

Equitable Subrogation as a Defense to Home Equity Lien Forfeiture

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The Texas Supreme Court recently held that a lender has a right to be equitably subrogated to an otherwise valid homestead lien when the lender's home equity loan is used to discharge the debt secured by that lien.

Background

Equitable subrogation is an equitable principle with deep historic roots, predating home equity lending in Texas. Equitable subrogation arises when a subsequent lender pays an existing debt. The doctrine allows a lender whose loan discharges an existing debt to be subrogated to the paid creditor's lien position. It can save a lender's interest when a defect in the loan process fails to convey title.

For equitable subrogation to apply, (1) the borrower must have been primarily liable on the discharged debt and (2) the new lender must have paid the debt involuntarily or at the borrower's request. This is the situation with a typical refinance. Texas leads other jurisdictions in applying equitable subrogation. The principle applies even if the new lender has actual knowledge that its loan is unconstitutional and can survive through multiple downstream loan transactions.

The Appellate Decision

In 2006, the Court of Appeals in San Antonio released its opinion in *LaSalle Bank, NA v. White*.¹ It held that a home equity lender could not use equitable subrogation to avoid the constitutionally-mandated lien forfeiture penalty for an invalid home equity loan, even if the home equity loan was used in part to pay off an existing purchase money lien and outstanding property taxes. According to the San Antonio court, because the Texas Constitution governs home equity loans and liens, a Constitutional homestead claim trumped the common law doctrine. Thus, under the appellate *LaSalle* decision, a home equity lender that failed to comply with all of the Texas Constitution's requirements to create a valid homestead lien could not be subrogated to an otherwise preexisting valid lien. This holding deprived home equity lenders of an equitable right that every other lender could enjoy. In such a scenario, home equity lenders would be better off making personal loans rather than home equity loans because only home equity loans would be ineligible for the creation of homestead liens by subrogation.

The Texas Supreme Court Decision

In December of 2007, the Texas Supreme Court reversed the San Antonio court, reconciled Texas's longstanding policy favoring preservation of the homestead with its well-settled equitable subrogation doctrine, and held that the Texas Constitution's home equity loan provisions did not supplant common law doctrines, including equitable subrogation.² In reconciling the two, the court noted that "the doctrine of equitable subrogation works to protect homestead property. Without equitable subrogation, lenders would be hesitant to refinance homestead property due to increased risk that they might be forced to forfeit their liens. The ability to refinance provides homeowners the flexibility to rearrange debt and avoid foreclosure." Home equity lenders that refinance existing valid homestead loans will be protected from forfeiture of their homestead lien to the extent of the refinanced homestead debt.

¹ *LaSalle Bank, NA v. White*, 217 S.W.3d 573 (Tex. App.-San Antonio 2006), *rev'd*, *LaSalle Bank, NA v. White*, No. 06-1016, Slip op. (Tex. Dec. 21, 2007).

² *LaSalle Bank, NA v. White*, No. 06-1016, Slip op. (Tex. Dec. 21, 2007).