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HOME EQUITY LOANS IN TEXAS: MAINTAINING THE TEXAS TRADITION OF HOMESTEAD PROTECTION

*Julia Patterson Forrester**

JOE M^cKnight has long been an authority on Texas homestead law, teaching and writing on the subject from the point of view of legal historian, expert on matrimonial property rights, and scholar of creditor's rights. In fact, if any subject best embodies the intersection of these three interests of Professor M^cKnight, it is the law of the Texas homestead.¹ As a result, Professor M^cKnight teaches about the Texas homestead in courses on Texas matrimonial property rights, creditor's rights, and American legal history. In addition, he has written numerous articles on Texas homestead law² and has been involved in guiding the Texas Legislature in matters relating to the homestead.³

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1. My scholarly interests are slightly different—property law, real estate finance, and bankruptcy, but these also fuel my interest in the home, the homestead, and home mortgage financing. Thus, I, like Professor M^cKnight, am interested in Texas homestead law, especially with respect to liens on homestead property. See Julia Patterson Forrester, *Constructing a New Theoretical Framework for Home Improvement Financing*, 75 OR. L. REV. 1095 (1996) [hereinafter *Home Improvement Financing*]; Julia Patterson Forrester, *Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of Home Equity Financing*, 69 TUL. L. REV. 373 (1994) [hereinafter *Home Equity Financing*].

2. Joseph W. M^cKnight, *Mexican Roots of the Homestead Law*, ESTUDIOS JURIDICOS EN HOMENAJE AL MAESTRO GUILLERMO FLORES MARGADANT 291-304 (1988); Joseph W. M^cKnight, *Texas Homestead Law*, 17 TEX. TECH L. REV. 1307 (1986); Joseph W. M^cKnight, *Property Code Amendments* 85-2 TEX. ST. B. FAM. L. SEC. REP. 52 (1985); Joseph W. M^cKnight, *Protection of the Family Home from Seizure by Creditors: The Sources and Evolution of a Legal Principle*, 86 SW. L.Q. 369 (1983) [hereinafter *Sources and Evolution*]; Joseph W. M^cKnight, *Modernization of Texas Debtor-Exemption Statutes Short of Constitutional Reform*, 35 TEX. B.J. 1137 (1972); Joseph W. M^cKnight, *The Spanish Legacy in Texas Law*, 3 AM. J. LEGAL HIST. 222 (1959). In addition, Professor M^cKnight has written a section of the SMU Law Review's Annual Survey of Texas Law on either family law or matrimonial property each year since 1969, and these surveys frequently discuss homestead law issues. See, e.g., Joseph W. M^cKnight, *Family Law: Husband and Wife*, 53 SMU L. REV. 995, 1025-33 (2000); Joseph W. M^cKnight, *Family Law: Husband and Wife*, 52 SMU L. REV. 1143, 1164-70 (1999).

3. Professor M^cKnight was the principal draftsman of Article XVI, Section 51 of the Texas Constitution adopted in 1983 and of Chapter 41 of the Texas Property Code adopted in 1985.

I have been fortunate indeed to have a mentor like Joe M^cKnight in the office catty-corner to mine. I cannot count the number of times I have wandered into his office with an obscure question about homestead or creditor's rights law. He is always willing to discuss my problem, and I am pleased that he also comes to my office to discuss legal issues. I thus feel privileged to write for this issue of the *SMU Law Review* honoring Joe, and I have chosen for my subject the most significant recent change in Texas homestead law—the amendment of the Texas Constitution to permit home equity loans in Texas.

In the past five years, the legislature has proposed and the voters of Texas have approved some of the most drastic changes to Texas homestead law ever made. In November of 1997, Texas voters approved an amendment to the Texas Constitution that for the first time permits Texas homeowners to obtain home equity loans.⁴ Before the constitutional amendment became effective on January 1, 1998, Texas was the only state that prohibited home equity loans. Texas remains the state most protective of the homestead, in part, because of the numerous constitutional restrictions on home equity loans.

This Article examines home equity financing in Texas, focusing on how continued protection of the homestead shelters Texas homeowners from problems experienced by some homeowners in other states. In Part I of the Article, I briefly explore the history of homestead protection and home equity loans in Texas, a subject on which Joe M^cKnight literally wrote the book. In Part II, I discuss the growth of home equity loans in other states, the reasons for their popularity, and the problems that have arisen for homeowners who have been victimized by predatory lenders. Part III examines the constitutional amendment that ultimately permitted home equity lending in Texas, focusing on the consumer protection requirements of the provision and how they are aimed at preventing predatory lending practices. In Part IV, I discuss criticism aimed at the amendment and problems that have arisen in interpreting and applying it. Part V discusses the limited legislative response to these issues and the court cases interpreting the amendment. In the Conclusion, I address the criticisms of the constitutional provision and defend its consumer protection measures.

I. HISTORY OF HOMESTEAD PROTECTION AND HOME EQUITY LENDING

The notion of the homestead as property protected from the reach of creditors first developed on the Texas frontier.⁵ A statute of the Mexican

4. TEX. CONST. art. XVI, § 50(a)(6). The amendment also permits reverse mortgage loans for elderly Texas homeowners for the first time. *Id.* § 50(a)(7). Lenders initially would not make reverse mortgage loans because of conflicts between state constitutional requirements and federal regulatory requirements. Reverse mortgage loans are beyond the scope of this article.

5. M^cKnight, *Sources and Evolution*, *supra* note 2, at 369.

state of Coahuila y Texas extended exemption principles originating in Castilian law to land grants,⁶ and an act of the Republic of Texas defined exempt land to include the family home.⁷ When Texas became a state in 1845, the framers of the Texas Constitution placed a homestead exemption provision in the Constitution.⁸ Other states followed Texas' lead, and by the end of the nineteenth century, most American states had adopted some type of homestead protection either by statute or constitutional provision.⁹ In addition, federal bankruptcy law recognized the homestead by permitting a debtor to exempt property in bankruptcy to the same extent that it was exempt under the law of the debtor's domicile.¹⁰

The homestead exemption enacted in the Texas Constitution of 1845 and the statutory or constitutional homestead provisions of most states protected the homestead from the reach of general creditors. Therefore, a creditor cannot execute upon a debtor's homestead in satisfaction of a judgment. These provisions do not, however, limit the ability of creditors to obtain consensual liens on a debtor's homestead to secure the payment of a debt. Beginning with the adoption of the Texas Constitution of 1876, Texas law did.¹¹ Thus, Texas homeowners, unlike homeowners in other states, could not borrow against the equity in their homes.

Since 1876, the Texas Constitution has limited the types of debts that a Texas homestead could secure by making invalid any lien on a homestead other than the permitted types. Until 1995, a Texas homestead could secure only debts for purchase money, improvements, or taxes.¹² Minor additions were made to the list of permitted liens in 1995,¹³ but home equity loans were still not permitted. For many years there was pressure on the Texas Legislature to amend the Constitution to permit home equity loans, but all attempts at passing a resolution consistently failed.¹⁴ After 1986, when Congress eliminated the federal income tax deduction for

6. Actas del Congreso, Dec. 28, 1828, p. 930, Jan. 9, 1829, pp. 935-36, Jan. 10, 1829, pp. 936-37, Jan. 12, 1829, p. 937, Jan. 13, 1829, p. 938.

7. 2 H.P.N. GAMMEL, *THE LAWS OF TEXAS 1822-1897*, at 125, 126 (Austin, Gammel Book Co. 1898).

8. TEX. CONST. of 1845, art. VII, § 22.

9. McKnight, *Sources and Evolution*, *supra* note 2, at 396. Most states exempt a homeowner's equity in a homestead up to a specified value as did the 1845 Constitution. A few states follow current Texas law in exempting a homestead defined by area rather than value. See *infra* notes 124-125 and accompanying text.

10. See McKnight, *Sources and Evolution*, *supra* note 2, at 398. Current law permits a debtor in bankruptcy to elect the state or federal exemption scheme unless the state has opted out of the federal exemptions. 11 U.S.C. § 522(b) (2000). The federal scheme exempts the debtor's interest in a homestead not to exceed \$7500. *Id.* § 522(d).

11. TEX. CONST. art. XVI, § 50(a) (amended 1995).

12. *Id.*

13. In 1995, the Constitution was amended to permit liens for an owelty of partition and the refinance of a lien on the homestead, including a federal tax lien. TEX. CONST. art. XVI, § 50(a) (amended 1997).

14. Between 1979 and 1987, resolutions for amending the Constitution to permit home equity loans were introduced in each legislative session, but none of the bills ever made it out of committee in either house. House Research Org. Rep. No. 147, Special Legislative Report: Second Mortgages and the Texas Homestead Exemption 19 (Dec. 21, 1988). In

consumer interest¹⁵ and made home equity loan interest deductible,¹⁶ the pressure increased. Finally, in 1997, the legislature passed and the voters approved a constitutional amendment permitting home equity loans.¹⁷

II. THE HOME EQUITY LOAN EXPERIENCE IN OTHER STATES

A. GROWTH AND POPULARITY OF HOME EQUITY FINANCING

In the years prior to the amendment of the Texas Constitution to permit home equity loans, the total amount of home equity debt grew significantly in other states, increasing from \$60 billion in 1981 to \$357 billion in 1991.¹⁸ Home equity loans have been popular with borrowers and lenders for a number of reasons. For some borrowers, a home equity loan may be the only source of credit available. For other borrowers, a home equity loan may be available at a lower interest rate than an unsecured consumer loan or credit card advance. The deductibility of interest paid on a home equity loan is another important advantage of a home equity loan for borrowers. A homeowner may deduct interest paid on up to \$100,000 of home equity debt,¹⁹ while interest on other consumer debt is not deductible under current tax law.

Lenders have many reasons for favoring home equity loans including the obvious advantage of having security for the loans. A borrower's home is probably better security for a loan than other property because of the lengths to which homeowners will go to save their homes.²⁰ Other benefits of home equity loans arise because of advantageous treatment for home mortgage lenders under federal law that applies when they make home equity loans as well as purchase money and home improvement loans.²¹

1995, the Senate passed a resolution which would have permitted home equity loans. S.J. Res. 25 (1996) enacted.

15. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 511, 100 Stat. 2247 (repealed 1987).

16. See Revenue Act of 1987, Pub. L. No. 100-203, § 10-102, 101 Stat. 1330-382, 1330-384 to 1330-386 (codified at I.R.C. § 163(h) (2000)).

17. TEX. CONST. art. XVI, § 50(a)(6).

18. See U.S. General Accounting Office, Tax Policy: Many Factors Contributed to the Growth in Home Equity Financing in the 1980s at 12, 14 (1993).

19. I.R.C. § 163(h)(3)(A)(ii), (h)(3)(C)(ii) (1994).

20. In their study of individual debtors in bankruptcy, Professors Warren, Westbrook, and Sullivan found that homeowners in bankruptcy would go to great lengths to continue making home mortgage payments. TERRESA A. SULLIVAN ET AL., AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA 134-35 (1989).

21. Federal law preempts state usury law for loans made by federally-related lenders and secured by a first lien on residential real estate. See 12 U.S.C. § 1735f-7a(a)(1) (2000) (Depository Institutions Deregulation and Monetary Control Act of 1980). Therefore, a home equity lender may avoid state usury limitations by requiring a homeowner to pay off existing liens on the home with the proceeds of the home equity loan. Federal law also preempts state laws that restrict alternative mortgage financing arrangements such as loans with variable interest rates, balloon payments, or negative amortization. See 12 U.S.C. § 3803 (2000) (Alternative Mortgage Transaction Parity Act).

Bankruptcy law also treats home equity loans favorably. In a Chapter 7 liquidation, secured lenders are paid the full amount of their claims or are entitled to the property

For borrowers, there are disadvantages to a home equity loan as well as advantages. The obvious disadvantage is the risk of loss of the home in the event of default. A home equity loan is particularly disadvantageous in bankruptcy as compared to unsecured debt or debt secured by property other than the homestead.²² Finally, not all home equity loans have a low interest rate. Some poor, minority, and elderly homeowners pay outrageously high interest rates and fees on certain home equity loans that consumer advocates have labeled "predatory loans."²³

B. THE PREDATORY LENDING PROBLEM

Predatory loans are characterized by high interest rates and points that exceed the amount necessary to cover the lender's risk,²⁴ excessive fees and closing costs that are usually financed as part of the loan,²⁵ frequent refinancing or loan flipping with additional points and fees,²⁶ and outright fraud.²⁷ Borrowers are often required to refinance low interest rate

itself. In addition, long term loans secured by the debtor's principal residence cannot be modified in Chapter 11 or Chapter 13 as can unsecured loans or loans secured by property other than the debtor's home. 11 U.S.C. §§ 1123(b)(5), 1322(b)(2) (1994).

22. A debtor in Chapter 7 can discharge an unsecured loan but cannot retain a home without paying home mortgage debt in full. In Chapter 13, a loan secured by property other than the debtor's home can be modified, and if the loan is undersecured, the lien can be striped down to the value of the property. *Id.* § 1322(b)(2). However, a debtor with a long term home equity loan must pay the loan in full on its original terms in order to retain possession of the home.

23. See Forrester, *Home Equity Financing*, *supra* note 1, at 387-92.

24. See *Predatory Mortgage Lending: Hearings Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (2001) [hereinafter *Hearings on Predatory Mortgage Lending*] 2001 WL 857919 (statement of David Berrenbaum, Nat'l Community Reinvestment Coalition), 2001 WL 857910 (statement of Esther Canja, President, AARP); *Adding Injury to Injury: Credit on the Fringe: Hearing Before the Subcomm. on Consumer Credit and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 103d Cong. 16 (1993) [hereinafter *1993 Hearing on Credit*] (statement of Bruce Marks, Executive Director, Union Neighborhood Assistance Corp.). These homeowners may pay interest rates as high 39% per annum. Jack Meyers et al., *Firm Wrote Loans at 39% Interest*, BOSTON HERALD, June 17, 1991, at 1, 20. They may pay points totaling as much as 33 percent of the amount financed. *Problems in Community Development Banking, Mortgage Lending Discrimination, Reverse Redlining, and Home Equity Lending: Hearings Before the Senate Comm. on Banking Housing and Urban Affairs*, 103d Cong. 447 (1993) [hereinafter *1993 Hearings on Problems in Lending*] (letter from Elizabeth Renuart, Managing Att'y, St. Ambrose Legal Servs., to Sen. Donald W. Riegle Jr. (Feb. 17, 1993)).

25. See *Hearings on Predatory Mortgage Lending*, *supra* note 24, 2001 WL 857948 (statement of Irv Ackelsberg, Community Legal Services), 2001 WL 857911 (statement of John A. Courson, Mortgage Bankers Ass'n); *Mortgage Lending Abuses: Hearing Before the House Banking and Financial Services Comm.*, 106th Cong. 12 (2000) [hereinafter *Hearing on Mortgage Lending Abuses*] (statement of Gary Gensler, Undersecretary for Domestic Finance, Dep't of Treasury).

26. See *Hearings on Predatory Mortgage Lending*, *supra* note 24, 2001 WL 857948 (statement of Irv Ackelsberg, Community Legal Services), 2001 WL 857911 (statement of John A. Courson, Mortgage Bankers Ass'n), 2001 WL 857907 (statement of Judith A. Kennedy, Nat'l Ass'n of Affordable Housing Lenders); *Hearing on Mortgage Lending Abuses*, *supra* note 25, at 12 (statement of Gary Gensler, Undersecretary for Domestic Finance, Dep't of Treasury).

27. See *Hearings on Predatory Mortgage Lending*, *supra* note 24, 2001 WL 857940 (statement of Jeffrey Zeltzer, National Home Equity Mortgage Association), 2001 WL 857910 (statement of Esther Canja, President, AARP), 2001 WL 857911 (statement of

purchase money loans as part of the new higher interest rate home equity loan.²⁸ When a borrower has difficulty making payments on the predatory loan, the lender may encourage refinancing of the debt with a larger loan carrying a higher interest rate and requiring higher monthly payments and payment of additional points and closing costs.²⁹ Borrowers rarely obtain any benefit from a loan flip other than postponing a foreclosure, and they end up owing more after having paid additional points and fees to the same or another predatory lender. Predatory loans may also have other unfair terms such as high prepayment fees, balloon payments, and required credit insurance.³⁰ Fraudulent practices include falsifying loan applications, forging borrowers signatures, changing loan terms at closing, misrepresenting loan terms, physically obscuring key terms, and having borrowers sign documents with key terms left blank.³¹ In many cases, lenders make the loans without regard to the borrowers' ability to repay.³²

Predatory lending can be distinguished from subprime lending. Subprime lenders are those that serve higher risk borrowers and thus charge higher rates than prime lenders.³³ Not all subprime loans are predatory, although predatory loans are almost always subprime.³⁴ Most predatory loans are either home equity loans or home improvement loans.³⁵

The targets of predatory lenders are most often minorities, the elderly, and the inner-city and rural poor.³⁶ Borrowers from predatory lenders

John A. Courson, Mortgage Bankers Ass'n); *Hearing on Mortgage Lending Abuses*, *supra* note 25, at 12 (statement of Gary Gensler, Undersecretary for Domestic Finance, Dep't of Treasury).

28. See *Hearings on Predatory Mortgage Lending*, *supra* note 24, 2001 WL 857948 (statement of Irv Ackelsberg, Community Legal Services); *1993 Hearings on Problems in Lending*, *supra* note 24, at 447 (letter from Elizabeth Renuart, Managing Att'y, St. Ambrose Legal Servs., to Sen. Donald W. Riegle Jr. (Feb. 17, 1993)).

29. See *1993 Hearings on Problems in Lending*, *supra* note 24, at 447.

30. See *Hearings on Predatory Mortgage Lending*, *supra* note 24, 2001 WL 857923 (statement of Mike Shea, Executive Director, ACORN Housing Corp.), 2001 WL 857919 (statement of David Berenbaum, Nat'l Community Reinvestment Coalition).

31. See *Hearings on Predatory Mortgage Lending*, *supra* note 24, 2001 WL 857919, (statement of David Berenbaum, Nat'l Community Reinvestment Coalition); *1993 Hearings on Problems in Lending*, *supra* note 24, at 309 (statement of Scott Harshbarger, Att'y General, Commonwealth of Mass.).

32. See *Hearings on Predatory Mortgage Lending*, *supra* note 24, 2001 WL 857948 (statement of Irv Ackelsberg, Community Legal Services), 2001 WL 857919 (statement of David Berenbaum, Nat'l Community Reinvestment Coalition).

33. See *Hearings on Predatory Mortgage Lending*, *supra* note 24, 2001 WL 857911 (statement of John A. Courson, Mortgage Bankers Ass'n), 2001 WL 857919 (statement of David Berenbaum, Nat'l Community Reinvestment Coalition).

34. See *Hearings on Predatory Mortgage Lending*, *supra* note 24, 2001 WL 857911 (statement of John A. Courson), 2001 WL 857919 (statement of David Berenbaum, Nat'l Community Reinvestment Coalition), 2001 WL 857923 (statement of Mike Shea, Executive Director, ACORN Housing Corp.).

35. In recent years, however, subprime lenders have also entered the purchase money loan market. See *Hearings on Predatory Mortgage Lending*, *supra* note 24, 2001 WL 857923 (statement of Mike Shea, Executive Director, ACORN Housing Corp.) (making 6.6% of conventional home purchase money loans in 1999, up from 1% in 1993).

36. See *Hearing on Mortgage Lending Abuses*, *supra* note 25, at 12 (statement of Gary Gensler, Undersecretary for Domestic Finance, Dep't of Treasury), at 20 (statement of

usually have substantial equity in their homes due to rising real estate values or to reduction of purchase money debt, but are short on cash because of their low or fixed incomes.³⁷ They may need money to make home repairs or improvements, to pay for necessities such as medical care, or to consolidate household debts.³⁸ The elderly are particularly vulnerable because they typically have a great deal of equity in homes that they have owned for many years and because they are likely to be on fixed incomes.³⁹

Perpetrators of predatory lending practices include lenders, mortgage brokers, and home improvement contractors.⁴⁰ These parties seek out particularly vulnerable homeowners on whom to prey.⁴¹ Upon finding a likely prospect, a lender, broker, or contractor may use high pressure tactics or fraud to induce the homeowner to enter into an abusive loan transaction.⁴² Using unscrupulous and often illegal tactics, lenders may induce unsophisticated borrowers to enter into loan transactions with payments larger than their incomes can support.⁴³

Predatory lenders have been accused of making loans designed to fail so that the lenders can take title to borrowers' homes through foreclosure.⁴⁴ These lenders often make loans without regard to the borrower's ability to repay, relying instead on the borrower's equity in the home to

Donna Tanoue, Chairwoman, FDIC); 1993 *Hearings on Problems in Lending*, *supra* note 24, at 254 (statement of Scott Harshbarger, Att'y General, Commonwealth of Mass.), 257 (statement of Kathleen Keest, Nat'l Consumer Law Ctr.).

37. See SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, THE COMMUNITY DEVELOPMENT, CREDIT ENHANCEMENT, AND REGULATORY IMPROVEMENT ACT OF 1993, S. REP. NO. 169, 103d Cong., 22 (1993).

38. See *id.*; 1993 *Hearings on Problems in Lending*, *supra* note 24, at 449 (letter from William E. Morris, Director of Litig., S. Ariz. Legal Aid, to Sen. Donald W. Riegle Jr. (Feb. 18, 1973)).

39. See *Hearings on Predatory Mortgage Lending*, *supra* note 24, 2001 WL 857910 (statement of Esther Canja, President, AARP); ROBERT J. HOBBS ET AL., NATIONAL CONSUMER LAW CENTER, CONSUMER PROBLEMS WITH HOME EQUITY SCAMS, SECOND MORTGAGES, AND HOME EQUITY LINES OF CREDIT 9 (Am. Ass'n of Retired Persons 1989).

40. See *Hearings on Predatory Mortgage Lending*, *supra* note 24, 2001 WL 857944 (statement of Consumer Bankers Ass'n); *Hearing on Mortgage Lending Abuses*, *supra* note 25, at 12 (statement of Gary Gensler, Undersecretary for Domestic Finance, Dep't of Treasury).

41. See *Hearings on Predatory Mortgage Lending*, *supra* note 24, 2001 WL 849991 (statement of Leroy Williams, private citizen). They may check foreclosure notices to find financially troubled homeowners or may cruise certain neighborhoods looking for homes in need of repair. See Mike Hudson, *Stealing Home: How the Government and Big Banks Help Second-Mortgage Companies Prey on the Poor*, 26 CLEARINGHOUSE REV. 1476, 1479 (1993).

42. See 1993 *Hearings on Problems in Lending*, *supra* note 24, at 309 (statement of Scott Harshbarger, Att'y General, Commonwealth of Mass.).

43. See 1993 *Hearing on Credit*, *supra* note 24, at 8-10 (statement of Richard F. Syron, President, Fed. Reserve Bank of Boston).

44. See 1993 *Hearings on Problems in Lending*, *supra* note 24, at 254 (statement of Scott Harshbarger, Att'y General of the Commonwealth of Mass.); *60 Minutes: A Matter of Interest* (CBS television broadcast, Nov. 15, 1992); see also HOBBS ET AL., *supra* note 39, at 38 ("Initially, it appeared that the equity skimmers were most interested in obtaining a quick foreclosure sale of consumers' homes, which they could buy and then sell for a large profit.").

secure the loan,⁴⁵ an underwriting practice clearly inappropriate for home mortgage lending.⁴⁶ This practice sets up the borrower for ultimate failure and loss of the home to foreclosure, but the lenders profit regardless. If the homeowner makes payments, the lender reaps an enormous profit based on the exorbitant interest rates. If the homeowner cannot pay, the lender gets the equity in the house through foreclosure.⁴⁷ Even if the borrower prepays the loan by refinancing, the lender profits from a prepayment penalty, which most predatory loans have.⁴⁸

In 1994 in response to the problem of predatory lending, Congress enacted the Home Ownership and Equity Protection Act,⁴⁹ which requires additional disclosures and prohibits certain unfair terms in connection with mortgages with interest rates or points and fees above the threshold set forth in the statute.⁵⁰ Some states have also adopted statutory or regulatory schemes designed to address the predatory lending problem.⁵¹ However, the problem persists. In fact, according to consumer advocates, the incidence of predatory loans has increased since 1994.⁵²

Until 1998 when home equity loans became available, Texas homeowners were protected from predatory lenders except in the context of predatory home improvement loans. Now Texas homeowners can obtain home equity loans. However, many of the provisions of the constitutional amendment permitting home equity loans were designed to address the predatory lending problems that borrowers have faced in other states.

45. See 1993 *Hearing on Credit*, *supra* note 24, at 16 (testimony of Bruce Marks, Executive Director, Union Neighborhood Assistance Corp.). In fact, some cases have been documented in which monthly payments on a home equity loan exceeded the borrower's monthly income. See, e.g., 1993 *Hearings on Problems in Lending*, *supra* note 24, at 260 (statement of Terry Drent, Ann Arbor Community Dev. Dep't) (discussing monthly payments of \$250 required of a borrower with a monthly income of \$220), 292 (statement of Eva Davis, Resident, San Francisco) (discussing approximate monthly payments of \$2,000 required of a borrower with a monthly income of under \$1,100); Gary Chafetz & Peter S. Canellos, *Elderly Poor Losing Homes in Loan Scam: Unregulated Lenders Offer High Rates, Risks*, BOSTON GLOBE, May 6, 1991, at 1, 6 (discussing monthly payments of \$2,062 required of a borrower with a monthly income of about \$800).

46. See 1993 *Hearings on Problems in Lending*, *supra* note 24, at 257 (statement of Kathleen Keest, Nat'l Consumer Law Ctr.); HOBBS ET AL., *supra* note 39, at 12.

47. See *Hearings on Predatory Mortgage Lending*, *supra* note 24, 2001 WL 857948 (statement of Irv Ackelsberg, Community Legal Services).

48. See *id.*

49. Pub. L. No. 103-325, tit. 1, subtit. B, 108 Stat. 2190 (codified at 15 U.S.C. §§ 1601-1648).

50. HOEPA applies to mortgages with an annual percentage rate more than ten percentage points greater than the rate on a Treasury security of comparable maturity or with points and fees exceeding the greater of 8% of the loan amount or \$400. 15 U.S.C. § 1602(aa).

51. See, e.g., N.C. GEN. STAT. § 241.1E (1999); N.Y. BANKING LAW § 6-i (McKinney 2001).

52. See *Hearings on Predatory Mortgage Lending*, *supra* note 24, 2001 WL 857923 (statement of Mike Shea, Executive Director, ACORN Housing Corp.). Subprime lending increased 900% between 1993 and 1999. *Id.* at 2001 WL 857923 (statement of Mike Shea, Executive Director, ACORN Housing Corp.), 2001 WL 857919 (statement of David Berenbaum, Nat'l Community Reinvestment Coalition) ("increased almost 1000 percent from 1993-1998").

III. THE CONSTITUTIONAL AMENDMENT

The constitutional amendment permitting home equity loans lists twenty-six requirements for a valid lien on the homestead, which are for the most part measures designed to protect homeowners from unscrupulous lenders or from the consequences of a bad decision.⁵³ The constitutional requirements include limitations on the amount of the loan, the security for the loan, fees that may be charged, and the lender's available remedies. In addition, the constitutional amendment requires notices and waiting periods and prohibits certain unfair or coercive practices by lenders.

A home equity loan may not cause the total debt secured by a homestead to exceed eighty percent of the fair market value of the homestead.⁵⁴ Therefore, the amount of the home equity loan when added to the total balances of all other debts secured by the home may not exceed eighty percent of the fair market value. Although this provision limits the ability of homeowners to reach all of the equity in their homes, it substantially reduces the risk of loss. A high loan-to-value ratio is one of the most significant factors in determining the risk of mortgage delinquency or foreclosure.⁵⁵ Therefore, home equity loans with a lower overall loan to value ratio are less likely to become delinquent or lead to foreclosure. Thus, by limiting the amount that homeowners can borrow against their homes, this provision retains some of the paternalistic protection of the pre-amendment constitutional provision that prohibited home equity loans altogether.

A home equity loan must be a nonrecourse loan⁵⁶ and may not be secured by any collateral, either real or personal, other than the homestead.⁵⁷ As a result, the lender's only recourse upon default is foreclosure of the lien on the borrower's home. The borrower cannot face a deficiency judgment or the loss of any property other than the home. The

53. TEX. CONST. art. XVI, § 50(a)(6).

54. *Id.* § 50(a)(6)(B). The parties are required to execute a written acknowledgment of the fair market value for the home on the date the loan is made. *Id.* § 50(a)(6)(Q)(ix). The lender is entitled to conclusively rely on the acknowledgment if the value is based on an appraisal conducted in accordance with state or federal requirements applicable to home equity loans and the lender does not have actual knowledge that it is incorrect. *Id.* § 50(h).

55. See JOHN P. HERZOG & JAMES S. EARLEY, HOME MORTGAGE DELINQUENCY AND FORECLOSURE at xvii-xix (1970); Robert J. Aalberts & Douglas S. Bible, *Mortgage Default in Louisiana: An Empirical Study of Recent Foreclosures on Residential Property in Caddo Parish*, 15 S.U. L. REV. 215, 219 (1988); Tim S. Campbell & J. Kimball Dietrich, *The Determinants of Default on Insured Conventional Residential Mortgage Loans*, 38 J. FIN. 1569, 1580 (1983); George M. von Furstenberg & R. Jeffrey Green, *Estimation of Delinquency Risk for Home Mortgage Portfolios*, 2 AM. REAL EST. & URB. ECON. ASS'N J. 5, 12 (1974); Jerry R. Jackson & David L. Kasserian, *Default Risk on Home Mortgage Loans: A Test of Competing Hypotheses*, 47 J. RISK & INS. 678, 686 (1980).

56. TEX. CONST. art. XVI, § 50(a)(6)(C).

57. *Id.* § 50(a)(6)(H). These two provisions together are particularly onerous for lenders, especially since a lender's failure to comply with constitutional requirements will invalidate the lien. See *infra* text accompanying notes 80-83.

lender, thus, takes the risk that the value of the property may fall below the amount of the debt encumbering it.

If a lender does foreclose on a home equity borrower's home, the foreclosure may occur only after a judicial proceeding.⁵⁸ Therefore, unlike other types of real estate loans in Texas, power of sale foreclosure without judicial intervention is not available. The opportunity for a hearing required by the constitution gives home equity borrowers the opportunity to raise facts relating to the lender's compliance with constitutional requirements or other defenses. If a home equity lender could foreclose by power of sale, the only means for a homeowner to assert a defense to foreclosure would be to bring suit to enjoin the foreclosure. The burden to initiate litigation creates a major obstacle for homeowners for several reasons.⁵⁹ First, consumers tend not to assert their legal rights when doing so requires them to initiate litigation.⁶⁰ In addition, the costs of initiating litigation may be prohibitive.⁶¹ Finally, the nature of the injunction action makes it a difficult and expensive suit for a homeowner to file.⁶² Therefore, the requirement that gives a homeowner the opportunity for a hearing before foreclosure of a home equity loan provides significant protection and is particularly important where there is a likelihood of defenses to foreclosure created by predatory lending practices.⁶³

While the constitutional amendment does not contain any limitation on

58. *Id.* § 50(a)(6)(D). The Texas Supreme Court has promulgated rules of civil procedure for expedited foreclosure proceedings for home equity loans. *See* TEX. R. CIV. P. 735, 736. Rule 736 provides a procedure for obtaining a court order that permits foreclosure pursuant to the power of sale foreclosure provisions of the Property Code. TEX. PROP. CODE ANN. § 51.002 (Vernon 1995).

59. *See* Forrester, *Home Improvement Financing*, *supra* note 1, at 1129-31.

60. Robert D. Cooter & Edward L. Rubin, *A Theory of Loss Allocation for Consumer Payments*, 66 TEXAS L. REV. 63, 81, 116 (1987). Homeowners may not be sufficiently sophisticated to know that a valid defense will prevent a foreclosure, *id.*, or they may be cynical about their own ability to prevail against the foreclosing lender, James J. White, *The Abolition of Self-Help Repossession: The Poor Pay Even More*, 1973 WISC. L. REV. 503, 528. In addition, they may be intimidated by the legal process or by the prospect of hiring an attorney. *See* Cooter & Rubin, *supra*, at 81, 116.

61. Although the poor have access to free legal services in many communities, low income homeowners may have incomes too great to qualify for such services. *See* Income Level for Individuals Eligible for Assistance, 66 Fed. Reg. 17,082 (2001).

62. To prevent a pending power of sale foreclosure, a homeowner must obtain a temporary restraining order (TRO), a preliminary injunction, or both. In addition, the homeowner must ultimately obtain a permanent injunction. Most jurisdictions require a plaintiff seeking either a TRO or a preliminary injunction to post a bond or other security. DAN B. DOBBS, *LAW OF REMEDIES* § 2.11(3) (2d ed. 1993). In order to obtain a preliminary injunction or TRO, the homeowner must typically show irreparable harm and some probability that the homeowner will prevail on the merits. *See id.* § 2.11(2). While a TRO may be issued in an ex parte hearing, its typical duration is only ten days to two weeks. *Id.* § 2.11(1). A preliminary injunction usually will be required to prevent a lender from foreclosing after expiration of the TRO and before a permanent injunction can be obtained. Securing a preliminary injunction requires an evidentiary hearing. *Id.* In an action to obtain a permanent injunction, the homeowner must prove a valid defense to the debt.

63. *See* Forrester, *Home Improvement Financing*, *supra* note 1, at 1132-33 (discussing why a judicial hearing should be required to foreclose certain home improvement loans where defenses are particularly likely).

interest rates,⁶⁴ it does limit the amount of fees that may be charged. The amendment limits fees to no more than three percent of the original principal amount of the loan,⁶⁵ but is not entirely clear in delineating which fees are included within the limitation.⁶⁶ Despite the questions raised by the limitation, it has been effective to reduce fees paid by Texas home equity borrowers.⁶⁷

With respect to payment terms, a home equity loan must be fully amortized⁶⁸ and must be fully prepayable without penalty or charge.⁶⁹ Early balloon payments are thus prohibited as well as prepayment premiums, which are common in predatory loans but not in other home mortgage loans. Open-ended accounts are also prohibited.⁷⁰ Therefore, home equity secured credit cards, popular in other states, are not permitted in Texas. In recent years, consumer advocates have observed predatory practices in connection with open-ended home equity loans.⁷¹

The constitutional amendment requires that the borrower be provided with a copy of a prescribed notice, which includes the list of constitutional requirements for a home equity loan, restated in plain language.⁷² Thus, homeowners have the information necessary to raise defenses to foreclosure if a lender has failed to meet the constitutional requirements. The loan may not close until the twelfth day after the notice is given,⁷³ and the loan must be closed in the office of the lender, an attorney, or a title

64. TEX. CONST. art. XVI, § 50(a)(6)(O).

65. *Id.* § 50(a)(6)(E).

66. *See infra* text accompanying notes 100-105.

67. *See* Richard A. Opper, Jr., *Home Equity Lending Law Defies Critics*, DALLAS MORNING NEWS, Sept. 13, 1998, at H7.

68. *See* TEX. CONST. art. XVI, § 50(a)(6)(L).

69. *Id.* § 50(a)(6)(G).

70. *Id.* § 50(a)(6)(F). An open-end account is statutorily defined as:

an account under a written contract between a creditor and an obligor in connection with which:

- (i) the creditor reasonably contemplates repeated transactions and the obligor is authorized to make purchases or borrow money;
- (ii) interest . . . may be charged from time to time on an outstanding unpaid balance; and
- (iii) the amount of credit that may be extended during the term of the account is generally made available to the extent that any outstanding balance is repaid . . .

TEX. FIN. CODE ANN. § 301.002 (West Supp. 2001). Revolving credit home equity loans, under which the borrower repeatedly repays principal and borrows again up to the loan amount or credit limit, are prohibited. Closed-end loans are permitted, and closed-end loans with multiple advances should be permitted. A loan is a closed-end loan even if advances are made at particular stages after the initial closing and interest is charged only upon the outstanding principal balance. The distinction is that under a closed-end loan, credit may not be made available to the extent that outstanding balances have already been repaid.

71. *See Hearings on Predatory Mortgage Lending*, *supra* note 24, 2001 WL 857948 (statement of Irv Ackelsberg, Managing Attorney, Community Legal Services).

72. TEX. CONST. art. XVI, § 50(g). The notice essentially sets forth the constitutional requirements; however, discrepancies exist between the requirements and the language of the notice. *See infra* text accompanying notes 106-107 and 138-142.

73. TEX. CONST., art. XVI, § 50(a)(6)(M).

company.⁷⁴ These provisions protect homeowners against high-pressure door-to-door solicitation of home equity loans since homeowners must wait some period of time before the closing and the loan cannot be closed in the borrower's home. In addition, the homeowner and spouse have a right to rescind the loan for three days after closing.⁷⁵

The constitution also prohibits a number of deceptive and coercive practices. The lender may not require the homeowner to sign loan documents with blanks not filled in,⁷⁶ a practice common in predatory loans. In addition, the lender may not require the homeowner to apply home equity loan proceeds to certain other debt owed to the same lender,⁷⁷ so lenders may not pressure homeowners to convert unsecured debt held by that lender to home equity debt. A homeowner may have only one home equity loan at a time⁷⁸ and may not refinance a home equity loan or obtain a new one more frequently than once a year.⁷⁹ These two provisions discourage loan flipping—the practice by lenders of repeatedly refinancing home equity loans, increasing the loans, or making new loans in order to obtain additional fees.

Under the homestead provision of the Texas Constitution, a valid lien cannot encumber a homestead unless it secures a debt described in the constitution.⁸⁰ A loan meeting all of the constitutional requirements for a home equity loan is a debt that may encumber a homestead.⁸¹ If a lender makes a home equity loan but fails to comply with any of the constitutional requirements for a home equity loan, however, the attempted lien on the homestead will not be valid. Since a home equity loan must be nonrecourse and may not be secured by other property, the lender will be left with an unsecured nonrecourse loan. The constitution further provides that the lender forfeits all principal and interest of the loan if the lender fails to comply with any of the constitutional requirements within a reasonable time after the borrower notifies the lender of the problem.⁸² Therefore, the consequences of a defect that is not cured are quite severe.⁸³

74. *Id.* § 50(a)(6)(N).

75. *Id.* § 50(a)(6)(Q)(viii). If the third day is a Saturday, Sunday or legal holiday, then the period for rescission is extended to the next business day. *See* TEX. GOV'T CODE ANN. § 311.014 (West 1988). The federal Truth in Lending Act gives a homeowner the right to rescind a home equity loan for three business days following the later of the closing of the loan or the delivery of the rescission notice and other disclosure required under the Act. 15 U.S.C. §1635(a), (e) (2000).

76. TEX. CONST. art. XVI, § 50(a)(6)(Q)(iii).

77. *Id.* § 50(a)(6)(Q)(i). *See infra* text accompanying notes 139-42.

78. TEX. CONST. art. XVI, § 50(a)(6)(K).

79. *Id.* § 50(a)(6)(M)(ii).

80. *Id.* § 50(c).

81. *Id.* § 50(a)(6).

82. *Id.* § 50(a)(6)(Q)(x).

83. It was unclear whether the lender only avoided forfeiture of principal and interest, or whether an invalid lien could be made valid by the lender's corrective action under this section, but the Texas Supreme Court recently answered this question. *See* Doody v. Ameriquest Mortgage Co., 49 S.W.2d 342 (Tex. 2001), discussed *infra* notes 143-148 and accompanying text.

Finally, the constitutional amendment provides that the constitutional requirements for a home equity loan are not severable.⁸⁴ If any of the provisions are held to be preempted by federal law, the entire amendment is invalid.⁸⁵ As a result, if any one of the constitutional requirements is held to be preempted, the entire home equity loan provision will fail, and home equity loans will once again be prohibited in Texas.

IV. CRITICISM

Lenders and commentators have criticized the constitutional amendment permitting home equity loans,⁸⁶ with criticism falling roughly into three categories. First are objections to the placement of the entire home equity loan scheme in the constitution with the attendant problems of amendment and interpretation. These objections are valid. Second are criticisms of the amendment's language which has raised ambiguities and uncertainties. At least some of these criticisms are legitimate. Finally, critics have challenged the basic consumer protection philosophy of the scheme. Based on the experience of homeowners in other states, this objection is not legitimate. I will discuss each category of criticism.

A. PLACEMENT IN THE CONSTITUTION

Critics of Texas home equity lending law have objected to the placement of the provision in the state constitution.⁸⁷ This problem originated in 1845, when limitations on the ability to create a lien were first placed in the Texas Constitution rather than adopted by statute.⁸⁸ However, the 75th Legislature continued this questionable tradition by placing every detail of the state's home equity lien law in the constitution rather than by enabling home equity loans by reference to statute. As a result, Texas law regulating home equity loans cannot be amended except by constitutional amendment, which requires a joint resolution favored by a supermajority of both houses and approval by a majority of the voters.⁸⁹

84. TEX. CONST. art. XVI, § 50(j)

85. *Id.*

86. See J. Alton Alsup, *Pitfalls (And Pratfalls) of Texas Home Equity Lending*, 52 CONSUMER FIN. L.Q. REP. 437 (1998); Charles C. Boettcher, *Taking Texas Home Equity for a Walk, But Keeping It on a Short Leash!*, 30 TEX. TECH L. REV. 197 (1999); Mark D. Morris, *Implementing a Texas Home Equity Lending Program—Documentation and Operational Issues*, 52 CONSUMER FIN. L.Q. REP. 471 (1998); Lawrence A. Young, *Texas Home Equity Lending—On the Horizon at Last, But with Storm Clouds Rising*, 51 CONSUMER FIN. L.Q. REP. 336 (1997); Patton L. Zarate, *An Ailing System: Possible Solutions for Curing the Texas Home Equity Loan Amendment*, 31 ST. MARY'S L.J. 461 (2000); Patrick Barta, *Lenders Seek to Clarify Lending Law*, WALL ST. J., Aug. 26, 1998, at T1; Robert Elder, Jr., *Lawmakers Tinker with Loan Law*, WALL ST. J., May 19, 1999, at T1; Earl Golz, *Looking for Equity: Lenders, Borrowers Both Have Problems with State Law*, AUSTIN AM.—STATESMAN, Dec. 20, 1998, at J1; Ann Graham, *Home Equity Update*, TEX. BANKING, May 1, 2000, at 48; Jack Hams, *Forging Ahead in the Brave New World of Home Equity Lending*, TEX. BANKING, Sept. 1, 1998, at 32.

87. See Morris, *supra* note 86, at 471; Zarate, *supra* note 86, at 501-02.

88. See *supra* note 8 and accompanying text.

89. TEX. CONST. art. XVII, § 1.

This difficulty of amendment is particularly problematic because of the detailed nature of the consumer protection measures in the constitution. Even small issues or ambiguities, which can arise in a complicated statutory scheme, can only be clarified or changed by constitutional amendment or resolved by the courts.

In addition, the amendment does not give administrative authority to any agency to interpret any ambiguities or uncertainties.⁹⁰ While the constitutional amendment is quite detailed, not every provision within it is entirely clear.⁹¹ In an attempt to clarify the provisions of the amendment, the Office of Consumer Credit Commissioner, the Texas Department of Banking, the Texas Savings and Loan Department, and the Texas Credit Union Department issued a Regulatory Commentary on Equity Lending Procedures.⁹² The agencies that issued the Commentary are responsible for regulating entities making home equity loans. The Commentary is designed to be used in examination and enforcement situations by these agencies, but it is not binding on courts resolving disputes between borrowers and lenders.⁹³ The constitution could be amended to give regulatory authority to construe the provision, but according to an Attorney General's Opinion, the legislature may not authorize a state agency to interpret the constitution.⁹⁴ Therefore, without another constitutional amendment, the legislature may not give power to an agency to interpret the home equity loan amendment.

B. LANGUAGE OF THE AMENDMENT

Other criticisms of the constitutional amendment are based on ambiguities and uncertainties within the amendment itself. For example, early criticism focused on the inability of homeowners to obtain home equity loans secured by urban homes situated on more than one acre.⁹⁵ Prior to 1999, the Texas Constitution limited the size of an urban homestead to one acre.⁹⁶ Because a lender is prohibited from taking collateral other than the homestead to secure a home equity loan,⁹⁷ a homeowner with more than one acre would be required to designate which acre was the homestead and thus the security for the home equity loan. If the lender ever foreclosed on the one acre homestead, however, the lender might violate subdivision requirements, zoning ordinances, or restrictive cove-

90. See Zarate, *supra* note 86, at 501-04; Barta, *supra* note 86, at T1.

91. See *infra* subpart B.

92. Office of the Consumer Credit Commissioner, Regulatory Commentary on Equity Lending Procedures (Oct. 1998) [hereinafter Regulatory Commentary].

93. Regulatory Commentary, *supra* note 92, at 1. However, the Texas Supreme Court has cited the Commentary and agreed with it. *Stringer v. Cendant Mortgage Corp.*, 23 S.W.3d 353, 357 (Tex. 2000).

94. Op. Tex. Atty. Gen. DM-495 (1998).

95. See Alsup, *supra* note 86, at 445-48; Boettcher, *supra* note 86, at 252-54; Zarate, *supra* note 86, at 493-501; Barta, *supra* note 86, at T1.

96. TEX. CONST. art. XVI, § 51 (amended 1999).

97. TEX. CONST. art. XVI, § 50(a)(6)(H).

nants.⁹⁸ As a result, homeowners with homes situated on more than one acre were not, as a practical matter, able to obtain home equity loans. The legislature addressed this problem in its 1999 legislative session as discussed below.⁹⁹

Another widely criticized provision of the amendment is the three percent cap on fees.¹⁰⁰ The provision specifically excludes interest but otherwise does not make clear which fees are included within the cap and which are not. Some critics have questioned whether discount points are included within the cap,¹⁰¹ although the Commentary, consistent with numerous court opinions interpreting state usury law, provides that points are interest and are thus excluded from the limitation.¹⁰² Another issue is the extent to which insurance premiums of various types are included within the cap.¹⁰³ Also at issue is whether fees charged after the inception of the loan, such as late fees, returned check charges, collection costs, and foreclosure costs would be included.¹⁰⁴ As I will discuss, courts have now addressed some of the issues raised by the fee cap.¹⁰⁵

Another criticism of the constitutional amendment is that discrepancies exist between the constitutional requirements and the constitutionally mandated notice to home equity borrowers.¹⁰⁶ The Texas Supreme Court addressed this inconsistency, determining that the requirements control over the notice.¹⁰⁷

Critics and attorneys have raised other ambiguities and uncertainties in the amendment, some of which are valid concerns¹⁰⁸ and others of which strain the language of the constitution or border on the ridiculous.¹⁰⁹ The

98. See Boettcher, *supra* note 86, at 253; Zarate, *supra* note 86, at 497-98.

99. See *infra* subpart V.A.

100. See Alsup, *supra* note 86, at 442-45; Boettcher, *supra* note 86, at 254-57; Zarate, *supra* note 86, at 486-93; Barta, *supra* note 86, at T1; Hams, *supra* note 86, at 32.

101. See Alsup, *supra* note 86, at 444; Zarate, *supra* note 86, at 488-90.

102. See Regulatory Commentary, *supra* note 92, at 3.

103. See Alsup, *supra* note 86, at 444; Boettcher, *supra* note 86, at 255. The Commentary takes the position that title insurance and mortgage insurance premiums are included while life insurance, health insurance and casualty insurance are not. Regulatory Commentary, *supra* note 92, at 3-4.

104. See Alsup, *supra* note 86, at 443; Zarate, *supra* note 86, at 492-93. The Commentary takes the position that they are not within the fee cap. Regulatory Commentary, *supra* note 92, at 4.

105. See *infra* text accompanying notes 149-53.

106. See Morris, *supra* note 86, at 480-81. The notice restates the constitutional requirements in plain language but with some discrepancies. See *supra* text accompanying note 72.

107. See *infra* text accompanying notes 138-42.

108. See, e.g., Alsup, *supra* note 86, at 448-52 (ambiguity in list of authorized lenders); Boettcher, *supra* note 86, at 257 (meaning of "reasonable time"), 258 (whether twelve-day cooling off period requires twelve business days).

109. The plaintiff in one case argued that the payment of points at the time of loan origination, if points were interest, violated the constitutional requirement that the loan be "scheduled to be repaid in substantially equal successive monthly installments." *Tarver v. Sebring Capital Credit Corp.*, No. 10-00-394-CV, 2002 WL 122743 (Tex. App.—Waco 2002) (quoting TEX. CONST. art. XVI, § 50(a)(6)(L)). The court did not address this issue on appeal. *Id.* at *4. In another case, the plaintiff argued that a severability provision in the deed of trust securing a home equity loan violated the non-severability provision of the

courts have resolved some of these issues¹¹⁰ and will presumably address the others at some point if the legislature does not.

C. CONSUMER PROTECTION PHILOSOPHY

In addition to raising ambiguities in the constitutional amendment, lenders and some commentators have criticized the extensive consumer protection measures of the amendment.¹¹¹ Lenders feel that the consumer protections are too stringent and have made home equity lending too risky for lenders.¹¹² Critics have expressed concern that small lending institutions cannot make home equity loans because of the restrictive nature of the provision,¹¹³ and have further suggested that secondary market investors such as Fannie Mae will not purchase Texas home equity loans.¹¹⁴ In addition, some critics have asserted that the consumer protections limit the freedom of consumers to obtain home equity loans to too great an extent.¹¹⁵

Despite the concerns that lenders have expressed about the consumer protection provisions, they are in fact making home equity loans in Texas.¹¹⁶ Although many small lenders have not entered the home equity loan market,¹¹⁷ some have.¹¹⁸ It remains to be seen whether additional small lenders will make home equity loans as more of the questions

constitutional amendment. *Edwards v. Option One Mortgage Corp.*, Nos. 00-51058-RBK, 00-5055-RBK, 2001 WL 708827 (Bankr. W.D. Tex. 2001). The court held that section 50(j) of the constitutional amendment does not prohibit a severability clause in loan documents, but provides that the provisions of the statute are not severable. *Id.* at *3. Finally, a plaintiff raised a number of issues including that the term "title company" is unconstitutionally vague, that the requirement that the loan be closed in the office of a lender, attorney or title company violates the borrower's right to travel under the federal Constitution, and that the requirement that both spouses sign loan documents violates the Equal Credit Opportunity Act. *Rooms with a View, Inc. v. Private Nat'l Mortgage Ass'n*, 7 S.W.3d 840, 844, 847, 849 (Tex. App.—Austin 1999). These issues were raised with respect to the home improvement loan provision of the Texas Constitution, but would be equally applicable to home equity loans. The court found none of the plaintiff's arguments to be convincing and affirmed a summary judgment in favor of the defendant. *Id.* at 851.

110. See *supra* note 109.

111. See Boettcher, *supra* note 86, at 260-66; Elder, *supra* note 86, at T1; Golz, *supra* note 86, at J1; Graham, *supra* note 86, at 48; Hams, *supra* note 86, at 32; Oppel, *supra* note 67, at H1.

112. See Elder, *supra* note 86, at T1; Golz, *supra* note 86, at J1; Graham, *supra* note 86, at 48; Hams, *supra* note 86, at 32; Oppel, *supra* note 67, at H1. Lenders were particularly concerned with the judicial foreclosure requirement and the lack of personal liability. Hams, *supra* note 86, at 32.

113. See Boettcher, *supra* note 86, at 263-66; Graham, *supra* note 86, at 48.

114. See Alsup, *supra* note 86, at 469-70.

115. See Boettcher, *supra* note 86, at 260-63; Oppel, *supra* note 67, at H1.

116. See Golz, *supra* note 86, at J1 (\$11 billion to \$12 billion in originations for 1998 with an expected \$20 billion on the books within four years); Oppel, *supra* note 67, at H1 (\$6 billion or more expected to be loaned in 1998 with a predicted market of more than \$25 billion by 2001).

117. See Graham, *supra* note 86, at 48; Hams, *supra* note 86, at 32; Oppel, *supra* note 67, at H1; John Reosti, *Home Equity Too Risky for Small Texas Banks*, AM. BANKER, Feb. 21, 2001, at 6.

118. See Hams, *supra* note 86, at 32; Oppel, *supra* note 67, at H1; *Two Years After Ban Is Lifted, 58 Texas Credit Unions Offering HELCs*, CREDIT UNION J., Mar. 19, 2001, at 3.

raised by the amendment are answered. In addition, Fannie Mae is committed to purchasing Texas home equity loans,¹¹⁹ so concerns that secondary lenders would not purchase Texas home equity loans appear to be misplaced.

From the consumer's point of view, the constitutional amendment does in fact limit the amount and terms of a home equity loan. Consumers who wish to borrow against all of the equity in their homes cannot do so, and they cannot borrow on a revolving credit basis. Most consumer protection law limits the freedom of consumers to some extent. Thus, the issue is not whether limitations exist, but whether they are necessary. Based on the experience of consumers in other states who have been victimized by predatory lenders, the limitations are necessary. In addition, the consumer protection measures have not stifled demand for home equity loans as critics had feared.¹²⁰ Despite the numerous restrictions, lenders are making home equity loans in Texas, homeowners are borrowing, and borrowers are saving money on fees because of the constitutional cap on fees.¹²¹ Thus, much of the criticism of the restrictions and limitations is unwarranted.

As discussed above, however, the amendment does have some ambiguities and uncertainties that must be addressed by the courts and the legislature.¹²² The Texas Legislature has met twice since the passage of the original constitutional amendment, with little change resulting, and cases are gradually winding through the courts.

V. LEGISLATIVE AND JUDICIAL RESPONSE

A. LEGISLATIVE REACTION

The legislature addressed only the one acre problem in its 76th session in 1999, adopting a resolution for a constitutional amendment increasing the size of the urban homestead from one to ten acres.¹²³ Texas voters approved the amendment, and now Texas homeowners may protect homes located on up to ten acres of property from the reach of general creditors. The intended result of this amendment was to permit homeowners with one to ten acre homesteads to obtain home equity loans, but the effect of the amendment is much broader. At a time when Texas members of Congress are struggling to maintain the right of Texans to preserve their homesteads in a bankruptcy proceeding, increasing the exemption was hardly a wise move.

Texas is among the states most protective of the home as against creditors. Only a few other states define the homestead by area rather than value, thereby exempting a home from the reach of creditors regardless

119. See *Fannie Mae Supports Equity Lending in Texas*, TEX. BANKING, Jan. 1, 1998, at 18.

120. Oppel, *supra* note 67, at H1.

121. *Id.*

122. See *supra* subpart B.

123. See Tex. S.J. Res. 22, 76th Leg., R.S., 1999 Tex. Gen. Laws 1510.

of its value.¹²⁴ Most states permit equity in a homestead up to a designated value, in some cases as low as \$2500, to be protected from the reach of creditors.¹²⁵ The Bankruptcy Code currently permits debtors in bankruptcy to elect either federal or state exemptions.¹²⁶ Debtors in Texas almost exclusively choose state exemptions because they are so much more generous than the federal exemptions provided by the Bankruptcy Code.

In 1997, the Bankruptcy Review Commission recommended in its report that the Bankruptcy Code be amended to place a floor and ceiling on the state homestead exemption that a debtor in bankruptcy may exempt.¹²⁷ The Commission felt that the lack of homestead protection in some states was inconsistent with the fresh start policy of bankruptcy as well as federal policy promoting home ownership.¹²⁸ On the other hand, the Commission felt that an unlimited homestead exemption violated the goal in bankruptcy of distributing assets among creditors.¹²⁹ Therefore, the Commission recommended the retention of state exemptions but with limitation to a designated range. Adoption of the Commission's proposal would have the effect of reducing the homestead exemption that Texas debtors could claim in bankruptcy from an unlimited exemption of an urban homestead of ten acres or less to an exemption of no more than \$100,000.¹³⁰

Since the Commission's report was issued, Congress has considered bankruptcy reform legislation that would address, among other issues, the homestead exemption.¹³¹ Many of the bills have adopted limits on the value of a homestead that may be exempted in bankruptcy.¹³² Texas members of Congress have worked each time to preserve the Texas homestead exemption against criticism in Congress that it is too generous.¹³³ No reforms have yet been enacted, but legislation remains

124. National Bankruptcy Review Commission, Final Report, Bankruptcy: The Next Twenty Years, 1 N.B.R.C. Rep. 1 (October 20, 1997).

125. *Id.*

126. 11 U.S.C. § 522 (1994).

127. National Bankruptcy Review Commission, *supra* note 124, at 2. Congress established the National Bankruptcy Review Commission to study issues relating to bankruptcy, to solicit different views, to evaluate proposals, and to submit a report. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, § 603, 108 Stat. 4107, 4147 (1994).

128. *See* National Bankruptcy Review Commission, *supra* note 124, at 126.

129. *See id.*

130. *See id.* at 2.

131. *See* H.R. 333, 107th Cong. (2001); S. 220, 107th Cong. (2001); S. 945, 106th Cong. (1999); S. 625, 106th Cong. (1999); S. 586, 106th Cong. (1999); H.R. 1282, 106th Cong. (1999); H.R. 833, 106th Cong. (1999); H.R. 3693, 105th Cong. (1998); H.R. 3150, 105th Cong. (1998); S. 1301, 105th Cong. (1997); S. 530, 105th Cong. (1997).

132. *See* H.R. 333, 107th Cong. § 308 (2001); S. 945, 106th Cong. § 320 (1999); S. 586, 106th Cong. § 2 (1999); H.R. 1282, 106th Cong. § 2 (1999); H.R. 3693, 105th Cong. § 2 (1998); S. 530, 105th Cong. § 2 (1997).

133. *See, e.g.*, S. 625, 106th Cong. § 308 (1999); H.R. 833, 106th Cong. § 308 (2000); H.R. 3693, 105th Cong. (1998). *See also* Robert Dodge, *Senate Bill Tightens Bankruptcy Criteria, Bush Backs Consumer Accountability*, DALLAS MORN. NEWS, Mar. 16, 2001, at A1 (describing homestead limit in bill and Sen. Hutchison's opposition); Kay Bailey Hutchison, *Bankruptcy Bill Not Right Answer*, SAN ANTONIO EXPRESS-NEWS, Nov. 29 1999, at B5

pending.¹³⁴

Against this backdrop, the Texas legislature, in a misguided attempt to solve a minor problem in the home equity loan provision of the Texas Constitution, adopted a resolution that, after approval by voters, increased the maximum permissible size of the Texas urban homestead from one to ten acres.¹³⁵ While this revision does permit homeowners with urban homesteads between one and ten acres to obtain home equity loans, it also permits very wealthy Texans to shield more property from creditors outside of bankruptcy and, for the time being, in bankruptcy. This change is likely to increase Congressional criticism of Texas homestead law and ultimately make more difficult the avoidance of a limit on the Texas homestead in bankruptcy. Furthermore, the change does nothing to make home equity loans available for homeowners with urban homesteads greater than 10 acres or rural homeowners with homesteads more than 200 acres. A more logical change would have modified the prohibition on taking security other than the homestead to permit a lien on land contiguous to the homestead to secure a home equity loan. Such a measure would have permitted homeowners with homes located on any size tract to obtain home equity loans without changing basic homestead law.

The legislature failed to address any other problems in the Texas home equity loan provision of the Texas Constitution in either the 76th or 77th legislative sessions. Therefore, except to the extent that the courts have intervened, the original criticisms concerning the lack of administrative oversight and ambiguities in language remain.

B. JUDICIAL DECISIONS

The courts have done substantially better than the legislature in resolving issues raised by the home equity loan amendment. The Texas Supreme Court has had two recent opportunities to address questions raised by the home equity loan provision, in each case on certified question from the United States Court of Appeals for the Fifth Circuit,¹³⁶ and other courts have resolved additional issues.¹³⁷

In *Stringer v. Cendant Mortgage Corp.*,¹³⁸ the Texas Supreme Court

(criticizing Senate bill provision limiting homestead); Catalina Camia, *Sessions Fights Homestead Exemption Cap*, DALLAS MORN. NEWS, Mar. 28, 1999, at A9 (describing limits in various bills and opposition)

134. See H.R. 333, 107th Cong. (2001).

135. Tex. S.J. Res. 22, 76th Leg., R.S., 1999 Tex. Gen. Laws 1510. The constitutional amendment has also been criticized on the basis that it eliminates homestead protection for urban business property unless it is contiguous to or a part of the residence. See Comment, Christopher John Kern, *Goodbye Texas Urban Business Homestead: An Analysis of the November 1999 Amendment to Article XVI, Section 51 of the Texas Constitution*, 52 BAYLOR L. REV. 663 (2000); John W. Gonzalez, *Election '99: Judicial Amendment's Author Says Loss Could Deter Qualified People*, HOUSTON CHRON., Nov. 4, 1999, at 32.

136. *Stringer v. Cendant Mortgage Corp.*, 23 S.W.3d 353 (Tex. 2000); *Doody v. Ameriquest Mortgage Co.*, 49 S.W.3d 342 (Tex. 2001).

137. See *infra* notes 149-153.

138. 23 S.W.3d 353 (Tex. 2000).

resolved a conflict between the constitutional requirements for a home equity loan and the language of the constitutionally mandated notice. The question raised by the conflict was whether a home equity lender could require a borrower to pay off third party debt not secured by the homestead with home equity loan proceeds.¹³⁹ Among the constitutional requirements for a home equity loan is one prohibiting a lender from requiring a borrower to apply loan proceeds to repay any debt other than one secured by the homestead or due to another lender.¹⁴⁰ The required notice to a home equity borrower states that the lender may not require the borrower to apply loan proceeds to a debt that is not secured by the home or to a debt to the same lender.¹⁴¹ The court held that section 50(a)(6) of the constitutional amendment sets forth the substantive rights and obligations of home equity borrowers and lenders while section 50(g) sets forth only the language of the required notice.¹⁴² Therefore, in a conflict between the substantive provision and the notice provision, the substantive provision would prevail.

In *Doody v. Ameriquest Mortgage Co.*, the Texas Supreme Court addressed whether a refund of closing costs in excess of the three percent constitutional cap cures the defect in the loan and validates the lien.¹⁴³ At the time of the closing of the home equity loan at issue, the lender, Ameriquest, had charged Doody closing costs in an amount exceeding three percent of the loan amount.¹⁴⁴ Ameriquest later discovered its error and refunded an amount necessary to reduce the total closing costs to three percent. Doody accepted the refund but later sued claiming that the loan did not comply with constitutional requirements and thus could not create a valid lien on his homestead.¹⁴⁵

The court held that the cure provision can be used to validate a lien.¹⁴⁶ In so holding, the court stated that all of the constitutional provisions must be read together and that the cure provision was not limited to avoidance of forfeiture.¹⁴⁷ In addition, the court distinguished cases cited by Doody holding that a lender cannot resurrect an invalid lien after the loan is made.¹⁴⁸ In this case, because the home equity loan amendment

139. *Id.* at 354.

140. TEX. CONST. art. XVI, § 50(a)(6)(Q)(i).

141. *Id.* § 50(g)(Q)(1).

142. 23 S.W.3d at 356. The court suggested that lenders include an additional notice to avoid misleading or confusing home equity borrowers; however, the court provided no penalty for a lender's failure to do so. *Id.* at 357.

143. 49 S.W.3d 342, 342 (Tex. 2001). The court did not reach the second question certified by the Fifth Circuit, whether the borrower's acceptance of a refund of an overcharged amount waives any claims under the constitutional provision. *Id.* at 342-43.

144. *Id.* at 343.

145. *Id.* Doody argued that because Ameriquest did not comply with the constitutional requirements for a home equity loan, its lien was never valid. Although the constitution permits cure to avoid forfeiture, Doody argued that cure was not available to validate an invalid lien. Ameriquest argued that the cure provision applies to validate the lien of a home equity loan as well as to avoid forfeiture. *Id.*

146. *Id.* at 347.

147. *Doody*, 49 S.W.3d 342, 345 (Tex. 2001).

148. *Id.* at 346.

includes a cure provision, the lien can be validated by the lender's subsequent efforts. Therefore, the court held that the cure provision applied not only to avoid forfeiture, but also to validate the lien.

Other courts have resolved issues relating to the constitutional provision that caps fees charged for a home equity loan at three percent.¹⁴⁹ The *Doody* case, discussed above, originated in federal court, and the Fifth Circuit had addressed the fee cap issue before certifying questions to the Texas Supreme Court. Doody argued to the Fifth Circuit that premiums for hazard insurance required by the lender should be included within the constitutional three percent cap.¹⁵⁰ The Fifth Circuit held that hazard insurance premiums are not "fees . . . necessary to originate" the loan and are thus not included within the three percent cap on fees.¹⁵¹ More recently, the Waco Court of Appeals addressed the issue of whether points charged by a lender are included within the fee cap.¹⁵² The court held that points are interest and are, therefore, specifically excluded from the fee cap provision.¹⁵³

In all, courts that have considered the constitutional provision to date have taken a practical approach to interpreting the provision. While there are issues left to be resolved, if the courts continue to take a common sense approach, lenders can continue to make home equity loans in Texas, and Texas homeowners will be protected by the consumer protection provisions of the constitution.

VI. CONCLUSION

Critics of the constitutional restrictions on home equity loans in Texas have focused on the placement of the home equity loan provision in the state constitution, on problems in the language of the constitutional scheme, and on its consumer protection philosophy. Certainly, a state constitution is not the best place for detailed consumer protection measures because the procedure for making corrections to a constitutional provision is so cumbersome. A statutory scheme would be much more manageable. However, the history of constitutional protection of the homestead in Texas runs deep, and a constitutional scheme for home equity lending is likely to remain in place, at least for the foreseeable future.

Critics of the language of the amendment are justified to some extent as it certainly contains ambiguities. In addition, critics and lawyers may strain interpretation of the provision to create litigation. The courts thus far have done an admirable job of solving these problems with common sense readings of the provision. A constitutional amendment to provide

149. *Doody v. Ameriquist Mortgage Co.*, 242 F.3d 286 (5th Cir. 2001); *Tarver v. Sebring Capital Credit Corp.*, No. 10-00-394-CV, 2002 WL 122743 (Tex. App.—Waco 2002).

150. 242 F.3d at 289.

151. *Id.*

152. *Tarver v. Sebring Capital Credit Corp.*, 2002 WL 122743 at *2.

153. *Id.* at *5.

regulatory oversight of the provision, however, would be an additional positive step that the legislature should consider in its next session.

Critics of the philosophy of protecting homeowners are simply wrong. Home equity lending is an industry fraught with opportunities for fraud. The experience of homeowners in other states is evidence of the tremendous need for consumer protection in this arena. A few other states have reacted to the predatory lending problem with statutes or regulatory measures, and Congress is considering additional measures. In the meantime, Texas homeowners have the protection granted by their constitution. The constitution can by no means prevent all abuse, but it can prevent some of the more common types of abuse. We should be proud of and maintain our long-held Texas tradition of protecting the home.