judgment, claiming the Riveras' claim was barred by the residual four-year statute of limitations. The trial court granted Countrywide's summary judgment.

The Riveras appealed. On appeal, the Riveras conceded that the four-year statute of limitations applied to their claim.

> "*The Riveras and Countrywide agree the four-year statute of limitations applies to the constitutional …causes of action.*"[17]

Rather than argue the applicability of the statute of limitations to a 50(a)(6) claim, the Riveras claimed the accrual date of their claim was "*the date of the final installment."*[18]

The Court of Appeals found that the Riveras' cause of action accrued on the date of closing. Because the Riveras did not argue the applicability of the four-year statute of limitations, the court did not address whether the four-year statute should even apply to the lawsuit.

After *Rivera*, other Texas courts applied the four-year statute of limitations to violations of Article 50(a)(6). In Schanzle v. JPMC Specialty Mortgage, LLC, the Austin Court of Appeals applied the four-year statute of limitations after a *pro se* appellant failed to properly brief the issue.[19] Federal courts followed the lead set by Texas courts and applied the four-year statute of limitations to 50(a)(6) claims.[20]

In 2011, a Federal District court in *Smith v. JPMorgan Chase Bank* refused to follow *Rivera* and decided that the residual four-year statute of limitations did not apply to 50(a)(6) violations.[21]

The *Smith* Court noted that the Texas Supreme Court had not addressed the issue whether the residual four-year statute of limitations applied to 50(a)(6) violations.

> "*As this Court's jurisdiction is based on diversity of citizenship, the task … is to determine and apply Texas law*". [22]

The *Smith* Court emphasized specific language of contained in Article 16, Section 50(c) of Texas Constitution:

> "*No mortgage, trust deed, or other lien on the homestead shall ever by valid unless it secures a debt described by this section*…"[23]

The Court noted that "*a noncompliant mortgage lien against a homestead is thus void ab initio*."[24]

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[14] Tex. Civ. Prac. Rem. Code §16.051.

[15] *Wood v. HSBC Bank USA, N.A.,* No. 14-13-00389-CV (Tex. App.—Houston [14th Dist.] 2014, pet. filed.).

[16] *Rivera v. Countrywide Home Loans, Inc*., 262 S.W.3d 834, 839 (Tex. App.—Dallas 2008, no pet.).

[17] *Id.* at 839 (*"The Riveras and Countrywide agree the four-year statute of limitations applies to the constitutional …causes of action.").*

[18] *Id.*

[19] *Schanzle v. JPMC Specialty Mortg. LLC,* 2011 WL 832170 (Tex. App.—Austin 2011, no pet.).

[20] *In re Ortegon,* 398 B.R. 431, 440 (Bankr. W.D. Tex. 2008); *In re Chambers*, 419 B.R. 652, 680 (Bankr. E.D. Tex. 2009); *Johnson v. Deutsche Bank Nat. Trust Co,* 2010 WL 4962897, *3 (S.D. Tex. 2010); *Hannaway v. Deutsche Bank Nat. Trust Co.,,* 2011 WL 891669 (W.D. Tex. 2011); *Reagan v. U.S. Bank Nat'l Ass'n,* Civil Action No. H-10-2478, 2011 WL 4729845 (S.D. Tex. Oct. 6, 2011); *Wiliams v. Deutsche Bank Nat. Trust Co.*, 2011 WL 891645 (W.D. Tex. 2011).

[21] *Smith v. JPMorgan Chase Bank, N.A.,* 825 F. Supp.2d 859 (S.D. Tex. 2011).

[22] *Id.* at 861.

[23] *Id.* at 867.

[24] *Id.* at 861.

The court found that a noncompliant Home Equity loan was "*void*" (not "*voidable*") but that the loan could be made legal and enforceable if the lender cured the violation within 60 days after receiving notice of such violation.

The *Smith* court distinguished prior cases and examined the language of Texas' residual four-year state statute of limitations. The Court noted that the residual four-year statute of limitations was inapplicable to an action for the *recovery of real property*, which presumably included the borrower's action to terminate the Home Equity lien.

As a final repudiation of the application of the residual four-year statute of limitations to 50(a)(6) violations, the court noted,

> "*Following Rivera would be to grant amnesty to errant lenders as a result of the passage of time, alone. The Court believes that justice for both parties is amply preserved by allowing the debtor to make his claim and allowing the lender to then invoke the cure provisions…"*[25]

A year later, in the case of Santos v. CitiMortgage, Inc., the Federal District Court for the Northern District of Texas addressed the same issue: *does Texas' residual four-year statute of limitations apply to 50(a)(6) violations?*[26]

The court in *Santos* was persuaded by the reasoning in *Smith* and found that the four-year statute of limitations was inapplicable to 50(a)(6) violations. The court distinguished between a borrower's claim that the lien is void and a suit for forfeiture of the equity loan's principal and interest.

According to *Santos*, the borrower's claim to terminate the Home Equity lien was not subject to a four-year statute of limitations period but the suit for forfeiture of all principal and interest was subject to a four-year statute of limitations.

2. The Priester Case

In 2013, the Fifth Circuit rejected the lower courts' analysis of *Smith* and *Santos* with its decision in *Priester v. JP Morgan Chase Bank, N.A.*[27]

In November, 2005, the Priesters obtained a $180,000 Home Equity loan from Long Beach Mortgage. Allegedly, they closed the loan in their own home, rather than the home of the lender, an attorney or title company as required under 50(a)(6)((N). They also claimed that they did not receive a copy of the Home Equity Notice as required under 50(a)(6)(M).

Five years after closing, the Priesters sent a "cure" demand letter to the holder of the Home Equity loan, JP Morgan Chase Bank. Chase took no action to cure the alleged violations.

Several months later, the Priesters filed suit in state court for declaratory relief that the loan was "void ab initio." Chase removed the case to federal court and moved to dismiss the suit, which was granted by the District Court. The Priesters appealed this dismissal.

On appeal, Fifth Circuit adopted the analysis of the state court cases of *Rivera* and *Schanzle* and found that 50(a)(6) claims were subject to Texas' residual four-year statute of limitations.

The court also distinguished between the "discovery rule" and "injury rule" for accrual of an action and was persuaded by the *Rivera* decision that a 50(a)(6) cause of action accrued from the date of loan closing.

> "*The injury occurred when the Priesters created the lien, and there was nothing that made the injury undiscoverable. The Priesters knew that the closing documents were signed in their living room and that they were not given notice of their rights. A lack of knowledge that that was a violation of the law is insufficient to toll limitations."*[28]

Under the *Priester* standard, Plaintiffs' prospects for 50(a)(6) lawsuits filed more than four years after closing are bleak. When such a suit is filed in state court, the out-of-state lender will remove the case to Federal court under diversity jurisdiction, then file for dismissal under Rule 12(b)(5), citing the 5th Circuit standard established in *Priester* .

Under the "rule of orderliness", all 5th Circuit courts are bound by the *Priester* decision, including the 5th Circuit itself. The power of this rule of orderliness is impressive.

In *Moran v. Ocwen Loan Servicing, LLC*, the Morans executed a Home Equity loan in 2002, defaulted ten years later and the lender commenced foreclosure. Moran then sent notice to the lender of alleged 50(a)(6) violations. The bank did not cure the alleged violations and Moran filed suit.[29]

The case was removed to federal court, the court granted the bank's motion to dismiss for failure to state a claim and the plaintiffs appealed to the 5th Circuit.

Citing *Priester*, the court upheld the lower court's dismissal and "*because Priester is controlling, we also deny the Morans' motion to certify"*. Although the Texas Constitution allows certified questions to the

[25] *Id.* at 868.
[26] 2012 WL 1065464 (N.D. Tex. 2012).
[27] *Priester v. JP Morgan Chase Bank, N.A.*, 708 F. 3d 667 (5th Cir. 2013).
[28] *Id.* at 675.
[29] *Moran v. Ocwen Loan Servicing, L.L.C.*, no. 13-20242, unpublished (5th Cir. 2014).

Texas Supreme Court, "*certification is not a proper avenue to change our binding precedent."*[30]

The conundrum for plaintiffs who file suit more than four years after loan closing is obvious: because of deference to the *Priester* precedent, if a 50(a)(6) case is removed to federal court, there is little chance that the court will permit certification of questions to the Texas Supreme Court regarding applicability of the four-year statute of limitations.

Fortunately, there is currently pending before the Texas Supreme Court a state court appeal that may provide a clear guidance whether the four-year statute of limitations applies to 50(a)(6) claims.

In *Wood v. HSBC,* Houston's 14th Court of Appeals affirmed the trial court's summary judgment for defendants based on the four-year statute of limitations. The case was appealed to the Texas Supreme Court and the Court may accept the appeal and address the issue.

The Texas Supreme Court has requested briefs on the merits from the parties, which are due by July 3, 2015. If the Supreme Court accepts the case, there should at last be clarity regarding the applicability of the four-year statute of limitations to 50(a)(6) claims.

3. Arguments Against the Application of Four-year Statute of Limitations to 50(a)

**a. Liens that Violate 50(a)(6) Requirements are Void.**

Article 50(u) of the Texas Constitution provides:

> "*No mortgage, trust deed, or other lien on the homestead shall ever be valid unless it secures a debt described by this section."*[31]

The Constitutional language is clear; "*no mortgage, trust deed or other lien on the homestead shall ever be valid"* unless is it complies with Section 50(a).

Liens that do not comply with of the requirements of 50(a)(6) are void *ab initio*. Under well settled Texas law, void liens, as opposed to voidable liens, are a cloud on title and are not subject to the four year statute of limitations.[32]

**b. Imposition of a Four-Year Statute of Limitations Would Undermine Texas' Longstanding Commitment to Protect the Homestead.**

Homestead protections in Texas are time-tested and vigorous. Texas was the first state to protect the homestead and last state to allow Home Equity financing.

When Home Equity lending was eventually authorized in 1997, it was purposefully filled with consumer protections. These safeguards had the single goal of protecting Texas homeowners. Limiting borrowers' rights to challenge Home Equity violations through the four-year statute of limitations would frustrate the purpose and spirit of Texas' homestead protections.

**c. Language of the Residual Four-Year Statute of Limitations Excludes Actions for the Recovery of Real Property**

The residual four-year statute of limitations provides:

> "*Every action for which there is no express limitations period, except an action for the recovery of real property, must be brought not later than four years after the day the cause of action accrue."* [33]

The courts in both *Santos* and *Smith* focused on the words "*except an action for the recovery of real property.*" The test of whether an action is one to recover real estate is if the title asserted by the plaintiff will support an action in trespass to try title. In Texas, where a deed is absolutely void, a trespass to try title suit may be maintained to recover land, irrespective of the residual four year statute of limitations.[34]

4. Arguments For Application of the Four-year Statute of Limitations

**d. The Constitutional Cure Provisions Make Non-Compliant Home Equity Liens *Voidable* rather than *Void***

Section 50(a)(6)(Q)(x) of the Texas Constitution provides a notice and cure period for non-compliant Home Equity loans.[35] The section allows borrowers to notify lenders of violations and gives lenders 60 days to "*cure*" the violations. Proponents argue that inclusion of this cure period makes non-compliant equity loans *voidable* rather than *void.*

A lender who is notified of a violation and does not cure within 60 days has a void lien. Until the expiration of the cure period, the lien is only *voidable.* The four year statute of limitations applies to voidable liens. Borrowers may not sleep on their rights; they must notify the lender of violations within 4 years or the voidable lien becomes valid.

**e. Application of the Four-Year Statute of Limitations is Fair**

[30] *Id.*
[31] Tex. Const. art. XVI, § 50(c).
[32] *See Tex. Land & Loan Co. v. Blalock*, 76 Tex. 85 (1890).
[33] Tex. Civ. Prac. Rem. Code § 16.051.
[34] *See Slaughter v. Qualls*, 162 S.W.2d 671, 674 (Tex. 1942).
[35] Tex. Const. art. XVI, §50(a)(6)(Q)(x).

Statutes of limitations provide legal closure to an otherwise open-ended threat of litigation. With the passage of time, evidence becomes stale, witnesses die, change careers or forget the details and documents are lost or destroyed.

Because of the catastrophic penalty for a lender's failure to cure 50(a)(6) violations, there should be a reasonable time limitation on the right of Home Equity borrowers to file suit.

**B. Are Incurable 50(a)(6) Violations Subject to the Four-Year Statute of Limitations?**

Section 50(a)(6)(Q)(xi) provides:

> "*the lender … shall forfeit all principal and interest …if the extension of credit is made by a person other than a person described under Paragraph (P) of this subdivision or if the lien was not created under a written agreement with the consent of each owner and each owner's spouse, unless each owner and each owner's spouse who did not initially consent subsequently consents.*"

If the lender was not an authorized Home Equity lender, then the violation cannot be cured. The previous discussion regarding the four-year statute of limitations involved violations that could have been cured if the borrower had timely notified the lender of those violations. With an unauthorized lender, the situation is different; under the terms 50(a)6)(Q)(xi), that violation could not be cured.

If not all owners and owners' spouses consent to the Home Equity lien, that violation also cannot be cured unless the missing parties subsequently consent.

1. Unauthorized Home Equity Lender

The issue of an unauthorized Home Equity lender was discussed in 2011 in *Boutari v. JP Morgan Chase Bank, N.A.*[36]

In *Boutari*, plaintiffs obtained a Home Equity loan in 1998 from Long Beach Mortgage. Long Beach Mortgage was not an "authorized lender" under Texas law.

Long Beach Mortgage obtained a license to originate Home Equity loans in Texas in October 1999, a year after the Home Equity loans were made to the plaintiffs in this case. The plaintiffs brought suit in 2009, 10 years after closing the original Home Equity loan.

In trial, plaintiffs argued that Long Beach Mortgage (who was later acquired by JP Morgan Chase) was not an authorized lender at the time the Home Equity loan was made, that this was an incurable violation and therefore not subject to the four year statute of limitations.

The plaintiffs relied on the 2003 amendment to support their assertion that an unauthorized lender was an incurable violation. The defendants responded that the claim was time-barred.

The District Court held that the claim was barred by the four-year statute of limitations. The loan was made before the constitutional cure provisions were adopted and those provisions did not have retroactive effect.

The Court reasoned that the plaintiffs' reliance on the 2003 amendment was an implicit admission that prior to 2003, any violation was curable. The Court further noted that even if the four-year statute of limitations did not apply, the defendants cured their violation when they became licensed in October, 1999.

The plaintiffs appealed the award of summary judgment and the Fifth Circuit affirmed the decision in a short, unpublished opinion.

2. Not all Owners and Owners' Spouses Consent to the Home Equity lien

The four-year statute of limitations was also applied in a case where the wife of the Home Equity borrower did not consent to the lien.

*Williams v. Wachovia Mortgage Corp.* involved a common law marriage. Robert Williams and Deborah Williams moved into a home in 1995.[37] In 2002, Mr. Williams took out a Home Equity loan from World Savings without the wife's knowledge or consent. The husband represented in his Home Equity loan application that he was an "*unmarried man.*"

After the Home Equity loan proceeds were spent, the husband informed the wife of the loan. In 2004, the wife filed divorce proceedings against the husband.. The husband denied the marriage but a jury found that they were married as common law husband and wife in 1992. The divorce was granted and the home in question was awarded to the wife.

In 2008, the wife brought suit against the holder of the Home Equity loan, Wachovia Mortgage, to remove cloud on title and to quiet title – she wanted the lien removed from her home.

Wachovia filed for summary judgment, claiming the issue of her non-consent was barred by the four-year statute of limitations. The trial court agreed and granted the motion.

The wife appealed to the Dallas Court of Appeals, who upheld the trial court's judgment. The wife ultimately appealed to the Texas Supreme Court but they denied the petition for review.

Section 50(a)(6)(Q)(xi), which provides for forfeiture of all principal and interest if not all owners and owners' spouses consent to the Home Equity lien,

[36] 429 Fed. Appx. 407 (5th Cir. 2011).

[37] 407 S.W.3d 391 (Tex. App.—Dallas 2013, pet. denied).

was added to 50(a) by a 2003 constitutional amendment. This provision was not in effect in 2002 when Mr. Williams' Home Equity loan was created. It is unclear whether the result in *Williams* would have been different if he had obtained the Home Equity loan after 2003.

### C. Does the Executed Acknowledgement of Fair Market Value Provide the Lender a Safe Harbor?

The Dallas Court of Appeals case, *Wells Fargo Bank v. Lonzie Leath*, is a sober reminder to lenders of the severe penalty for failing to cure a 50(a)(6) violation: forfeiture of all principal and interest and termination of the lender's lien.[38]

Lonzie Leath took out a $340,000.00 Home Equity loan in 2005 with H&R Block Mortgage, which was exactly 80% of the $425,000 appraised market value.

At closing, Leath signed an acknowledgement of that the fair market value of the home was $425,000, an amount based on an independent appraisal ordered by the lender. Leath used a substantial part of the Home Equity loan proceeds to pay off an existing mortgage on the property.

In 2008, Leath requested that the lender (now Wells Fargo) modify or restructure the loan to help him get "back on track financially." Wells Fargo refused and began foreclosure proceedings.

In response to Wells Fargo's application for foreclosure, Leath answered that the loan violated 50(a)(6)(B) because the loan exceeded 80% of the fair market value of the property at closing. He also alleged that he had notified Wells Fargo of this more than 60 days previously but that Wells Fargo had done nothing to correct this violation.

At trial, the appraiser who had prepared the $425,000 appraisal testified that the appraisal contained a written condition that certain repairs (estimated to cost several thousand dollars) were needed in order for the property to appraise at the full $425,000. Those repairs were not done before the loan closing.

The case was submitted to a jury on a single question: what was the market value of the property at the time of the loan closing?

The jury found that the market value of the home at the time of loan closing was $421,400 (presumably the $425,000 appraised value less the necessary and uncompleted repairs). The court took judicial notice that Leath's Home Equity loan of $340,000 exceeded 80% of $421,400.

The court then found that the loan violated the 80% limit set out in 50(a)(6)(B) and that Wells Fargo had not cured the violation within 60 days of notification. The court declared that the Home Equity lien was void and the principal and interest of the loan were forfeited. As a final blow, the Court awarded attorney's fees to Leath's attorney.

Wells Fargo argued on appeal to the Dallas Court of Appeals that Leath failed to give proper of notice to Wells Fargo of the violations, as required by 50(a)(6)(Q)(x).

The Court of Appeals found that Leath's answer to the foreclosure application was sufficient notice to satisfy the Home Equity requirements. Because "*the issue of notice was conclusively established by the evidence of the record…it was unnecessary to submit the question (to the jury) of whether Leath notified Wells Fargo of its alleged non-compliance…*"[39]

A mutually executed acknowledgment of fair market value should provide a safe harbor for a Home Equity lender but in this case, it appears the lender was aware, or should have been aware, that the $425,000 appraised value was dependent on completion of certain repairs before closing, which repairs were not done.

> *"A lender or assignee for value may conclusively rely on the written acknowledgment as to the fair market value of the homestead made in accordance with this Subsection…if:*
>
> *(1) The value acknowledged to is the value estimate in an appraisal or evaluation prepared in accordance with a state or federal requirement…; and*
> *(2) the lender…does not have actual knowledge…that the fair market value…is incorrect."*

The record indicates a substantial portion of the Home Equity proceeds were used to pay off an existing, valid mortgage on the homestead. Wells Fargo should have been subrogated, and their lien should have been valid, for at least the amount spent to pay off the prior lien.[40]

Wells Fargo appealed to the Texas Supreme Court, which denied the petition.

### D. Will the New Federal Loan Disclosures Impact Texas Home Equity Loans?

Texas Home Equity loans are subject to the new home loan disclosure requirements mandated by Dodd-Frank and implemented by the Consumer Financial Protection Bureau that take effect August 1, 2015.[41]

[38] 425 S.W.3d 525 (Tex. App.—Dallas 2014, pet. denied).

[39] *Id.* at 533.

[40] *Id.* at 540.

[41] 12 C.F.R. 1026 (2011).

The Consumer Financial Protection Bureau (CFPB), the new federal consumer protection agency created under Dodd-Frank in 2010, has issued a number of mortgage-related regulations that have had a powerful impact on the entire mortgage industry.

Beginning with loan applications received on or after August 1, 2015, new borrower disclosure documents will be required for all mortgage loans, including Texas Home Equity loans.

All home loan lenders (including Home Equity lenders) will be required to provide a new disclosure at loan application called the "Loan Estimate", which combines the current Good Faith Estimate of Closing Costs and the Early Truth in Lending Disclosure.

Three days prior to loan closing, the borrower must receive a new disclosure called the "Closing Disclosure", which combines the current HUD-1 Settlement Statement and the final Truth in Lending Disclosure.

The new forms are intended to provide borrowers with more and easier to understand loan information.

Both the Loan Estimate and Closing Disclosure contain a "loan purpose" box, which informs the borrower of their type of loan: purchase, refinance, construction, or home equity.

If any of the Home Equity loan proceeds are used to pay off an existing mortgage on the property, the Texas Home Equity loan must be classified as a "refinance."

The Home Equity loan will be classified as a "Home Equity" on the Loan Estimate and Closing Disclosure only if none of the proceeds are used to pay off an existing mortgage.

### E. Is a Military Power of Attorney Subject to the Standards Established by the Texas Supreme Court in the Norwood Decision?

The Texas Supreme Court in *Finance Commission of Texas v. Norwood* made clear that a power of attorney used to execute Home Equity loan documents must have been executed in the office of a lender, title company or attorney.[42]

After the *Norwood* decision, the Finance Commission modified Texas Administrative Code §153.15(2) to reflect the Supreme Court's decision. A lender may rely on an established system of verifiable procedures to evidence compliance with the power of attorney requirement.

The requirements for military powers of attorney are set out in 10 U.S. Code §1044b. That section provides in section (a) that a military power of attorney is "*exempt from any requirement of form, substance, formality, or recording that is provided for powers of attorney under the laws of a State; and shall be given the same legal effect as a power of attorney prepared and executed in accordance with the laws of the State concerned.*"

Is the Texas Supreme Court's ruling regarding execution of the power of attorney considered a "form, substance, formality…under the laws of a State…"?

The Texas Supreme Court in *Norwood* discussed the military power of attorney and implied that when Military powers of attorney are used for Home Equity loans, they also must be executed in accordance with the Court's rule.

> "*For the military, the Judge Advocate General Corps provides lawyers here and abroad. We recognize that JAG lawyers may not be as accessible to military personnel as civilian lawyers are…but we also recognize that soldiers and sailors in harm's way are no less susceptible to being pressured to borrow money and jeopardizing their homes than people in more secure circumstance."*[43]

There appears to be a conflict between the language of the federal statute and the requirements set out in the Norwood ruling and that conflict will need to be resolved.

### F. How Can a Lender Correct a Home Equity Closing that Used an Improperly Executed Power of Attorney?

This violation appears curable under 50(a)(6)(Q)(x)(f) by refunding/crediting the borrower $1,000 and offering to re-execute the loan with the properly executed power of attorney.

### G. May a Lender Modify a Home Equity Loan to Include Amounts Advanced on Behalf of a Borrower for Past-Due Taxes and Insurance?

The Texas Supreme Court recently answered "yes" to this question in *Sims v. Carrington Mortgage Services, L.L.C.*[44].

In 2003, Sims obtained a 30-year Home Equity loan. In 2009, they fell behind on their payments and entered a "Loan Modification Agreement" with Carrington Mortgage Services, LLC. The modification agreement capitalized the past-due interest, unpaid taxes and insurance premiums. The interest rate and monthly payments were reduced.

Two years later, the Sims again fell behind and the lender commenced foreclosure proceedings. The Sims resisted, claiming the 2009 modification violated constitutional requirements for Home Equity loans.

The parties entered a second modification agreement, further reducing the interest rate and payments. Both the 2009 and 2011 modifications

[42] 418 S.W.3d 566 (Tex. 2014).

[43] *Id.* at 597.

[44] 440 S.W.3d 10 (Tex. 2014).

provided that all other obligations set out in the original loan documents remained in full force and effect.

The original loan documents required that Sims pay taxes, assessments and insurance premiums and also authorized the lender to "*do and pay for whatever is reasonable or appropriate"* to protect its interest in the property. Any amounts dispersed by lender to that end "*shall become additional debt of Borrower secured by this Security Instrument."*

Shortly after the second modification in 2011, Sims filed suit against the lender in Federal District Court. The borrowers alleged that the modifications violated the requirements of a Texas Home Equity loan. The District Court granted summary judgment to the lender and the Sims borrowers appealed to the Fifth Circuit.

After oral argument, the Fifth Circuit certified four questions to the Texas Supreme Court:

1. *After an initial extension of credit, if a Home Equity lender enters into a new agreement with the borrower that capitalizes past-due interest, fees, property taxes, or insurance premiums into the principal of the loan but neither satisfies nor replaces the original note, is the transaction a new extension of credit for purposes of Section 50 of Article XVI of the Texas Constitution?*

*If the transaction is a modification rather than a refinance, the following questions also arise:*

2. *Does the capitalization of past-due interest, fees, property taxes, or insurance premiums constitute an impermissible "advance of additional funds" under Section 154.12(2)(B) of the Texas Administrative Code?*
3. *Must such a modification comply with the requirements of Section 50(a)(6), including subsection (B), which mandates that a Home Equity loan have a maximum loan to value ratio of 80%?*
4. *Do repeated modifications like those in this case convert a Home Equity loan into an open-end account that must comply with Section 50(t)?*

Sims argued that any increase in the principal amount of a Texas Home Equity loan constituted "a new extension of credit" and all the required disclosures and other requirements were imposed on the lender. They also argued that the lender violated the constitution when it increased the loan balance by capitalizing past due amounts, sending the loan to value ratio above 80%.

The Texas Supreme Court held "*the restructuring of a Home Equity loan that… involves capitalization of past-due amounts owed under the terms of the initial loan and a lowering of the interest rate and the amount of installment payments, but does not involve the satisfaction or replacement of the original note, an advancement of new funds, or an increase in the obligations created by the original note, is not a new extension of credit that must meet the requirements of Section 50."*[45]

The Court held that advancing past-due interest, taxes insurance premiums and other fees was not an "*advance of additional funds*" if the borrower was required to pay these amounts in the original loan agreement. "*The test should be whether the secured obligations are those incurred under the terms of the original loan."*[46]

Such advances merely deferred the borrowers' existing obligation under the loan agreement in a way that allowed the borrower to retain their home.

### H. May a Lender Modify a Home Equity Loan to Include Amounts Advanced on Behalf of a Borrower When Such Amounts Are Not Past-Due?

To date, there are no court decisions that directly address whether a Home Equity modification can include amounts for taxes, insurance and other items that are not yet past due.

The Texas Supreme Court's ruling in *Sims* discussed only capitalization of past-due sums that were the borrower's obligation under the loan documents. It is not clear if a modification could include not-yet-due amounts that are the responsibility of the borrower.

The typical Home Equity Deed of Trust requires the borrower to pay taxes and maintain insurance. The lender is authorized to pay those amounts if the borrower fails to do so. Payment of those items by the lender before they are past due may be considered an advance of "additional funds" that would necessitate a new Home Equity loan with all of its attendant disclosures.

Under the interpretive rules issued by the Finance Commission/Credit Union Department, "*an advance of additional funds to a borrower is not permitted by modification of an equity loan."*[47]

### I. Can a Home Equity Modification Provide for a Balloon Payment or for Interest-Only Payments?

[45] *Id.* at 17.
[46] *Id.* at 13.
[47] Tex. Admin. Code, tit. VII, §153.14(B).

The *Sims* decision did not address whether Home Equity modifications may include interest-only payments and require balloon payments.

Under Section 50(a)(6)(L), Home Equity loans must be "*scheduled to be repaid in substantially equal successive periodic installments*" and each installment "*equals or exceeds the amount of accrued interest as of the date of the scheduled installment."*

The Texas Finance Commission/Credit Union Department has interpreted this repayment requirement to mean that "*some amount of principal must be reduced with each installment*" and that "*this requirement prohibits balloon payments."*[48]

The same Rule states that the requirement for "*substantially equal successive periodic installments" "does not preclude a lender's recovery of payments as necessary for other amounts such as taxes, adverse liens, insurance premiums, collection costs, and similar items."*[49]

Does the phrase "recovery of payments as necessary" mean that if the lender advances amounts for past due taxes, they may require such advances to be repaid in manner that would not have been permitted in original Home Equity loan?

The Interpretive rules provide:

> "*A modification of an equity loan may not provide for new terms that would not have been permitted by applicable law at the date of closing of the extension of credit."*[50]

This interpretive rule prohibits repayment terms in the modification agreement that would not have been allowed at the initial closing.

Under 50(a)(6), a Home Equity loan has be repaid in "*substantially equal successive periodic installments*", which had been interpreted to mean that the loan must be amortized and may not be require a balloon payment. Further, "*some portion of principal must be reduced with each installment,"* which precludes interest-only payments.

If that rule applies to amounts advanced by the lender to pay past-due taxes, insurance, etc, then the modification agreement should also provide that such advances be repaid in "*substantially equal successive periodic installments*"

### J. Can a Home Equity Borrower Be Personally Liable for the Lender's Attorney's Fees?

In the recent case of *Wells Fargo v. Murphy*, the Texas Supreme Court held that Home Equity borrowers may be personally liable in separate legal actions filed by the borrower after the lender has commenced foreclosure proceedings.[51]

Section 50(a)(6)(C) provides that a Home Equity loan is "*without recourse for personal liability against each owner and the spouse of each owner, unless the owner or spouse obtained the extension of credit by actual fraud*." The only security for a Home Equity loan is the home. If the lender forecloses its lien and there is a deficiency, the lender is prohibited from pursuing the debtor for such deficiency.

In *Murphy*, the borrower received a Home Equity loan from Wells Fargo. Shortly after the loan was made, the borrower fell behind in payments and Wells Fargo initiated foreclosure proceedings.

The borrower filed a separate and original declaratory judgment proceeding against Wells Fargo. Under Texas Rules of Civil Procedure Rule 736.11(a), the separate filing by the debtor automatically stayed the Wells Fargo's foreclosure application and the state district court dismissed the application.

In the debtor's separate declaratory judgment action, Wells Fargo sought summary judgment and attorney's fees, which the trial court granted. Wells Fargo's attorney's fees totaled $116,505.75. The borrowers appealed.

The appellate court upheld the summary judgment but reversed the award of attorney's fees – claiming the award of attorney's fees violated Texas' prohibition on personal liability for Home Equity loans. Wells Fargo appealed to the Texas Supreme Court and the Court granted petition.

The Texas Supreme Court recognized the limitation of personal liability for Home Equity loans but noted that the limitation of personal liability relates only to charges incurred as part of the home equity loan. The attorney fees incurred by the lender in defending against the borrower's separate declaratory judgment action were not incurred enforcing the Home Equity note.

> *"Having initiated a separate and original proceeding, and having provided a mechanism for Wells Fargo to both incur and recover its attorney's fees, there is no basis for the Murphys to hide behind the nonrecourse status of their home-equity loan."*[52]

[48] *Id.* at 153.11 (3).
[49] *Id.* at 153.11(4).
[50] *Id.* at 153.14(D).
[51] 2015 WL 500636 (Tex. 2015).
[52] *Id.*

# OVERVIEW – ALTA VERSUS TEXAS TITLE INSURANCE ENDORSEMENTS (Ver. 1.3 – 5-11-15)

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**CHAPTER 17**

**Bio**

**Richard Worsham**

Richard Worsham is a 7th generation Texan and a 1985 graduate from the University of Houston Law Center. After law school, he spent 10-years handling commercial litigation, bankruptcy, and real estate workouts, primarily representing companies buying assets from the FDIC and RTC. In 1996 he founded a small law firm specializing in real estate and creditors' rights, became a fee attorney for Safeco Land Title and then Stewart Title, and over 10-years transitioned from being a litigator to a full-time real estate attorney.

In 2006 Mr. Worsham left private practice to join Title Resources Guaranty Company as underwriting counsel, where he stayed for 6-years. During his time at Title Resources, the company went from 6% of the Texas market to 9%, and expanded from doing business in 5 states to 26.

In 2012, Mr. Worsham joined the Houston office of First American Title's National Commercial Services division as underwriting counsel. At National Commercial Services, Mr. Worsham assists in closing numerous 8 and 9-figure transactions, working with large and small law firms, investors, REITs, and real estate developers throughout the United States.

Richard Worsham has extensive experience teaching realtors, escrow officers and attorneys. He was a speaker at the Texas Land Title Association's Land Title Institute in 2012, taught a webinar for the Texas Land Title Association in 2013, and taught at South Texas College of Law's Annual Real Estate Conference and for the Houston Bar Association in 2014. He has also taught seminars in the offices of many of the major law firms in Texas.

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# OVERVIEW – ALTA VERSUS TEXAS TITLE INSURANCE ENDORSEMENTS

## FORMS OF ENDORSEMENTS

The American Land Title Association, commonly known by the acronym ALTA, is not a state or federal regulator, but a trade association representing the title insurance industry. It promulgates forms with no obligation for anyone to use them, but these forms are generally used in 49 of the 50 states, and most territories of the United States. Texas is where ALTA forms are not used, because title insurance forms in Texas are promulgated by the state regulator, the Texas Department of Insurance ("TDI").

The California Land Title Association (CLTA), another trade association, also promulgates title insurance forms. These are not only used in California, but among most of the Rocky Mountain States and along the West coast. CLTA forms are often duplicative or virtually identical to ALTA forms, but the CLTA forms often have a greater diversity of versions applicable to specific situations. Because of the overlap of common provisions in CLTA and ALTA forms, because CLTA forms are not used in most of the United States, and in the interest of brevity, this paper does not address CLTA forms.

Behind the unofficial nature of the ALTA and CLTA forms are the various state regulators. Under the federal McCann-Ferguson Act, regulation of insurance companies is reserved to the various states, and each state's insurance department regulates the title insurance industry to a greater or lesser degree.

In some states where ALTA forms are used, the forms must be approved and adopted by the state agency, often with minor changes, before they can be used. These states may not have adopted all of the ALTA forms, and some endorsements may not be available there.

Some states are commonly called "filed form states," where the State does not have official forms, and often does not even approve the forms, but the title company must file the form with the state before it can be issued. These filed form states generally fall into two categories, those where if the form is filed by any title insurance company it can be used by any title insurance company, and those where the filed form may only be used by the company which filed it. Consequently, in some states you may find a form filed by one title company but not another, and so available from one title company but not another.

There are a handful of states where title companies are allowed to issue coverage on whatever forms they choose, and mostly ALTA forms are used in those states.

In addition to these ALTA and CLTA forms, in states other than Texas it is possible for the title company to draft its own forms, and we will occasionally see a form used that is specific to the title company using it. For example, the First American F.A. 61 form is commonly used for incremental coverage for mechanics liens in ALTA states, and there is no exact ALTA or CLTA equivalent. These sort of special endorsements are too specific to particular companies and particular circumstance to be covered by this paper.

In Texas, Procedural Rule P-35 of the Texas Basic Manual for Title Insurance states specifically that:

> "No Title Insurance Company, Title Insurance Agent, Direct Operation, Escrow Officer, nor any employee, officer, director or agent of any such entity or person, shall issue or deliver any form of verbal or written guaranty, affirmation, indemnification, or certification of any fact, insurance coverage or conclusion of law to any insured or party to a transaction other than: (i) a statement that a transaction has closed and/or has been funded, (ii) issuance of an insured closing service letter, or any insuring form or endorsement promulgated by the State Board of Insurance, or (iii) certification of copies of documents as being true and exact copies of the original document or of the document recorded in the public records."

Further, Texas Insurance Code Section 2703.101(c) states, "Unless authorized by rule adopted by the commissioner, an insurer may not enter into a contract or other agreement concerning an individual title insurance policy if the contract or other agreement is not expressed in the policy. A contract or agreement prohibited by this subsection is void."

That is, if the title insurance coverage is not on a Texas TDI promulgated form, it is not valid title insurance in Texas. You cannot issue title insurance using ALTA forms in Texas. Unfortunately, because ALTA forms are used every place else in the United States, a Texas attorney often sees lender instructions requesting ALTA forms, and this paper should allow you to interpret these instructions and converse with the lender about what coverage they can get.

## TYPES OF ENDORSEMENTS

A title insurance policy "jacket" contains the basic terms of the insurance policy, subject to the provisions of Schedule A, Schedule B and the endorsements. It is called the jacket because originally these were pre-printed folders with unique number identifiers and standard policy terms printed on them. Schedules and endorsements were placed inside of the jacket when

the policy was issued. Most policies are computer generated today, and the "jacket" will appear in the front and at the back of the schedules as the terms on normal printed paper.

The jacket is composed of three main parts, the Insuring Clauses, Exclusions from Coverage, and the Conditions. Simply stated, a title insurance policy is a contract of indemnity where the Title Company indemnifies and holds harmless the named Insured against certain events covered under the Insuring Clauses, subject to the Exclusions From Coverage, any special exceptions to title shown on Schedule B to the policy, and further subject to the stated Conditions and Stipulations to the policy.

Webster's defines an endorsement as "a provision added to an insurance contract altering its scope or application." A title insurance endorsement therefore is an amendment, change, alteration, deletion, or other deviation from the standard stated coverage, accomplished by deleting or amending an exclusion or condition/stipulation, or by providing coverage over what would otherwise be an exception to title, and therefore a non-covered matter.

The typical format of an endorsement will:

- Identify the name of the endorsement;
- Identify the policy it amends;
- State the amending language;
- Any limitations in coverage.

Limiting language will specify any conditions to the endorsement. One of these may be to specifically state whether the date of policy is changed by the endorsement, or if the amendment applies back to the original effective date of the policy. As a general rule, an endorsement will not change the effective date of the policy unless expressly stated.

Endorsements are often described as loan policy endorsements or owner policy endorsements, which can be confusing since some endorsement forms are used for both, and some are specifically for one but not the other.

Endorsements commonly requested on *both* Owner's and Loan Policies include:

- Comprehensive endorsements, which generally have several coverages involving:
  - Minerals
  - CCR's
  - Encroachments
  - Private Rights
  - Occasionally other matters
- Survey Coverage
- Access
- Zoning
- Contiguity
- Leasehold
- Delete Arbitration

Endorsements Commonly available only for Loan Policies include:

- First Loss
- Usury
- Revolving Credit
- Variable Rate
- Tax Lot
- Subdivision
- Address
- Environmental Lien
- Tie-In (Aggregation)
- PUD
- Mezzanine
- Non-Imputation
- Co-Insurance

The list of endorsements in the Appendix shows if the endorsement is available on an OTP only, a loan policy only, or if it is available for both.

**ENDORSEMENTS COMMONLY REQUESTED ON BOTH OWNER & LOAN POLICIES**

*Comprehensive Endorsements, Also known as Restrictions, Encroachments and Minerals (ALTA 9, 28 & 35, TX T-19, T-19.1, T-19.2, & T-19.3)*

Originally this was the ALTA Form 9 Series of endorsements, which in turn inspired the Texas T-19 (Loan Policy) and T-19.1 (Owner's Title Policy). Comprehensive endorsements are the most commonly requested endorsement for both an Owner's Title Policy and a Loan Policy. Comprehensive endorsements originally combined coverage of several commonly requested endorsements into a single endorsement: (a) coverage for encroachments, (b) violations of covenants, conditions and restrictions ("CCR's), and (c) damages to improvements for mineral production. While the Texas T-19 and 19.1 can still be characterized as comprehensive endorsements, the current ALTA endorsements really are not.

ALTA Revisions

In 2012-2015, the ALTA Forms Committee extensively revise the ALTA 9 coverage, producing 9 different versions of the ALTA 9, some for the Owner's Title Policy ("OTP") and some for the Loan Policy:

- ALTA 9.1 – Unimproved Land - CCR's - OTP
- ALTA 9.2 – Improved Land - CCR's – OTP
- ALTA 9.3 – CCR's – Loan Policy
- ALTA 9.6 – Particular "private rights", CCR's – Loan Policy
- ALTA 9.6.1 – Same as 9.6, but "private rights" coverage limited to date of policy
- ALTA 9.7 – CCR's, encroachments, minerals, land under development – Loan Policy
- ALTA 9.8 – CCR's, encroachments, minerals, land under development – OTP
- ALTA 9.9 – Particular Private Rights and CCR's – OTP
- ALTA 9.10 – CCR's and Encroachments – Loan Policy
  (ALTA 9.4 and ALTA 9.5 were withdrawn in 2012)

Generally, the ALTA 9.1, 9.2, and 9.3 protect the insured from violations of covenants, conditions and restrictions existing at the time of closing. The ALTA 9.7 and 9.8 provide more comprehensive coverage for land under development, *provided* you build the property to particular defined "Plans." The ALTA 9.6, 9.6.1, and 9.9 insure against particular private rights, which include leases, rights of first refusal, options, and, for the loan policy only, private assessments such as property owner's association dues. The 9.6.1 was added in April, 2015, for the specific purpose of limiting the private rights coverage to the date of the policy, to avoid title company liability for future property association assessments. The ALTA 9.10 covers CCR's and some encroachments, but not minerals.

To provide coverage similar to the older ALTA 9 forms, the policy now needs an endorsement from two additional endorsement groups, the ALTA 28 series for encroachments into setback lines, easements, and across property lines, and the ALTA 35 series to protect against damages to improvements from development of minerals.
ALTA 28 forms include:

- ALTA 28 – Encroachment into easements
- ALTA 28.1 – Encroachment into easements, setback lines, property lines.
- ALTA 28.2 – Assures specified improvements do not encroach.
- ALTA 28.3 – Encroachment coverage for new construction built to specified plans. (The ALTA 28.3 was only added as of April, 2015.)

ALTA 35 forms include:

- ALTA 35 – Enforced removal of buildings for mineral production.
- ALTA 35.1 – Enforced removal of "improvements" as defined.
- ALTA 35.2 – Enforced removal of specifically listed improvements.
- ALTA 35.3 – Enforced removal of improvements for new construction built to specified plans.

The 2012-2015 revisions to these forms define coverage more clearly by both adding definitions for certain terms and specifically carving out certain coverage. These changes include:

- Defining the term "covenant" in all of the ALTA 9 series forms.
- Defining "improvement" in all ALTA 9 and ALTA 35 series forms.
- Defining "future Improvement" and "plans" in the ALTA 9.7 and 9.8
- In each of the ALTA 9 and ALTA 35 series forms, listing matters specifically not covered by the particular endorsement.

Notes on Plans

One of the more important innovations of the ALTA 2012 changes introduced, and not just particular to the comprehensive series of endorsements, is that all endorsements drafted specifically for new construction now insure only if the property is properly built according to specified plans, which must be described in the endorsement by architect or engineering firm, project name, date, and number of pages.

If an attorney is requesting an endorsement for new construction, he or she must be prepared to provide such plans in advance for review by the title insurance company's underwriting counsel. Some consideration should be given in planning with the engineer or architecture to have suitable plans with a graphic representation of the property as it is to be built in order to obtain the desired coverage.

This "Plans" requirement applies to the ALTA 3.2 (Zoning), 9.7 (lender CCR's), 9.8 (OTP CCR's), 35.3 (Minerals), 41.3 (Water), and the new (4/2/15) 28.3 (Encroachments).

Texas Comprehensive Endorsements

In Texas, the comprehensive endorsements, being the T-19 (loan policy) and T-19.1 (owner's policy) remain comprehensive. Until January of 2014, the T-19 and the T-19.1 remained similar to the pre-2012 ALTA 9 forms. When the Texas Department of Insurance decided to re-write the T-19 and T-19.1, instead of breaking up the coverage into separate endorsements as ALTA did, they added new

definitions and coverage limitations similar to what ALTA added or removed in re-writing the ALTA 9 and ALTA 35 in 2012. Unlike the ALTA forms, the T-19 and T-19.1 continue to provide a broad range of coverage in a single endorsement, while expanding coverage over prior versions.

Broadly, the T-19 and T-19.1 as revised cover the following matters:

- Violations of covenants
- Encroachments
- Damages to improvements from production of minerals.
- New coverage for "Private Rights"
- New coverage for existing violation of an environmental covenant that is filed of record.

Insurance against private rights is a new coverage for the Texas T-19 series, similar to coverage contained in the 2012 revised ALTA 9.6, and is defined in the endorsements to include coverage against the following:

- Option to purchase
- Right of 1st Refusal
- Right to approve a future purchaser
- In the T-19 (loan policy) only, a private charge or assessment.

The revised T-19 and T-19.1 also define "covenant" to include only covenants in effect on the date of the policy.

The revised T-19 and T-19.1 also now clearly limit certain coverage, with new provisions similar to those adopted by ALTA in 2012 for the revised ALTA 9 and ALTA 35 endorsements. These include carving out coverage for:

- Any covenant requiring maintenance, repair, or remediation on the Land.
- "contamination, explosion, fire, fracturing, vibration, earthquake, or subsidence…"
- "negligence" by anyone exercising a right to develop minerals on the land.
- covenants contained in leases
- covenants related to environmental protection (except a notice of violation filed of record).

Procedural Rule P-50 of the Texas Basic Manual for Title Insurance authorizes deletion of any particular insuring provision in the T-19 or T-19.1 which the title company considers an unacceptable risk.

The Texas T-19.2 and T-19.3

A few years ago, a banking attorney in Dallas wrote the Texas Department of Insurance complaining that Texas title insurance commitments and policies were using a general exception to minerals, which appeared to be a violation of Procedural Rule 5 of the Texas Basic Manual for Title Insurance. TDI initially agreed, and informed the title companies that they had to except to specific mineral matters filed of record. The Texas Land Title Association ("TLTA") then objected that TDI had been licensing small title agents with 25-year title plants which could not search back far enough to make a determination of mineral ownership, and that a general exception was therefore necessary. TDI then withdrew its letter and set hearings to make a determination as to how mineral exceptions would be handled in Texas. These hearings resulted in Procedural Rule P-5.1, authorizing use of a general mineral exception, and TDI promulgating two specific endorsements to cover only damages to improvements from mineral production, the T-19.2 and the T-19.3.

Originally, TDI said that the T-19.2 or T19.3 were mandatory if title companies used the general mineral exception. The Texas legislature subsequently overruled TDI, and said TDI could not make the forms mandatory. At the end of 2013 TDI re-wrote the Procedural Rule governing issuance of these endorsements, Rule P-50.1, to make clear the issuance was permissive rather than mandatory. Unfortunately, the way TDI originally wrote the rule implied these endorsements could be issued at any time and was mandatory only when the general mineral exception was used, but the way it was re-written implies the T-19.2 and T-19.3 can ONLY be issued when the general mineral exception is used.

The common question is when do you use the T-19.2 or the T-19.3? The answer is set forth in procedural rule P-50.1 as follows, and is not as clear as you might wish:

**A. "As to real property of one acre or less improved or intended to be improved for one-to-four family residential use, the Company upon request by the insured and if it meets the Company's underwriting standards may issue its Minerals and Surface Damage Endorsement (Form T-19.2) to an Owner's or Loan Policy.**

**B. "As to real property improved or intended to be improved for office, industrial, retail, mixed use retail/residential, or multifamily purposes, the Company upon request by the insured and if it meets the Company's underwriting standards may issue its Minerals and Surface Damage Endorsement (Form T-19.2) to an Owner's or Loan Policy.**

**C. "As to other real property, the Company upon request by the insured and if it meets the Company's underwriting standards may issue its Minerals and Surface Damage Endorsement (Form T-19.3) to an Owner's or Loan Policy."**

The difference between the 2 forms is minimal. The 19.3 insures against damage to, "..permanent buildings..," and the 19.2 insures against damages to, "improvements (excluding lawns shrubbery, or trees).." both saying "…located on the Land on or after Date of Policy…" Otherwise the forms are identical.

*Survey Coverage (ALTA 25, Survey Deletion)*

The ALTA 25 insures that the property is the same as that set forth on a particular survey, described in the endorsement. The ALTA 25.1 insures that the property is the same as a portion of the survey, in case you are insuring a small pad site in a large shopping center.

Texas has no survey endorsements. Instead, the insured can pay to get "survey deletion." The standard Texas survey exception states, "Any discrepancies, conflicts, or shortages in area or boundary lines, or any encroachments or protrusions, or any overlapping of improvements." Survey deletion reduces it to, "shortages in area." This implies discrepancies, conflicts, boundary lines encroachments, protrusions or overlapping of improvements would be covered, although deleting this provision does not mean that the policy says so, and leaves much open to interpretation.

TDI provides for no "same as survey" coverage, and the customer must rely on their surveyor to have E&O coverage. When an existing survey is used instead of having a new survey certified to the client, as is allowed in Texas to obtain survey deletion, the risk is somewhat raised for the attorney, since he becomes responsible for survey review.

For affirmative coverage against improvements encroaching across property lines, the ALTA 28 or the Texas T-19 or T-19.1 can be obtained.

However, see, *Lawyer's Title Insurance Company vs. Doubletree Partners, LP*, 739 F.3d 848 (5th Cir. 2014).

*Access (ALTA 17, 17.1 / TX T-23)*

A standard Texas and ALTA policy of title insurance insures "legal access" in its insuring provisions. This standard coverage does not insure the quality of the access or vehicular access. A T-23 or ALTA 17 Access Endorsement insures actual vehicular and pedestrian access to a named public roadway, and that the named roadway is physically open. In addition, the ALTA version insures that there is a right to use existing curb-cuts.

ALTA also has a form 17.1 that insures access via an easement when the land does not physically touch a public roadway, referred to as an Indirect Access Endorsement, usually used when the only access is via an easement benefitting the insured tract. Texas does not have a similar form. However, in Texas, if your filed documentation supports adding the easement tract as an additional insured tract, and your survey reflects the easement abuts both the primary property and the road, it is possible to get a contiguity endorsement insuring the easement tract is contiguous to the property benefitting from the easement, and get an access endorsement stating that the easement tract has access to a physically open public road.

In addition, ALTA has a Utility Access Endorsement, the ALTA 17.2-06, sometimes referred to informally as a "Utility Endorsement," which insures the owner or lender the property has access to specified utilities. An ALTA survey or other acceptable evidence must be provided to the title company showing the utility access exists in order to get this coverage. Texas has no similar coverage.

*Contiguity (ALTA 19, 19.1 / TX T-25, T-25.1)*

The Texas T-25 endorsement insures that, where there are 2-4 parcels, they have specified contiguous boundaries. This is identical coverage to the ALTA 19 endorsement. The Texas T-25.1 insures that 5 or more tracts are contiguous without the "…presence of any gaps, strips, or gores lying between…," but does not list specific boundaries. It is arguable the T-25.1 provides somewhat broader coverage than the T-25 because of its encompassing language. ALTA did not have multi-tract coverage similar to the T-25.1 until April of 2015, when the substantially similar ALTA 19.2 became available.

ALTA also has a form 19.1 which insures a single parcel is wholly contiguous, but Texas has no equivalent.

*Zoning*

The ALTA 3 (Unimproved Land), 3.1 (Improved Land) and 3.2 (Land Under Development) provide coverage in the event the property is not zoned as stated on the endorsement, and insures the proposed or present use is a permitted use under local zoning ordinances. The ALTA 3.1 endorsement further insures there is sufficient parking to satisfy the requirements of the applicable zoning ordinances. Typically issuance of these endorsements will require an independent zoning report, a zoning letter, surveyor statement, or other evidence or assurances from the local Planning Department.

Zoning coverage is not available in Texas, and is specifically excluded by the policy forms. Instead, the attorney can request the surveyor state what the zoning is, obtain a zoning report from a 3rd party provider, or

research the issue with the City and County authorities.

*Leasehold Owner/Lender(ALTA 13, 13.1 / TX T-4, T-5)*

In Texas, there are two endorsements used when the insured estate is leasehold rather than a fee interest, the T-4 (for an Owner policy) and a T-5 (for a Lender policy). The purpose of these endorsements is to amend the Conditions to properly reflect the leasehold interest rather than a fee interest. These endorsements also amend certain definitions in Section 1 of the policy, and change the method of calculating loss to a formula more appropriate to a leasehold situation. This includes certain consequential damages for relocating the Tenant and its Improvements to a new leasehold location.

The T-4 Endorsement is almost identical to the ALTA 13, and the T-5 endorsement is almost identical to the ALTA 13.1 for a loan policy, with no substantial differences in coverage.

Texas also has a T-4R Residential Leasehold Endorsement, which provides similar coverage to the T-4, but with simplified language.

On every leasehold policy that these endorsements are attached to, the "insured estate" on Schedule A should state it is a leasehold estate.

**COMMONLY REQUESTED LOAN POLICY ENDORSEMENTS**

*First Loss (ALTA 20 / TX T-14)*

In a loan policy, loss under the policy is not measured until after the Lender has executed its rights to any and all collateral. A T-14 First Loss endorsement offers coverage to a Lender under a Loan Policy when there are other uninsured tracts of real property securing the loan, without requiring the Lender to first pursue its remedies against the collateral. (Note that if all of the tracts are to be insured, they can be insured under one policy, or an Aggregation Endorsement can be obtained, described below.) The endorsement provides for payment when the Lender has a covered loss that results in the Lender becoming under secured, material impairment being defined as when the collateral is worth less than the amount of the secured debt. A high loan to value ratio may affect the title company's willingness to issue this endorsement.

Until 2006, there was no ALTA version of a First Loss endorsement. Each title insurer had their own version, substantially identical, which provided for coverage when the loss exceeded 10% of the loan amount. In 2006, ALTA adopted its version of the endorsement (ALTA 20), which provides identical coverage as the T-14 in the event the Lender believes becomes under secured as a result of the loss.

*Future Advance/Revolving Credit (ALTA 14, 14.1, 14.2, 43 / TX T-35*

The Texas T-35 endorsement is a near mirror of the ALTA 14 endorsement. The T-35 endorsement provides coverage against the invalidity, unenforceability or lack of priority of the lien as to each advance or re-advance made subsequent to the date of policy, or a failure to comply with the requirements of state law to secure such advances. In addition to the preceding coverage, the ALTA 14 also provides further coverage against the invalidity or unenforceability of the lien resulting from provisions of the loan agreement that provide for interest on interest charges, changes in interest rate, or the addition of unpaid interest to the outstanding principal balance.

ALTA also has a form 14.1 that excludes coverage for an advance made after the Lender has knowledge of the existence of an outstanding lien or encumbrance that arises after the date of policy and the date of an advance under the Credit Agreement. Finally, there is also an ALTA form 14.2 that applies specifically to Letters of Credit.

In addition, in December, 2013, ALTA adopted the ALTA 43 "Anti-Taint" Endorsement, which, on a revolving credit loan, insures against loss of priority if the loan decreases and then increases in value after the date of insurance. Local state law regarding lien priority may affect the ability of the title company to issue this endorsement.

*Variable Rate (ALTA 6, 6.1, 6.2 / TX T-33, 33.1)*

The Texas T-33 and the ALTA 6 are almost identical, and cover damages resulting from the invalidity or loss of priority of the insured mortgage resulting solely from the change in interest rate provided in the note. The ALTA 6.1 authorizes exception to statute or regulations concerning variable rate or loans, and has been withdrawn in some states because it is too similar to the ALTA 6. The ALTA 6.2 and Texas T-33.1 apply to variable rate loans with a negative amortization.

*Environmental Lien (ALTA 8.1. 8.2 / TX T-36, 36.1)*

The Texas T-36 endorsement, as well as its ALTA counterpart, the ALTA 8.1, insures against a loss of priority of the insured mortgage against an environmental protection lien filed under Federal or State law. In Texas, the T-36 is available only on property used "..for residential purposes." This not only includes 1-4 family residences, but also apartment complexes, nursing homes, dormitories and any other structure where people reside. In ALTA states, the ALTA 8.2 is available for commercial property.

In the Fall of 2013, Texas adopted the T-36.1 form as a commercial environmental endorsement similar to the ALTA 8.2. However, Rate Rule R-2 in

the Texas Basic Manual for Title Insurance states, *inter alia*, "A company shall not issue or deliver a policy, binder or endorsement until a rate therefor has been adopted by the Commissioner." The T-36.1 is therefore unavailable until the Texas Department of Insurance adopts a rate rule providing a charge for the endorsement. Given the normal scheduling for rate rule hearings by TDI, this is unlikely to occur before 2016.

*Tie-In (Aggregation) (ALTA 12, 12.1 / T-16)*

In the case of a single loan or series of loans secured by multiple properties, often in different states, the ALTA 12 Aggregation endorsement is used to allow the Lender to aggregate its coverage and spread it out over any of the listed properties/policies in any combination. Some states (such as Florida and New York) have restrictions about aggregating policies to cover properties outside state boundaries, but allow aggregation of sites within state lines, and for these ALTA has issued the ATLA 12.1. Texas does allow aggregation of policies insuring properties outside Texas, using the T-16, which is very similar to the ALTA 12.

Because the aggregation endorsement allows the insured to reach policies outside of the state for losses within Texas, and Texas has somewhat higher title insurance rates than other states, there is a tendency when requesting an aggregation endorsement for an attorney to undervalue the Texas property and overvalue the out of state property, thereby purchasing coverage in Texas at a discount. Procedural Rule P-66.B.2 of the Texas Basic Manual for Title Insurance requires, "When the land covered in the policy represents only part of the security of the loan(s), then the policy shall be written in the amount of the value of such land or the amount of the loan, whichever is the lesser." This means that where the insured is blatant in such valuations, the title company is not only within its right to state the policy must be issued for the value of collateral under P-66, but could be subject to fine by the Texas Department of Insurance if it fails to object. If interpreted by TDI to be an illegal kickback in violation of Procedural Rule P-53, TDI could also fine the insured, so the title company is not only protecting itself, but also the customer. Title companies tend to be liberal in interpreting P-66, but they cannot accept a property valuation from the insured that is both unbelievable and undocumented.

*Planned Unit Development (PUD) (ALTA 5, 5.1 / TX T-17)*

The T-17 and ALTA 5 PUD endorsements provide coverage to a Lender against:

- loss caused by a present violation of covenants;
- lack of priority to present and future assessments by an "association of homeowner's";
- forced removal of an improvement due to an encroachment; and
- failure of title due to a right of first refusal

In Texas, the T-17 may only be issued on "residential property" as defined in Procedural Rule P1.u of the Texas Basic Manual for Title Insurance (1-4 family residential or up to 200 acres primarily used for agricultural production and containing a residence). While the ALTA 5 could theoretically be issued on non-residential property, the reference to "association of homeowner's" makes clear it is intended for residential property as well.

ALTA also has the ALTA 5.1, which insures against enforcement of present home owner's assessments but no future homeowner's association assessments, for which there is no Texas equivalent.

The desirability of the ALTA 5.1 points out a common problem which occurs when issuing the T-17 in Texas. Many residential developments were developed before the legalization of home equity loans in Texas, and the restrictive covenants state that the homeowner's association assessments are subordinate to purchase money and home improvement loans only, since home equity or other cash out loans were not contemplated at the time. Also, some restrictive covenants do not contemplate making the homeowner's association assessments subordinate to mortgages at all. Issuing a complete T-17 would therefore make the title company potentially liable for the homeowner association assessments. The title company is authorized by Procedural Rule P-9.b(14) to delete any provision of the T-17 it considers unacceptable, and the title company may delete that portion of the T-17 endorsement insuring that the mortgage is superior to the homeowner's association assessments. (The good news for lenders here is that Texas has amended its laws for foreclosure of homeowner's association liens to require notice to any lienholder, so the lienholder can step in and protect its interest when it does not have T-17 coverage. This does make it incumbent on the lender to make sure ownership of the lien is clear on the real property records, so the lender can get proper notice.)

For some time there has been some overlap between T-17 coverage and T-19 coverage. The amendments to the T-19 effective January 3, 2014, adding so-called "private rights" coverage, increase this redundancy. Lenders in Texas are therefore asking for the T-17 less often. Further, the new "private rights" provisions in the T-19, which insure priority of

the insured lien over private assessments of all types, brings the issue of priority of property owner association assessments into the commercial side of the title insurance business, where it has not been a concern in the past. Note that the 2012 revisions of the ALTA 9.6 creates the same issue in states using ALTA forms.

*Non-Imputation and Mezzanine Endorsements (ALTA 15, 15.1, 15.2, 16 / TX 24, 24.1)*

The T-24 Non-Imputation Endorsement may be given when there is not an actual conveyance of the property, but rather when there is a change in the ownership interest of the business entity holding title to real property. This endorsement gives the new member or partner assurance that any knowledge from the exiting partners, shareholders or members that would cause a denial of a claim will not be imputed to the incoming new partners, shareholders or members. The underwriting guidelines for this endorsement require the existing owners execute an affidavit and indemnity agreement with the Title Company.

ALTA has 3 different Non-Imputation Endorsement forms to cover distinct fact situations, one for a Full Equity Transfer (ALTA 15), one to add an additional insured when a partner or equity member is added (ALTA 15.1) and the last to cover when there is only a partial transfer of an equity or ownership interest (ALTA 15.2).

Texas has an additional form, the T-24.1, termed a "Non-Imputation Endorsement (Mezzanine Financing)." Mezzanine financing is essentially anytime a lender has the ability to convert debt to equity in the project, thereby becoming an owner of the investing entity. Like any other incoming partner, shareholder or investor, the lender does not desire its coverage limited by imputed knowledge of the existing owners.

ALTA handles mezzanine coverage through an ALTA 16 Mezzanine Financing Endorsement, which provides similar coverage to the Texas T-24.1. Because these two forms have distinctly different headings, this often creates confusion as to the availability of mezzanine financing coverage in Texas.

*Co-Insurance ("Me Too") (ALTA 23/ TX T-48)*

On a large loan transaction, often a Lender will not allow a single Title Company to insure the full amount of the transaction as a single risk, and require the liability be shared between two or more companies as co-insurers. Usually one Title Company is designated to act as the "lead", and any other co-insurer can agree to rely on the lead Title Company's title exam and underwriting. This is accomplished by what some call a "me too" endorsement, which is exactly as its nickname implies. The Co-Insurance Endorsement binds the second Title Company to the same exceptions and coverage as provided by the lead, to the extent of the second Company's involvement in the co-insurance of the deal.

The form for doing this outside of Texas is the ALTA 23, and in Texas, the T-48. The forms are substantially the same. The catch in Texas is that if the transaction is less than $15-million, the T-48 cannot be issued, and the customer must instead get two title insurance policies. This rule has a financial impact. When the Texas T-48 is used in transactions exceeding $15-million, the premium on the total coverage is prorated between the two title insurance companies based on their percentage of the coverage assumed, whereas for amounts under $15-million, when the insured must get two separate policies, each policy is charged for separately. Since the premium rates decline as the policy coverage increases in Texas, getting separate policies for a transaction under $15-million incurs an additional financial cost within Texas. In ALTA states the ALTA 23 can be used in transactions of any value, and the premium is always prorated between the 2 companies.

On many large transactions the title insurance company may be reinsuring the transaction with another major underwriter whether or not the customer has requested coinsurance, and without the customer knowing unless they ask. Because there are few large underwriters, such reinsurance may be with the same underwriter the attorney is considering to coinsure the transaction. Further, Title Insurance companies generally use the ALTA Facultative Reinsurance Agreement or the TDI promulgated Facultative Reinsurance Agreement, which provide the insured with the right for a direct action suit against the reinsurer. This essentially puts the insured in the same legal position as coinsurance. Counsel may wish to ask the title company about reinsurance options before deciding whether coinsurance is needed.

*Assignment of Rents and Leases (ALTA 37, TX T-27)*

The Texas T-27 Assignment of Rents and Leases Endorsement may only be issued contemporaneously with a Loan Policy, and cannot be issued at a later date. It insures against loss sustained by a defect in the execution of the assignment and against the existence of a prior recorded assignment of the lessor's interest in the leases specified in the document. The title company must verify no previous assignment of rents and/or leases has been granted by the current or a prior owner, unless such an assignment was as additional security for a loan since released or being paid out of closing. A release of a deed of trust will normally be considered to have released the assignment of rents and leases related to the same loan. The conflict in assignments is most often encountered when the lender is asking for this endorsement in connection with a

second lien, and the first lien already contains an assignment of rents and leases.

The ALTA 37 is substantially similar to the Texas T-27, but whereas Texas Rule P-60 prohibits the T-27 from being issued on residential property, there is no such prohibition for the ALTA 37.

Both endorsement forms require reference to an assignment of rents in the Schedule B exceptions. Where the assignment of rents is instead contained within the deed of trust or mortgage agreement itself, it requires the form to be altered to reference the insured deed of trust or insured mortgage in Schedule A. While that is commonly done in ALTA states, there is no specific authority allowing such revision in the Texas Procedural Rules, though it is often done. The correct way to do it in Texas is to separately except to the assignment of rents and leases contained in the insured deed of trust in Schedule B, which is rarely done.

## COMMON ALTA ENDORSEMENTS WITH NO TEXAS EQUIVALENTS

*Water Endorsements (ALTA 41, 41.1, 41.2, 41.3)*

In December of 2013, the ALTA forms committee adopted the new ALTA 41 series water endorsements:

ALTA Endorsement 41-06 Water – Buildings
ALTA Endorsement 41.1-06 Water – Improvements
ALTA Endorsement 41.2-06 Water – Described Improvements
ALTA Endorsement 41.3-06 Water – Land Under Development

These endorsements are similar to the mineral coverage provided by the ALTA 35 endorsements, in that they protect improvements from damage due to development of water. These were somewhat inspired by the CLTA 103.5 Water Endorsement, commonly used in the Western United States. They may not be available in all ALTA states at this time.

Texas has not adopted any water endorsements at this time. While there is a standard promulgated exception in all Texas title insurance policies as to various water rights, which cannot be deleted, it does not appear to address private water rights.

*Usury (ALTA 27)*

The ALTA 27 insures there will be no loss of priority for the insured lien due to a finding that the debt secures a usurious note. In Texas the title insurance company can provide no coverage against usury.

*Tax Lot (ALTA 18, 18.1)*

The ALTA 18 endorsement insures that the insured property has its own separate tax parcel identification number and is not part of any other tax parcel. There is also a form 18.1 that provides the same coverage, except allowing for multiple tax parcels for the insured land.

While TDI allows no similar coverage, most title companies subscribe to a tax service, and will provide tax certificates for each property upon request.

*Subdivision (ALTA 26)*

The ALTA 26 Subdivision endorsement covers any loss resulting from failure of the land to be a separate and lawfully created tract of land pursuant to applicable local and state laws. There is no similar coverage available in Texas.

*Location (ALTA 22, 22.1)*

The ALTA 22 endorsement provides coverage to an Owner or a Lender against loss suffered if the insured property does not have certain identified improvements located thereon or the stated address proves to be incorrect. There is also an ALTA 22.1 endorsement that further assures the location of the improvements on the property according to an attached map, plat or survey. TDI provides for no such coverage, and the customer must rely on their surveyor on this issue in Texas.

## RESIDENTIAL ONLY ENDORSEMENTS

While most endorsements can be issued on both residential and commercial property, there are a handful of ALTA and Texas endorsements which only apply to residential property

*Texas Home Equity Loan Endorsements (TX 42, 42.1)*

Home equity loans and reverse mortgages were illegal in Texas prior to 1999, and it took a convoluted State Constitutional Amendment to legalize it, with many requirements unique to Texas. This results in two unique to Texas home equity endorsements, the T-42 and T-42.1, designed to insure compliance with Texas home equity lending laws. The T-42 is mandatory any time the title company insures a home equity lien in Texas. While the T-42.1 is technically optional, this endorsement was created based on FHA guidelines, and you will need this endorsement if your lender expects to sell the loan in the future.

The Texas Constitution provides that in order to be valid, a home equity loan and lien must be executed in the office of a Title Insurance Company, a licensed attorney or the lender. The cautious practitioner needs to know case law indicates the office of a licensed attorney means a Texas licensed attorney, and presumably this means the phrase “the office of a Title Insurance Company” is restricted to a Texas licensed title insurance company and office. Also, if the transaction is not closed in the office of the insuring title company, many portions of the T-42.1 must be

deleted, and this deletion may impair the ability to resell the home equity loan.

Title companies were commonly closing home equity loans using powers of attorney, but the Texas Supreme Court determined this can be done only if the power of attorney is executed in a location acceptable under the Texas Constitution for signing a home equity loan. *Finance Commission of Texas vs. Norwood*, 418 SW3d 566 (Tex. 2013).

*Reverse Mortgage Endorsements (ALTA 14.3, TX T-43)*

The Texas T-43 Reverse Mortgage Endorsement assures compliance with specific provisions of Texas Constitution applying to Reverse Mortgages, and compliance with certain provisions of FHA guidelines..

The ALTA equivalent is the, "ALTA 14.3 Future Advance (reverse mortgages)," which insures against:

- invalidity, unenforceability or lack of priority of the insured mortgage as security for advances,
- invalidity or unenforceability of the mortgage because of re-advances and repayments, lack of outstanding debt before an advance, and failure to comply with legal requirements for advances;
- failure of the insured mortgage to state the term for advances;
- failure of the insured mortgage to state the maximum amount secured;

- failure of the mortgagors to be at least 62 years old at Date of Policy
- invalidity, unenforceability or loss of priority of the insured mortgage because of adjustment of interest or addition of principal or interest

*Manufactured Housing Unit ("MHU") (ALTA 7.1, 7.2 / TX T-31)*

The Texas T-31 Manufactured Housing Endorsement insures that the land described in the policy and improvements thereon, including a manufactured housing unit identified by serial number, constitute real property. As simple as this insurance is, it is actually a fairly complicated process, and no attorney or title officer should close a property with a manufactured housing unit without carefully reviewing the Texas guidelines for obtaining and filing a Statement of Location from the Texas Department of Housing, contained on their web site.

ALTA divides their "Manufactured Housing Unit Conversion" Endorsement into a Loan Policy form, the ALTA 7.1, and an Owner's Policy form, the ALTA 7.2.

The ALTA 7.1 and 7.2 each insure that the MHU is part of the real property under local state law, that it is located on the land, that the owner of the land is the owner of the MHU, and that there are no liens attached to the MHU as personal property. The ALTA 7.1 additional insures that the lender's lien is enforceable against the MHU as well as the land, and that both the MHU and land can be foreclosed against in a single foreclosure procedure.

While the ALTA endorsements are more verbose, the Texas T-31 implicitly assumes much of the same obligations set forth in the ALTA 7 series by merely insuring the MHU is part of the real property.

*Condominium Endorsements (ALTA 4, 4.1 / TX T-28)*

The Texas T-28 Condominium Endorsement is a loan policy endorsement only, and insures against loss created by the unit not being a part of the condominium regime and the failure of the condominium declaration to meet the statutory requirements to the extent such failure affects the title to the unit. It also insures against violations of restrictive covenants unless a notice of violation of those restrictions has been filed in the real estate records and excepted to in Schedule B of the policy, and that those covenants do not provide for a forfeiture or reversion of title. Additional insured items are that any lien for charges or assessments do not have priority over the insured mortgage, the failure of the unit to be entitled to be assessed as a separate parcel, any obligation to remove improvements which encroach upon another unit or the elements of another unit, and the exercise of any right of first refusal to purchase the unit.

The T-28 has two ALTA counterparts, the ALTA 4 for loan policies only, and the 4.1 for both owner and loan policies. The ALTA 4 is essentially identical to the Texas T-28. The ALTA 4.1 is substantially the same, except it insures against any assessments being due on the date of closing rather than insuring priority of the lien over such assessments.

# Appendix A

*ALTA/TLTA COMPARISON CHART*

| ALTA | ENDORSEMENT | TDI | OTP | Loan |
|---|---|---|---|---|
| **3** | **Zoning - Unimproved Land** | **N/A** | XXX | XXX |
| **3.1** | **Zoning - Improved Land** | **N/A** | XXX | XXX |
| **4** | **Condominium** | **T-28** | | XXX |
| **4.1** | **Condominium** | **N/A** | XXX | XXX |
| **5** | **Planned Unit Development** | **T-17** | | XXX |
| **5.1** | **Planned Unit Development** | **N/A** | XXX | XXX |
| **6** | **Variable Rate** | **T-33** | | XXX |
| **6.1** | **Variable Rate, Regulations** | **N/A** | XXX | XXX |
| **6.2** | **Variable Rate, Negative Amortization** | **T-33.1** | | XXX |
| **7** | **Manufactured Housing Unit** | T-31 | XXX | XXX |
| **7.1** | **Manufactured Housing Unit-Conversion-Loan** | **T-31** | | XXX |
| **7.2** | **Manufactured Housing Unit-Conversion-Owners** | **T-31** | XXX | |
| **8.1** | **Environmental Liens** | **T-36** | | XXX |
| **8.2** | **Environmental Liens (Commercial)** | **T36.1** | | XXX |
| **9** | **Restrictions, Encroachments & Minerals** | **T-19/T19.1** | XXX | XXX |
| **9.1** | **CCR's Unimproved Land** | **T-19/T19.1** | XXX | |
| **9.2** | **CCR's Improved Land** | **T-19/T-19.1** | XXX | |
| **9.3** | **CCR's Loan Policy** | **T-19** | | XXX |
| **9.6** | **Private Rights – Loan Policy** | **T-19** | | XXX |
| 9.6.1 | Private Rights – Loan Policy | **T-19** | | XXX |
| **9.7** | **REM-Under Development** | **T-19/T19.1** | | XXX |
| 9.8 | CCR's-Under Development | T-19.1 | XXX | |
| 9.9 | Private Rts. | T-19.1 | XXX | |
| 9.10 | Current **Restrictions, Encroachments & Minerals** | **T-19** | | XXX |
| **12** | **Aggregation / Tie-In - Lender** | **T-16** | | XXX |
| **13** | **Leasehold - Owner** | **T-4** | XXX | |
| **13.1** | **Leasehold - Lender** | **T-5** | | XXX |
| **14** | **Future Advance - Priority** | **T-35** | | XXX |
| **14.1** | **Future Advance - Knowledge** | **N/A** | | XXX |
| **14.2** | **Future Advance - LOC** | **N/A** | | XXX |
| **14.3** | **Future Advance - Rev Mtg** | **N/A** | | XXX |
| **15** | **Non Imputation-Full Equity** | **T-24** | XXX | |
| **15.1** | **Non Imputation-Add'l Insured** | **N/A** | XXX | |
| **15.2** | **Non Imputation-Partial Equity** | **N/A** | XXX | |
| **16** | **Mezzanine Loan** | **T-24.1** | XXX | |
| **17** | **Access-Direct** | **T-23** | XXX | XXX |
| **17.1** | **Access-Easement** | **N/A** | XXX | XXX |
| **18** | **Tax Lot-Single** | **N/A** | XXX | XXX |
| **18.1** | **Tax Lot-Multiple** | **N/A** | XXX | XXX |
| **19** | **Contiguity-Multiple** | **T-25, T25.1** | XXX | XXX |
| **19.1** | **Contiguity-Single** | **N/A** | XXX | XXX |
| **20** | **First Loss** | **T-14** | | XXX |
| **22** | **Location** | **N/A** | XXX | XXX |
| **22.1** | **Location and Map** | **N/A** | XXX | XXX |
| **23** | **Co-Insurance** | **T-48** | XXX | XXX |
| **25** | **Same as Survey** | **N/A** | XXX | XXX |
| **25.1** | **Same as Portion of Survey** | **N/A** | XXX | XXX |
| **26** | **Subdivision** | **N/A** | XXX | XXX |
| **27** | **Usury** | **N/A** | | XXX |
| **28** | **Easement Encroachment** | **T-19/T19.1** | XXX | XXX |
| **28.1** | **Easement and Boundary Encroachment** | **T-19/T19.1** | XXX | XXX |
| 28.2 | Encroachment for Described Improvements | T-19/T19.1 | XXX | XXX |
| 28.3 | Encroachments Prop. Under Construction | T.19/T19.1 | XXX | XXX |
| **35** | **Minerals – Damage to Buildings** | **T-19/T19.1** T-19.2/T-19.3 | XXX | XXX |
| **35.1** | **Minerals – Damage to Improvements** | **T-19/T19.1** | XXX | XXX |

T-19.2/T-19.3

## Appendix A

*ALTA/TLTA COMPARISON CHART*
*(Continued)*

| ALTA | ENDORSEMENT | TDI | OTP | Loan |
|---|---|---|---|---|
| **35.2** | **Minerals – Described Improvements** | **T-19/T-19.1** T-19.2/T-19.3 | XXX | XXX |
| **35.3** | **Minerals – Land Under Development** | **T-19/T-19.1** T-19.2/T-19.3 | XXX | XXX |
| **N/A** | **Balloon Mortgage** | **T-39** | XXX | |

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**37th ANNUAL**
**ADVANCED REAL ESTATE LAW**
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**CHAPTER 18**

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American Bar Association Real Property, Trust & Probate Section – Member, Special Committee on In-House Counsel.

Finalist, Houston Business Journal, 2006 Best Corporate Counsel Awards
Member, College of the State Bar of Texas

Speaking experience – ABA RPTE Spring Symposia, ABA RPTE Webcast, University of Houston, Houston Bar Association, R.E. Section and Houston Paralegal Association Seminars.

**EDUCATION**
***Notre Dame Law School****, J.D. 1989.*
***Texas A&M University****, B.S. Petroleum Engineering May, 1986,*

**LANGUAGES**: Fluent spoken and written German. Fluent conversational Italian.

**PERSONAL**: Married with two children, 15 & 18. National MS Society Club 300 Top Fundraiser. Completed two MS-150 cycling events riding 170 miles from Houston to Austin.