Articles + Publications | May 15, 2023

Locke Lord QuickStudy: Texas Supreme Court Clarifies How ?Equitable Subrogation Operates for Texas Home ?Loans

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On May 12, 2023, the Supreme Court of Texas held, in a unanimous decision, that a claim to foreclose on a subrogated real property lien accrues when the refinance loan is accelerated, not when the prior loan (the payoff of which gave rise to subrogation) matures. *PNC Mortgage v. Howard*, ___ S.W.3d ___, 2023 WL 3398580, at *5 (Tex. 2023). In the process, the Court reaffirmed its ruling in *Federal Home Loan Mortgage Corp. v. Zepeda*, 601 S.W.3d 763 (Tex. 2020), "that in the mortgage-lending context specifically, a refinance lender's negligence in preserving in its own lien plays no part in its entitlement to enforce an earlier lien through equitable subrogation." *PNC Mortgage*, 2023 WL 3398580, at *1. The Court also importantly clarified "how subrogation operates in the mortgage-lending context." *Id.* at *2. This decision is particularly relevant to Texas home-equity loans under Article XVI, Section 50(a)(6) of the Texas Constitution, because the issue of subrogation most often arises in connection with these loans. Through the clarification provided by the Court in *PNC Mortgage*, a home-equity lender now has a better understanding of what it can do, as a practical matter, when its own lien is constitutionally invalid but it is either equitably or contractually subrogated to a prior lien.

Focusing on "'the dual nature of a note and deed of trust' under Texas law," the Court observed that "[i]n the refinance transaction, the original note is paid. That note then ceases to exist; … and a new note between the borrower and the refinance lender is executed." *Id.* at *4 & n.24 (quoting *Martins v. BAC Home Loans Servicing, L.P.*, 722 F.3d 249, 255 (5th Cir. 2013) (explaining that where "a note is … secured by a lien, the lien and the note constitute separate obligations" and "the ?note and the deed-of-trust lien afford distinct remedies on separate ?obligations"?)). Thus, "[w]hat equitable subrogation actually transfers to a refinance lender is the original creditor's *security interest*, so the refinance lender has *an alternative lien* if its own lien is later determined to be invalid. This transfer occurs automatically, by operation of law, when the refinance lender's money is used to pay off the original creditor's loan and discharge its lien." *Id.* (emphasis added). Put differently, "[i]f the lien created by the refinance transaction turns out to be invalid, then equitable subrogation substitutes the remedy of foreclosing on the original creditor's lien instead." *Id.* at *5.

The Court also clarified that "[t]he transfer or substitution that occurs through subrogation puts the party receiving the interest on par with the party from whom the interest was transferred. Subrogation does not put the party receiving the interest in a better position than the party from whom it was transferred." *Id.* In other words, while a

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subrogated lender may foreclose on the subrogated lien, its recovery from that foreclosure is limited to what the original creditor could have recovered under its lien and to the property to which the original creditor's lien attached. As other cases have explained, the limitation on the amount a subrogated lender may recover from a foreclosure sale is the amount the lender advanced to pay off the prior loan plus any statutory or contractual interest that has accrued since that payoff. *See, e.g.*, *Chase Home Fin., F.C.C. v. Cal. W. Reconveyance Corp.*, 309 S.W.3d 619, 629 (Tex. App.—Houston [14th Dist.] 2010, no pet.) (holding that for contractual subrogation, interest accrues on the amount recoverable through the foreclosure of a subrogated lien from the date the prior loan was paid off); *O'Carolan v. GMAC Mort. Co.*, 575 F. App'x 446, 449 (5th Cir. 2014) (per curiam) (adopting the district court's analysis in full, which held that for equitable subrogation, interest accrues on the amount recoverable through the foreclosure of a subrogated lien in accordance with Tex. Fin. Code § 302.002—*i.e.*, six percent a year beginning on the 30th day after the date the prior loan was paid off).

The Texas Supreme Court's delineation between a note and the lien securing that note also makes clear that when a subrogated lender's own lien is constitutionally invalid, and therefore cannot secure the borrower's repayment of the note between that lender and the borrower, two things occur. First, the note between the borrower and the subrogated lender remains secured, but it is secured by the prior lien to which the lender is subrogated rather than the lender's own constitutionally invalid lien. Second, the lender may foreclose on the prior lien to which it is subrogated if the borrower defaults on the note between the borrower and that lender.

Because the loan between a borrower and subrogated lender remains secured by the prior lien and the lender may foreclose on that lien if the borrower defaults, *PNC Mortgage* also clarifies that, while subrogation may result in the loan being under-secured due to the limitation on the amount the subrogated lender can recover from a foreclosure of the subrogated lien, subrogation has no effect on the borrower's obligation to timely repay the entire debt in accordance with the terms of the loan to avoid foreclosure because a default on that obligation will entitle the lender to foreclose on the subrogated lien. Thus, the only way a Texas residential borrower can escape the obligation to timely repay the entire debt in accordance with the terms of the loan is if each of the following conditions occurs: (1) the loan agreement incorporates the constitutional forfeiture provision in accordance with Tex. Const. art. XVI, § 50(a)(6)(Q)(x); (2) the lender fails to comply with its obligations under the terms of the loan; (3) one of the six specific constitutional corrective measures in § 50(a)(6)(Q)(x) would actually correct the lender's failure to comply with its obligations under the terms of the loan; (4) the lender fails to timely perform the corrective measure following proper notice from the borrower; and (5) the borrower timely brings a breach-of-contract claim seeking the contractual forfeiture remedy provided in the loan agreement. *See Garofolo v. Ocwen Loan Servicing, L.L.C.*, 497 S.W.3d 474, 484 (2016) ("A borrower may seek forfeiture through a breach-of-contract claim when the constitutional forfeiture provision is incorporated into the terms of a home-equity loan, but forfeiture is available only if one of the six specific constitutional corrective measures would actually correct the lender's failure to comply with its obligations under the terms of the loan, and the lender nonetheless fails to timely perform the corrective measure following proper notice from the borrower.").

In conclusion, *PNC Mortgage* provides sorely needed clarification on the practical effect of subrogation in the context of Texas residential refinance loans. Lenders—and especially home-equity lenders—in Texas may now look to *PNC Mortgage* for guidance on what they can do to enforce such loans when a borrower has defaulted, or is in danger of default, and the lender finds that its own lien is constitutionally invalid. Conversely, *PNC Mortgage* also helps residential borrowers—and especially home-equity borrowers—in Texas avoid foreclosure by educating them on their continued obligation to perform under their loan agreement even if the lien originally securing their loan is

constitutionally invalid.

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