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Equitable Subrogation Clarified

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On April 24, 2020, the Texas Supreme Court delivered an opinion in *Fed. Home Loan Mortg. Corp. v. Zepeda* holding that a lender who discharges a prior, valid lien on a borrower's homestead property is entitled to equitable subrogation, even if the lender fails to correct a curable defect in the loan documents. The decision is being hailed as a victory for lenders, but it is likely to benefit borrowers as well by making loans more readily available. Examining the home equity lending provisions of the Texas Constitution and the doctrine of equitable subrogation is necessary to understand the significance of the opinion.

Texas has long held homestead protections sacrosanct. In keeping with this policy, home equity lending was prohibited by the Texas Constitution prior to 1998. In that year, new provisions were added to Article XVI, Section 50 of the Texas Constitution that lifted the prohibition. Although home equity loans are now permissible, the new provisions contain, as *Garofolo v. Ocwen Loan Servicing LLC* calls it, "a litany of exacting terms and conditions." Since 1998, even more provisions have been added to Section 50.

The Takeaway

The doctrine of equitable subrogation allows a subsequent lienholder, by fully and "involuntarily" discharging a debtor's obligation, to take the lien-priority status of a prior lienholder. The Texas Supreme Court clarified Texas law, holding that a lender is still entitled to equitable subrogation even when it fails to correct a curable constitutional defect in the loan documents.

Likewise, Texas courts have long favored the doctrine of subrogation. Subrogation can be described as the substitution of one person for another with respect to a lawful claim or right. Under the right circumstances, one person steps into the shoes of another and is entitled to assert that other person's rights against a third party. The most familiar example occurs when an insurance company pays its insured for some injury to person or property caused by the negligence of a third party. The insurance company is then subrogated to the rights of

the insured against the third party and may pursue a claim against that third party.

'A Legal Fiction'

Three types of subrogation are recognized in Texas: contractual, equitable, and statutory. The *Zepeda* case deals with equitable subrogation. *Bank of Am. v. Babu*, a leading Texas case, describes equitable subrogation as follows:

> Equitable subrogation "is a legal fiction" whereby "an obligation, extinguished by a payment made by a third person, is treated as still subsisting for the benefit of this third person, so that by means of it one creditor is substituted to the rights, remedies, and securities of another." *First Nat'l Bank of Houston v. Ackerman,* 70 Tex. 315, 8 S.W. 45, 47 (1888); *accord Smart v. Tower Land & Inv. Co.,* 597 S.W.2d 333, 337 (Tex.1980). **It essentially allows a subsequent lienholder to take the lien-priority status of a prior lienholder.** *First Nat'l Bank of Houston,* 8 S.W. at 46–47; *Murray v. Cadle Co.,* 257 S.W.3d 291, 299 (Tex.App.-Dallas 2008, pet. denied). The general purpose of equitable subrogation is to prevent unjust enrichment of the debtor. *First Nat'l Bank of Kerrville v. O'Dell,* 856 S.W.2d 410, 415 (Tex.1993); *Murray,* 257 S.W.3d at 299.

A fitting (and common) example is found in the facts of the *Zepeda* case itself. In 2007, Sylvia Zepeda bought a home. She financed the purchase with a purchase money loan from CIT Group/Consumer Finance Inc., securing the loan with the homestead as collateral. In 2011, Zepeda refinanced with a cash-out home equity loan from Embrace Home Loans Inc., again using the homestead as collateral. Embrace paid off Zepeda's debt to CIT Group to obtain a release of CIT's claim, thus putting itself in first lien position. This payment is what established the right to equitable subrogation.

To establish equitable subrogation, two elements must be proven: first, that the party on whose behalf the claimant discharged a debt was primarily liable on the debt, and second, that the claimant paid the debt "involuntarily." There is no question that these elements were met. First, the primary liability for the original purchase money loan was Zepeda's, and Embrace paid it on Zepeda's behalf. Second, Embrace paid the debt in order to protect its interest in the collateral by obtaining the first lien on the property. Such a payment is not considered voluntary. As held in *McDermott v. Steck Co.*, paying a debt that, if left unpaid, would jeopardize the payor's interest is considered involuntary.

In accordance with Article XVI, Section 50, this loan was now allowed, but the lender was required to comply with the "litany of exacting terms and conditions" referenced in *Garofolo*. One of those conditions is the lender's signing of a form acknowledging the homestead's fair market value. In 2015, Zepeda notified Embrace of its failure to do so and requested that Embrace cure the defect within 60 days, as required. Embrace responded by sending another copy of the document, but failed to sign it. Later, Embrace sold the loan to the Federal Home Loan Mortgage Corp., also known as Freddie Mac.

Zepeda sent the same notice and demand to Freddie Mac, who did not respond. Zepeda filed a suit to quiet title, contending that due to the failure, Freddie Mac's lien was invalid. Freddie Mac asserted that it was

Cases Cited in this Article

Fed. Home Loan Mortg. Corp. v. Zepeda, 601 S.W.3d 763 (Tex. 2020).

Garofolo v. Ocwen Loan Servicing LLC, 497 S.W.3d 474, 477 (Tex. 2016).

Bank of Am. v. Babu, 340 S.W.3d 917, 925 (Tex. App.—Dallas 2011, pet. denied)(emphasis added).

McDermott v. Steck Co., 138 S.W.2d 1106, 1109 (Tex. Civ. App.—Austin 1940, writ ref'd).

Zepeda v. Fed. Home Loan Mortg. Corp., 935 F.3d 296, 301 (5th Cir. 2019).

LaSalle Bank Nat'l Ass'n v. White, 256 S.W.3d 616 (Tex. 2007) (per curiam).

Providence Institution for Sav. v. Sims, 441 S.W.2d 516 (Tex. 1969).

entitled to equitable subrogation because Embrace (its predecessor-in-interest) paid off the balance owed by Zepeda to CIT Group. The elements of equitable subrogation appeared not to have been challenged by Zepeda. Instead, she countered that Freddie Mac was not entitled to equitable subrogation because it failed to cure the defect in the loan documents. The case was decided on competing summary judgment motions in federal district court, where Zepeda prevailed. The district court held that, due to the negligence of the lender, the lender could not be entitled to equitable subrogation.

Freddie Mac appealed to the Fifth Circuit, which was tasked in the case with applying Texas law as to whether the lender's failure precluded it from invoking the doctrine of equitable subrogation. After a review of Texas decisions, the court interpreted Texas law as being silent on the issue and submitted the following certified question to the Texas Supreme Court for guidance:

> Is a lender entitled to equitable subrogation, where it failed to correct a curable constitutional defect in the loan documents under Section 50 of the Texas Constitution? (*Zepeda v. Fed. Home Loan Mortg. Corp.*)

The Supreme Court answered emphatically, "Yes." The court noted that Section 50 required the signed fair market value acknowledgement, but observed that the remedy for that failure, after failure to cure, was a forfeiture of all principal and interest on the loan *in an eventual foreclosure action*. Because Freddie Mac was not seeking foreclosure, that remedy did not apply. Then the court went on to review its decisions on equitable subrogation, stating that none of the decisions have ever considered any other factor than the lender's discharge of a prior, valid lien. In fact, the lender's right to subrogation is "fixed" when such a lien is discharged (*Fed. Home Loan Mortg. Corp. v. Zepeda*).

The court rejected Zepeda's argument that the amendments to Article XVI, Section 50 eliminated equitable subrogation rights. In doing so, it revisited its previous opinion in *LaSalle Bank Nat'l Ass'n v. White*. The right to equitable subrogation, it held, derives from the prior discharge of a valid lien. It does not derive from the lender's own lien, which was constitutionally invalid.

While this holding certainly protects mortgage lenders, it also benefits borrowers by assuring that lenders are better able to protect their interests in properties used as collateral. Without such assurances, lenders' risk would be significantly greater, and loans would be less readily available.

It should be noted that equitable subrogation is generally available only when the creditor's claim against the debtor is paid in full, although there are some exceptions. For an example, see *Providence Institution for Sav. v. Sims*.

Remember, too, that a lien obtained by application of the equitable subrogation doctrine is good only to the extent of the prior obligation that was paid off.

Nothing in this publication should be construed as legal advice for a particular situation. For specific advice, consult an attorney.

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