BLACK | MANN & GRAHAM L.L.P.

Attorneys At Law

2905 Corporate Circle

Flower Mound, TX 75028

Phone: 972-353-4174

Fax: 972-221-9316

Partners

Shawn P. Black [1]

Ryan Black [2]

Daniel S. Engle [3]

Steven Kubik

Senior Lawyers

Margaret A. Noles

Syndy Davis

Associates

Joshua Verkerk

Andrew Stokes

Of Counsel

David M. Tritter

Calvin C. Mann, Jr.

Gregory S. Graham [4]

Retired Partner(s)

Calvin C. Mann, Jr.

Thomas E. Black, Jr.*

Gregory S. Graham [4]

1 Also Licensed in Kentucky and New York

2 Also Licensed in District of Columbia

3 Also Licensed in New York

4 Also Licensed in Georgia

***Retired from the practice of law**

October 18, 2024

To: Clients and Friends

From: Daniel S. Engle

Subject: Court of Appeals of Texas, Fort Worth Issues Lender-Friendly Decision on Texas Home Equity Document Construction and Cure Provisions. *Frost Bank v. Kelley Jr.*, --- S.W.3d --- 2024 WL 4509721.

On October 17, 2024, the Court of Appeals of Texas, Fort Worth in *Frost Bank v. Kelley Jr.*, --- S.W.3d --- 2024 WL 4509721 overruled a trial court's decision and found that a lender's loan documents for a Texas Home Equity loan made under the authority of Article XVI, Section 50(a)(6) of the Texas Constitution were legally sufficient to create a foreclosure-eligible lien. Additionally, in *dicta*, the appellate court commented that, in the event that the documents were faulty, the lender's response to the owners' notice of the alleged faulty documents would have likely cured any defect.

The facts of this case began on July 11, 2007 when Richard Kelley Jr. applied for a home equity loan from Frost Bank on homestead property owned by himself and his wife Tamra. The loan closed on August 8, 2007 with Richard Kelley Jr. as the borrower on the Promissory Note and with both Kelleys consenting to the loan on the Deed of Trust, and other supplemental documents. The note had a principal amount of $344,000 and required, among other things, that the Kelleys promise to pay property taxes. The loan paid off a prior mortgage secured by the homestead in the amount of $230,800.51.

In 2016, various taxing authorities sued the Kelleys and Frost Bank for delinquent property taxes. Frost Bank notified the Kelleys that unpaid property taxes could lead to acceleration of its Note and subsequent foreclosure, but the Kelleys did not pay their property taxes and ceased making payments on their mortgage in June 2016. Frost Bank then sent the Kelleys a notice of default and intent to accelerate. After the Kelleys did not cure the defects of failing to pay the mortgage and property taxes, Frost Bank sent notice it was accelerating the loan. Frost Bank also began paying the property taxes on the Kelleys' homestead to avoid judicial foreclosure that would have extinguished Frost Bank's lien. Frost Bank paid $41,530.20 in property taxes between October 2016 and January 2020 to avoid foreclosure of the tax liens.

Frost Bank commenced foreclosure proceeding in October 2016. The Kelleys responded on November 21, 2016 by arguing that Frost Bank's lien was not foreclosure-eligible due to the loan agreement not containing all of the required loan terms for Texas home equity loans under Article XVI, Section 50(a)(6) of the Texas Constitution. In particular, they argued that the following terms or conditions in Section 50(a)(6)(B), (C), (E), (F), (I), (J), (K), (P) and (Q) (x)-(xi) were missing. Frost Bank responded on January 18, 2017 (within the proper 60 days to respond to alleged violations of a home equity loan) with a letter that did two things. First, the letter argued that all of these terms or conditions were included and pointed out where Frost Bank believed they were located. Second, Frost Bank agreed to adopt all of the terms or conditions in the loan agreement in the event that they were not sufficiently included in the document, so as to cure any potential violations. Frost Bank's initial foreclosure action was dismissed.

In late 2017, Frost Bank filed a second foreclosure action which was interrupted and stayed by the Kelleys filing suit to quiet title on the property.

In the quiet title action, the Kelleys argued that Frost Bank's lien was ineligible for foreclosure due to it not containing the nine terms and conditions mentioned above. They also alleged that Frost Bank's letter response did not cure the alleged violations under Article XVI, Section 50(a)(6)(Q)(x) of the Texas Constitution. Frost Bank counterclaimed that its lien was valid and, in the alternative, claimed equitable subrogation in the amount it paid to pay off the prior mortgage and property taxes. The bench trial took place in April and June 2022. The Kelleys stipulated at trial that their only challenge was on whether the loan documents or the cure letter response sufficiently met the requirement to disclose that the loan was conditioned on the cure provisions detailed in Article XVI, Section 50(a)(6)(Q)(x) being applicable for any violations, and the testimony and evidence during the trial focused on this one issue.

In its decision, the trial court ruled for the Kelleys. It held that Frost Bank did not have a foreclosure-eligible lien. It also held that equitable subrogation was not applicable to the prior mortgage being paid off but rather only to the property taxes. Frost Bank appealed on five issues: 1) the court erred in its quiet title action because the document either explicitly contained the allegedly missing terms or incorporated them by reference, 2) the court erred by not finding that, in the event that the documents had missing terms, the letter cured any defects, 3) the court erred by not awarding Frost Bank a judicial foreclosure, 4) the court erred by denying Frost Bank equitable subrogation on the prior mortgage and 5) the court erred by concluding that Frost Bank's equitable subrogation claim on the prior mortgage was time-barred by the statute of limitations. Due to the Kelleys' stipulation at trial that concentrated their challenge on whether the loan documents or the cure letter response sufficiently met the requirement to disclose that the loan was conditioned on the cure provisions detailed in Article XVI, Section 50(a)(6)(Q)(x) being applicable for any violations, the appellate court focused its analysis on this issue.

The appellate court overruled the trial court's finding and held that Frost Bank's loan documents were legally sufficient to create a foreclosure-eligible lien. The court also held that the trial court erred by not granting a judicial foreclosure and remanded to the trial court. The appellate court did not rule on the other issues but did add *dicta* that, in the event that the loan documents were not legally sufficient, Frost Bank's January, 2017 letter would have likely cured the alleged violations. This holding and the court's *dicta* are favorable for lenders.

First, the holding that the documents were legally sufficient clarified that a lender on a home equity loan may incorporate necessary terms and conditions by reference. The appellate court drew on guidance from the Texas Supreme Court in *Garofolo v. Ocwen Loan Servicing, LLC,* 497 S.W. 474 (2016). As the appellate court stated:

> We see no reason why these principles [incorporation by reference] should not apply to home-equity loan agreements, and the Texas Supreme Court in *Garofolo* signaled that the forfeiture provision can be incorporated by reference into a home-equity loan. *See Garofolo,* 497 S.W.3d at 479 & n7 (explaining that the home equity loan in that case incorporated the forfeiture remedy where it cited to Section 50(a)(6)(Q)(x), though it did not recite the provision verbatim). *Kelly* at 6.

Although Frost Bank's loan did not "include a verbatim recitation of the lengthy forfeiture provision" (*Kelley* at 6) the appellate court found that the loan documents satisfactory incorporated the necessary provisions:

> Here, although the loan agreement does not include a verbatim recitation of the lengthy forfeiture provision, the Contract and Deed's "Cure Notice" paragraph referred specifically to the forfeiture

> provision. It stated that "Section 50(a)(6)(Q)(x) of the Texas Constitution" gave Frost Bank the right to correct any loan deficiencies upon receiving a notice of noncompliance from the Kelleys. Beyond this, the loan agreement repeatedly refers to Chapter 50(a)(6) and makes it clear that the Kelleys were granting Frost Bank a foreclosure-eligible home-equity lien. We hold that this shows a clear intent by the parties to incorporate the Section (Q)(x) forfeiture provision as a term into the loan agreement. *See Gross*, 2014 WL 7334950, at *3. Accordingly, we also hold that the trial court erred by concluding that Frost Bank's lien was invalid on the basis that the loan agreement did not include the requisite Section 50(a)(6) terms and conditions, and we sustain Frost Bank's first issue. *Kelley* at 6.

Therefore, this ruling helps establish that incorporation by reference of the necessary terms and conditions can meet documentary requirements to have a valid, foreclosure-eligible lien on a Texas home equity loan. This will hopefully prevent disputes due to interpretations of loan document provisions and whether they sufficiently describe the necessary terms or conditions to establish a foreclosure-eligible Texas home equity loan.

Secondly, the appellate court provided valuable guidance to lenders in its *dicta*. The *dicta,* although non-binding, provides commentary on how a lender may address an allegation of faulty loan documents on a Texas home equity loan. In addition to arguing that its loan documents were sufficient, the court noted that Frost Bank acted "[t]o fix this perceived problem, [by sending] a January 18 letter, in which it explicitly adopted and bound itself to each of the allegedly missing terms and conditions, including the forfeiture provision." *Kelley* at 7. In applying guidance from *Garofolo,* the court commented that this action was likely all that was necessary to cure the loan in the event that the court had found that the loan documents were faulty :

> Thus, reading the requirements of curative measure (Q)(x)(c) alongside *Garofolo's* instructions, Frost Bank needed only to disclose and agree to the forfeiture provision in writing. Further, the Contract and Deed provided that "any change or amendment" to the contract would be effective if it was in writing and "signed by whoever w[ould] be bound or obligated by the change or amendment." Frost Bank's letter was in writing, timely sent to the Kelleys' attorney, included verbatim the full text of the forfeiture provision (and the other allegedly missing terms and conditions), and notified the Kelleys that Frost Bank agreed to be bound by those terms. Accordingly, had we reached this issue, we likely would have held that Frost Bank's letter "actually fix[ed]" the problem. *Kelley* at 7.

Consequently, the *dicta* provides guidance to lenders that the cure letter itself can likely resolve alleged violations due to missing terms and conditions without having to have a loan modification signed by the homestead owners as well. This is in line with the official Texas Home Equity interpretations in the Texas Administrative Code, 7 TAC Section 153.95(c) ("A borrower's refusal to cooperate fully with an offer that complies with Section 50(a)(6)(Q)(x) to modify or refinance an equity loan does not invalidate the lender's protection for correcting a failure to comply.").

Going forward, this decision helps provide a "roadmap" on how a lender should address consumer notices of Texas Home Equity violations due to alleged missing terms and conditions on the loan documents and adds strength to lender responses to alleged violations. First, it is imperative that a lender timely responds to an alleged violation, as Frost Bank did, by replying within the 60-day response window. Second, Frost Bank's response both argued that its documents were sufficient and in the event that the documents were not sufficient, they agreed to be bound by all of the alleged missing terms or conditions. By adding this curative language, Frost Bank would have likely won the case even if the appellate court had found that its original loan documents were defective.

Further, the court's holding that necessary disclosures for terms and conditions of a Texas home equity loan may be incorporated by reference will hopefully avoid future trial court actions over construction of loan documents. And, as noted before, its *dicta* provides guidance that a lender's response should have the lender clearly agree to adopt any alleged missing terms or conditions. Additionally, this is also a published appellate-level case that is binding authority. The Texas Constitution in Article XVI, Section 50(u) states that a lender or noteholder's act or omission does not violate a 50(a)(6) provision if it conforms to an interpretation by a Texas or federal appellate court that is in effect at the time or act or omission, which provides a "safe harbor" for lenders relying on existing court decisions such as this one. In responding to an alleged violation due to faulty loan documents, a lender should reference this case along with this Constitutional provision to help bolster its response. Overall, this case should help lenders and noteholders make robust responses to alleged violations for faulty loan documents on Texas home equity loans that will cure any alleged defects and hopefully deter costly litigation.

This Memorandum is provided as general information in regard to the subject matter covered, but no representations or warranty of the accuracy or reliability of the content of this information are made or implied. Opinions expressed in this memorandum are those of the author alone. In publishing this information, neither the author nor the law firm of Black, Mann & Graham L.L.P. is engaged in rendering legal services. While this information concerns legal and regulatory matters, it is not legal advice and its use creates no attorney-client relationship or any other basis for reliance on the information. Readers should not place reliance on this information alone, but should seek independent legal advice regarding the law applicable to matters of interest or concern to them. The law firm of Black, Mann & Graham L.L.P. expressly disclaims any obligation to keep the content of this information current or free of errors.