

# DEED IN LIEU OF FORECLOSURE TRANSACTIONS\*

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## I. INTRODUCTION

Confronted with the inability to continue to make payments to a lender in accordance with the loan documents, a borrower may offer to convey the mortgaged property to the lender in exchange for not foreclosing on the property and settlement of the secured debt. This deed in lieu of foreclosure transaction can offer significant benefits to both borrower and lender, but presents risks and costs to the parties that require careful analysis and structure. If the disadvantages outweigh the benefits, the lender must be prepared to abandon the deed in lieu transaction and proceed with foreclosure or another resolution. This article will examine the benefits of a deed in lieu transaction, the due diligence that a lender should conduct, the bankruptcy and equitable risks, subordinate lien and title insurance issues involved in these transactions and negotiation of the settlement agreement. Attached to this paper is a checklist for deed in lieu transactions.

## II. BENEFITS

A deed in lieu of foreclosure provides several benefits to a lender and borrower. The primary benefit to a lender of a deed in lieu is quick control of the income and operation of the property, allowing the mortgagee to initiate actions to maximize the value of the property. Control also enables a lender to market the property for resale sooner. Accelerated control is particularly attractive in slow judicial foreclosure states such as Ohio and New York. Deeds in lieu are rarely used in quick action trustee sale states like Texas. In fact, the Texas Supreme Court stated in 1987 “there is no such deed as a deed-in-lieu of foreclosure.”<sup>1</sup> In the case study, the lender seeks to gain control of the property to negotiate the expansion lease and retain the major tenant. A deed in lieu can save the parties the time and expense of foreclosure and receivership. A borrower may benefit in transactions in which the lender pays for part or all of the expenses of the transfer, such as transfer taxes, title policy and recording costs. A sales commission normally incurred in a sale of the property by a borrower to a third party will be saved. The delay of waiting for expiration of the redemption period can be avoided by recording of the deed. A deed in lieu reduces the risk of deterioration and waste to the property. If in construction, a deed in lieu can avoid work stoppages. A partially completed project is worth only a fraction of the outstanding loan and expeditious completion is necessary to maximize recovery. With respect to completed projects, a voluntary turnover can be less disruptive to

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<sup>1</sup> *Flag-Redfern Oil Co. v. Humble Exploration Co.*, 744 S.W.2<sup>nd</sup> 6, 8 (Tex. 1987); The court’s unenlightened position that was corrected by statute, TEX. PROPERTY CODE, §51.006.

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tenants and vendors. Interruption of services to the property can also be avoided. The lender is able to capitalize on the borrower's cooperation and obtain better and more complete information about the property. Not only is the borrower more willing to operate the property through closing in accordance with the lender's standards, but borrowers will often agree to deliver more information and original documents regarding the property. Other covenants and warranties may be negotiated in the settlement agreement. As with any other workout, a settlement agreement is an opportunity to correct deficiencies in loan documentation. The lender may be able to avoid the risk of delay of a filing of a petition in bankruptcy. The filing of a deed in lieu is private transaction. The stigma of a foreclosure for the property and adverse credit rating can be avoided for the borrower. If the lender takes title in a subsidiary, it avoids the publicity and notoriety of a public sale. A quick closing can end the borrower's responsibility for payment of property expenses, insurance and property taxes. The parties can reach a final settlement of their liabilities under the loan documents. The borrower and guarantors can be released from claims for deficiency and carve-out liabilities and the lender can receive a release from any lender liability claims.

### **III. DUE DILIGENCE**

A. Property Review. A deed in lieu of foreclosure is an acquisition of title to real property and should be approached with the same due diligence and scrutiny of the purchase of any other property. A lender needs to understand all the obligations and responsibilities of ownership of the property. At a minimum, operating statements and books and records for the property should be obtained and reviewed to understand the revenues, payables, capital expenditures, and security and utility deposits. The lender should review all contracts and other agreements relating to the property, including management contracts, brokerage agreements, equipment leases and service contracts, and determine whether the contracts are assignable and whether to continue or terminate them upon closing. Replacement agreements may be needed in the event of any terminations. The lender may want to obtain estoppels from certain vendors and counterparties. For example, if the title to the property is held under a ground lease, the lender will want a current estoppel certificate from the ground lessor. A current rent roll and all leases and lease guaranties should be obtained and reviewed to determine the obligations of the landlord and tenants, and confirm that the tenants are required to attorn to a successor owner. It may be necessary to obtain subordination, non-disturbance and attornment agreements from some tenants and estoppels should be obtained from all tenants. If not already in its files, the lender should obtain copies of and review all permits, certificates of occupancy and other approvals for the property, plans and specifications, warranties, and insurance policies. The adequacy of the insurance policies should be assessed, payment of premiums confirmed, and a determination made whether to continue the policies or place new insurance at closing. The property should be inspected to determine its condition, identify needed repairs and unsafe conditions and conditions of non-compliance with applicable handicap access or other laws and regulations.

Public records should be searched for any outstanding violations and whether the property complies with existing zoning, land use and other laws and regulations. The lender should determine whether all property, gross receipt, income, sales, withholding and payroll taxes have been paid by the borrower. The lender should discover the status of any pending tax protests. The lender should also conduct searches for any pending litigation or claims against the property or borrower.

B. Environmental. The lender must obtain an updated Phase I environmental report on the property. A mortgage lender acquiring title to a property by either a deed in lieu of foreclosure or by foreclosure may become an “owner or operator” with strict liability for future costs and expenses of remediation of hazardous substances under federal or state environmental laws unless the lender can prove it qualifies as a “bona fide prospective purchaser.” This defense requires the owner to show that prior to purchasing or acquiring title to the property, it conducted all appropriate inquiry of the previous ownership and uses of the property consistent with good commercial or customary practices.<sup>2</sup> Thus, the lender cannot rely upon the old environmental report delivered at the time of the loan closing. This defense imposes continuing obligations upon the owner during its period of ownership regarding known contaminants. In some cases, the inquiry may lead the lender to conclude that it does not want to accept a deed to the property or foreclose on the property, and the lender may want to reconsider accepting a discounted payoff or a discounted sale of the mortgage loan.

A lender should not accept a deed to the property unless it is confident that the cost of the clean-up is small. It has been suggested that a lender might accept title to a contaminated property in an entity controlled by the lender, but the lender may find that it is unable to resell the property to another purchaser without paying or indemnifying the purchaser for the costs of remediation. A lender may face the risk of a third party or the government piercing the corporate veil of the controlled entity to seek recovery directly from the lender. Moreover, a lender should determine whether the protection of secured lender exemptions extend to the controlled entity of the lender accepting a deed in lieu of foreclosure.

Several states have adopted their own environmental liability schemes, such as Responsibility Transfer Acts which require the recording of environmental disclosure statements upon the recording of property transfer. Some of these states require the assumption of the responsibility to remediate known environmental conditions and permit any party to the transaction to void the transaction for non-compliance. The lender should determine whether any applicable state statutes require compliance or exempt a deed in lieu of foreclosure.<sup>3</sup>

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<sup>2</sup> 40 C.F.R. §312 (2010); ASTM E1527-05; In addition, the “secured creditor” exemption can provide exemption from the status of an owner or operator even where the lender has taken title through foreclosure (including a deed in lieu), 42 U.S.C. A. §9601(20) (2010); *See* TEX. WATER CODE §26.3514(D) (Vernon 2010) dealing with storage tanks.

<sup>3</sup> Indiana Responsible Party Transfer Act, IC 13-25.3; The Connecticut Transfer Act C.G.S.A. 22a-134(1)(C) exempts a transferee of a deed in lieu of foreclosure, as defined in and that qualifies for the secured lender exemption pursuant to §22a-452f(b).

C. Title Search. A lender must obtain title and UCC financing searches of the property to identify all matters and liens affecting the property. Unlike a foreclosure, a voluntary transfer of the property pursuant to a deed in lieu conveys title to the lender subject to all subordinate encumbrances.<sup>4</sup> Many lenders will not accept a deed in lieu if any subordinate liens are revealed by the searches, even if it is anticipated that there will only be short time between recording of title and a later foreclosure cutting off the junior liens. For example, pension fund lenders do not want to be subject to acquisition indebtedness. The lender may not want to face the risk of dealing with other secured creditors in the event of a bankruptcy filing or a loan workout. Finally, a lender rarely will want to incur the substantial expenses of negotiating and closing a deed in lieu transaction and subsequently be compelled to pay for all the expenses of a subsequent foreclosure.

If the lender accepts the deed in lieu of foreclosure, even if title and UCC financing searches are clean of junior liens, there is no guarantee that a subordinate lien will not appear after closing of the transaction so it is important that the lender preserve its mortgage lien. A lender in consideration of a deed in lieu transaction should carefully review local law on the issue of merger. Under the common law doctrine of merger the combination in the same person of greater estate of land, such a fee simple title, with a lesser estate, such as mortgage, extinguishes the lesser interest through a merger into the greater estate, leaving no mortgage lien to foreclosure.<sup>5</sup> Contrary to Section 8.5 of the Restatement on Property (Mortgages) which provides that the doctrine of merger applies to mortgages, several state foreclosure statutes provide that “a deed in lieu of foreclosure, whether to the mortgagee or mortgagee’s nominee, shall not effect a merger of the mortgagee’s interest as mortgagee and the mortgagee’s interest derived from the deed in lieu of foreclosure.”<sup>6</sup> Section 51.006 of the Texas Property Code allows a lender that has accepted a deed in lieu of foreclosure the option either (1) to void the deed within four years of the date of the deed if the debtor failed to disclose a lien or encumbrance and the lender has no personal knowledge of the undisclosed lien or encumbrances when it accepted the deed and reinstate the deed of trust without impairment of its priority, or (2) foreclose its deed of trust without electing to void the deed. Other states rely upon the intention of the parties to determine whether the mortgage lien merges into the deed. However, the Sixth Circuit Court of Appeals in *United States Leather, Inc.*<sup>7</sup> did not enforce the anti-merger provision in a deed in lieu of foreclosure because the rights of an innocent third party lender would be lost through a fraud or inequitable conduct by the parties to the deed where a mortgagee attempted to avoid paying a debt it had previously acknowledged owing.<sup>8</sup> Clear intent to preserve the mortgage lien should be placed in the settlement agreement and in the deed. In some states, it is prudent to take title in a separate entity controlled by the lender to

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<sup>4</sup> *North Texas Building & Loan Ass’n v. Overton*, 86 S.W.2d 738 (Tex. 1935).

<sup>5</sup> See Ann M. Burkhart, *Freeing Mortgages of Merger*, 40 VAND. L. REV. 283, 342 (1987).

<sup>6</sup> S.H.A. 735 ILCS 5/15-1401.

<sup>7</sup> *United States Leather, Inc. v. Mitchell Mfg. Group, Inc.*, 276 F.3d 782 (6<sup>th</sup> Cir. 2002).

<sup>8</sup> John C. Murray, *Deeds in Lieu: Subsequent Foreclosure of Mortgage* (2006).

avoid merger and extinguishment of the mortgage lien. Careful review of the state income and transfer taxes should be made before deciding to use a separate entity. For example, life insurance companies are not subject to state income taxes, but a corporation or limited liability company controlled by the insurance company may be. For this reason, a business trust may be preferable for the controlled entity. In addition, some states impose transfer taxes upon transfers to a separate entity, but not to the lender holding the debt.

Finally, the lender should not, intentionally or inadvertently, extinguish the debt or cancel the mortgage lien before the property is ultimately resold to another third party purchaser. This means that a lender should give a covenant not to sue to the borrower and not a general release that may extinguish the debt and make a subsequent foreclosure impossible. A covenant not to sue has demonstrated the intent not to merge and overcome the mortgagor's burden of proof.<sup>9</sup> It should be noted, however, that if a new owner title policy is being issued to the lender, the title company may request that the mortgage lien be released of record. I believe that this request is based upon Section 2.a in the 1992 ALTA Loan Policy that provides for continuation of coverage only if the insured acquires the property by "conveyance in lieu of foreclosure, or other legal manner which discharges the lien of the insured mortgage." This provision does not appear in the new 2006 ATLA Loan Policy and therefore the title company should recognize procedures to preserve the mortgage lien.<sup>10</sup> Reservation of the mortgage lien protects the lender against unknown subordinate encumbrances and allows reinstatement of the loan documents in the event that following recordation of the deed, the transfer is set aside by bankruptcy court as a fraudulent conveyance or preference.

A lender should be cautious about accepting a deed in lieu with known subordinate liens. There is a comment in the Restatement Third of Property, that a "mortgagee who takes a deed in lieu with actual knowledge of a junior lien will lose the right to foreclose irrespective of whether there is merger intent."<sup>11</sup> Professor Burkhart has also written "the senior mortgagee should be prohibited from exercising its lien in this situation regardless of whether it has manifested any intent concerning merger. Each time a deed in lieu transaction is negotiated with the understanding that the mortgagee will acquire title subject to junior liens, the senior mortgagee has waived its right to eliminate those liens."<sup>12</sup> If the title or UCC searches reveal subordinate liens, the lender may want to continue the benefits of a cooperative borrower and request that the borrower stipulate to the foreclosure of the property and appointment, if necessary of a receiver. In a friendly foreclosure, the lender could obtain the advantages of a comprehensive settlement agreement with the borrower and save time and expense. In the alternative, if the amount of the subordinate liens is small, the expense of negotiating settlement

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<sup>9</sup> *Sanderson v. Hadlett*, 832 So. 2d 845 (Fla. App. 4th Dist. 2002); See also Michael F. Jones, *Structuring the Deed in Lieu of Foreclosure Transaction*, 19 REAL PROP., PROB. & TR. J. 58, 70 (Spring 1984).

<sup>10</sup> John C. Murray, *Deeds in Lieu of Foreclosure – Title Insurance Issue*, ACMA ABSTRACT (Spring 2011).

<sup>11</sup> RESTATEMENT THIRD OF PROPERTY (MORTGAGES) §8.5 Comment.

<sup>12</sup> Ann M. Burkhart, *Freeing Mortgages of Merger*, 40 VAND. L. REV. 283, 348-49 (1987).

of the subordinate liens and proceeding with the deed in lieu may be less than the costs of completing the foreclosure.

D. Bankruptcy Concerns. A transfer to the lender can be voided under the Bankruptcy Code as a fraudulent conveyance if there is a lack of fair consideration. Section 548(a)(1) of the Bankruptcy Code provides that

“the trustee may void any transfer ... of an interest of the debtor in property, or any obligation ... incurred by the debtor, that was made or incurred on or within two years before the date of filing of the petition, if the debtor voluntarily or involuntarily... received less than a reasonably equivalent value in exchange for such transfer or obligation;...and was insolvent on the date that the transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation...”<sup>13</sup>

In addition, a trustee may set aside a transfer using any applicable state fraudulent conveyance statute which may be broader in scope.<sup>14</sup> A transfer can also be voided if made with the intent “to hinder, delay or defraud a creditor”, but actual fraud is very difficult to prove and unlikely to be present in any arms-length deed in lieu transaction. In extreme cases, equitable subordination has been applied where the lender’s behavior was overreaching.<sup>15</sup> If the transfer is set aside, the lender will be considered a creditor, but if the lender’s lien is shown to be unperfected, the lender will be treated as an unsecured creditor. This is a reason to confirm perfection of a lender’s lien before recording a deed in lieu of foreclosure. If set aside, the trustee can either order the transferee to reconvey the property to the debtor or to pay to the trustee the difference between the value of the property as determined by the court and the sales price.<sup>16</sup>

Satisfaction of an antecedent debt is considered value. Where the outstanding debt, including interest, default interest, and late charges, exceeds the value of the property, the debtor has received reasonably equivalent value. This is the reason it is critical to obtain a solid appraisal of the property from an independent qualified third party appraiser to establish that adequate consideration is being given for the property. A more difficult situation is where the value of the property and the debt are approximately equivalent. Most lenders prefer a margin of safety to avoid an evidentiary battle of appraisers. If the value of the property exceeds the amount of the debt, the borrower and its constituent partners, members or shareholders of the borrower may have an incentive to challenge the transfer in bankruptcy court to recover their equity in the property. To avoid this situation, the lender might consider paying to the borrower

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<sup>13</sup> 11 U.S. C. A. §548(a)(1) (Supp 2011); The preference period was extended from one to two years by Bankruptcy Abuse Prevention and Consumer Act of 2005.

<sup>14</sup> A trustee can bring an action before the closing of the bankruptcy case using a state fraudulent conveyance law within of 2 years after the entry of order of relief or 1 year after appointment of the trustee, 11 U.S.C. A. §544(b) and §546(a); Section 3 of the Uniform Fraudulent Conveyance Act requires the transfer to be made in “good faith.”

<sup>15</sup> 11 U.S.C.A. §510.

<sup>16</sup> 11 U.S.C.A. §550.

at the time of the transfer an amount in cash equal to the shortfall between the difference between the amount of the debt and the value property. If the transaction is nevertheless voided by a bankruptcy court, the cash payment would not be refunded to the lender until after the plan of reorganization has been approved or the property is sold in the bankruptcy case.<sup>17</sup> The better approach under these circumstances is to proceed with a foreclosure because title taking through a foreclosure is not treated as a fraudulent conveyance under the Bankruptcy Code.<sup>18</sup> Most lenders, after analyzing the risks under these circumstances where the value of the property exceeds the debt, will decline acceptance of a deed in lieu of foreclosure.

A transfer to a lender by an insolvent borrower may be voided as a preferential transfer by a bankruptcy trustee in a subsequent bankruptcy filing made within 90 days of the date of the transfer.<sup>19</sup> The debtor must be insolvent or made insolvent at the time of the transfer. While there is a presumption of insolvency of the debtor within 90 days preceding the date of filing,<sup>20</sup> the inability to pay debts as these become due does not indicate that the borrower is insolvent under the Bankruptcy Code. Insolvency is a balance sheet test. The trustee must prove all five elements in Section 547(b). If the lender can show that the borrower is solvent (which may not be possible if the borrower is a single asset entity), there is no preferential transfer. A lender should therefore obtain a current financial statement for the borrower to determine its solvency under the Bankruptcy Code. More importantly, the transfer can be only be a preference if the creditor receives more of its claim than it would have received in a distribution from the bankruptcy if the transfer has never been made. Once again, establishing the value of the property is critical to determining what the creditor is entitled to receive in a distribution. The creditor is entitled to receive the value of the property that does not exceed its secured debt. Therefore, if the value of the property is less than the secured debt, there is no preference and the transfer cannot be voided by the trustee. The lender should confirm that its debt is properly secured and perfected. An unperfected security interest will fail this test and can be voided by the trustee. For example, a security interest in a cooperative apartment would be unsecured if the lender failed to properly file and continue UCC financing statements.

### III. DOCUMENTATION

A. Negotiation. The motivations and positions of the parties are important in negotiating a settlement agreement. Both parties approach the possible transaction burdened with a misjudgment of the original loan transaction and the performance of the property and borrower. A borrower of a non-recourse loan is in a stronger bargaining position than an obligor of a personally guaranteed loan because the non-recourse lender's opportunity to recover depends solely upon the improvement of the value of the property. While a recourse lender may

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<sup>17</sup> 11 U.S.C.A. §548(c).

<sup>18</sup> *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 114 S. Ct. 1757 (1994).

<sup>19</sup> 11 U.S.C. §548(a); The ninety day period can be extended to 1 year if the transferee is an insider, *Levit v. Ingersoll Rand Fin. Corp.*, 874 F. 2d 1186 (7<sup>th</sup> Cir. 1989).

<sup>20</sup> 11 U.S.C.A. §547(f).

prefer to pursue the personal liabilities of the borrower and guarantors, a non-recourse lender has a strong incentive to obtain title to the property quickly. It is important to identify who is able to negotiate for the borrower.<sup>21</sup> An awareness of possible conflicts among the parties constituting the borrower is important. The general partner or managers may want a release of all obligations under the loan documents and may want to retain project management. The limited partners or investors will be concerned about their lost opportunity and tax liabilities. Their differences may create conflicting demands and the parties constituting the borrower may need separate counsel. The negotiating party for the borrower needs to remember his fiduciary duties to the other partners. Conveying the property to the lender in return for a release that benefits only the general partners may constitute use of a partnership asset for nonpartnership purposes.<sup>22</sup>

Do not assume that the authority to make the original loan is sufficient to consummate the proposed transfer. The organizational documents of the borrower should be reviewed to determine the authority of the borrower to convey the property. The lender needs to confirm what consents are required for the proposed transaction and whether all necessary parties are willing and able to deliver such consents. A lack of consensus among the borrower parties can easily derail the transaction.

A borrower may be using the negotiation of the settlement agreement as a delaying tactic to retain title to the property.<sup>23</sup> A realistic schedule for the negotiations and closing of the transaction should be established, and if agreement is not reached within a reasonable time, the lender may have to proceed with foreclosure. The lender may want to initiate a foreclosure at the same time that the deed in lieu transaction is being negotiated to give the lender more leverage in the negotiations and forestall delays, but this approach imposes additional expenses on the lender.

B. Voluntary Conveyance. A deed in lieu conveyance must be a voluntary transaction under state law. Every borrower has a right to redeem its property with full payment of the obligation within certain time frames. A borrower cannot lose its right of redemption, except through a valid foreclosure action or in a conveyance for adequate consideration. Jack Murray has written:

Unless the offer of conveyance by the borrower is voluntary, there is a significant risk that the borrower may later contest the transaction. Factors that taint a transaction include undue pressure, fraud (actual or constructive), unconscionable advantage, duress, undue influence, or grossly inadequate consideration. For example, if the borrower

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<sup>21</sup> Douglas R. Prince, *Counseling the Borrower on Friendly Foreclosures and Deeds in Lieu*, 10 PRAC. REAL ESTATE LAWYER 37 (March 1994).

<sup>22</sup> Alan Bromberg & Larry Ribstein, BROMBERG AND RIBSTEIN ON PARTNERSHIP §6.07 (1995).

<sup>23</sup> Diane S. Coscarelli, *The Deed in Lieu of Foreclosure: To Do or Not to Do?* (ACMA Annual Meeting 2009); Dianne S. Coscarelli, *Avoiding the Traps in Workouts and Deeds in Lieu of Foreclosure*, 13 PRAC. REAL ESTATE LAWYER 7 (July 1997); Nancy J. Appleby, *Counseling the Lender on Friendly Foreclosures and Deeds in Lieu*, 10 PRAC. REAL ESTATE LAWYER 21 (March 1994).

successfully argues duress or undue influence, the entire transaction may be set aside. In the alternative, the borrower may choose to recover the value of the property, the equity of redemption, or the profits realized on sale. Additionally, if the lender's conduct is flagrant or outrageous, courts may assess punitive damages against the lender.<sup>24</sup>

Moreover, if the transaction is set aside by reason of a lender's conduct, the title company may raise a defense of "acts of insured" to any claims. The best practice is to document that the transaction originated after a loan default with an offer from or on behalf of the borrower to tender a deed to the lender. The documentation should state the reasons for the offer. This will forestall later claims by the borrower or others of undue influence, duress, oppression or the absence of good faith. The lender should respond setting forth the written conditions under which the lender is willing to accept the voluntary conveyance. All these conditions must be satisfied before the lender is obligated to close the transaction.<sup>25</sup>

C. Settlement Agreement. It is important for both the borrower and lender to document the transaction in a comprehensive settlement agreement. The draftsmen should be mindful that courts view deeds in lieu with suspicion because of the common unequal bargaining power between lenders and borrowers. Viewing the transaction as an arms-length purchase of the property, the lender will want representations, title warranties, extensive deliverables and title insurance. A borrower will prefer a simple transaction without these items involving delivery of a deed in exchange for a full release of all liabilities under the loan documents. The agreement should recite the voluntary nature of the transaction and set forth the consideration for the conveyance. If the loan is recourse, consideration is most likely the full or partial forgiveness of the debt. If non-recourse, the consideration is the value of the property. Waiver of the right to foreclose immediately and exercise other remedies is also consideration. The borrower should confirm the amount of the debt, the default, the value of the property, and that it has no equity in the property. The lender may ask for a representation of solvency of the borrower, but this may not be possible for a single asset borrower. The transaction should be described as an absolute conveyance with no continuing rights or interests of the borrower in the property or rights of redemption. Recitation should be made that the debt is not being extinguished and that there is no intent to merge the debt into the deed. The lender needs to identify all of the personal and real property that is to be transferred and address any special circumstances that require particular attention, such as liquor licenses, hotels, cooperatives and condominiums.

The borrower will want to be released from any deficiency (if the loan is recourse) and all carve-out liabilities (if the loan is non-recourse) and all other obligations under

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<sup>24</sup> John C. Murray, *Deeds in Lieu of Foreclosure: Practical and Legal Considerations*, 26 REAL PROP. PROB.& TR. J. No. 3, 459, at 463 (Fall 1991).

<sup>25</sup> The unilateral execution and recording of a deed by a borrower to a lender is not binding upon the lender absence evidence that the lender accepted the deed, *Martin v. Uvalde Savings and Loan Assn.*, 773 S.W. 2d 808 (Tex Civ. App. – San Antonio 1989); *Hennessey v. Bell*, 775 S.W.2d 650 (Tex Civ. App.-Corpus Christi 1988), *writ denied*.

the loan documents. The reasons for providing a covenant not to sue rather than a release have been discussed above. The agreement should clearly state what is and what is not being released or covered by the covenant not to sue, and whether the guarantors are being released or covered. Acceptance of a deed in lieu of foreclosure generally does not preclude the lender seeking a deficiency, but to avoid an inadvertent release, it is advisable to review any applicable state statute governing this type of transaction. For example, an Illinois statute provides that “Acceptance of a deed in lieu of foreclosure shall relieve from personal liability all persons who owe payment or the performance of other obligations secured by a mortgage, including guarantors of such indebtedness or obligations, except to the extent a person agrees not to be relieved in an instrument executed contemporaneously.”<sup>26</sup> The lender will want to exclude from the covenant not to sue the representations and covenants of the borrower in the settlement agreement, deed warranties and environmental indemnifications. The borrower and guarantors should release any claims against the lender. The covenant not to sue should provide that in the event the transaction is subsequently set aside in a bankruptcy or other action, the covenant is null and void and all the loan documents are reinstated.<sup>27</sup> The covenant should contain a reservation of any claims against any other guarantors or other parties not being released. If not being fully released, the guarantor’s consent should be obtained. The borrower’s counsel should opine on the due authorization, execution, validity and enforceability of the settlement documents and that the mortgage and related security interests are valid and properly perfected under applicable state law. Finally, it is not in the interest of the lender for the terms of the settlement agreement to be shared with other borrowers or discussed among borrowers, so a confidentiality provision is recommended.

D. Absolute Conveyance. The borrower may seek to retain control of the property by asking to remain in possession of the property, or to manage the property after the recording of the deed, or request a right to repurchase, right of first refusal, or share in the profits. The lender should be very cautious regarding these requests. These rights may be inconsistent with intent to divest title.<sup>28</sup> Each of these rights could be considered the equivalent of an equitable mortgage or may be deemed voidable as a clog on the equity of redemption.<sup>29</sup> For example, when a borrower defaulted under an arrangement by which it transferred the property to a lender who agreed to reconvey the property to the borrower upon completion of debt payment, the court held this arrangement a mortgage.<sup>30</sup> A transfer has been held a mortgage when the borrower leased back the property and retained an option to purchase the

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<sup>26</sup> S.H.A. 735 ILCS 5/15-1401.

<sup>27</sup> A title company may raise an exception in its owner policy for this reinstatement right, John C. Murray, *Deed in Lieu of Foreclosure – Title Insurance Issues*, 10, ACMA ABSTRACT (Spring 2011).

<sup>28</sup> *Riley v. W.R. Holdings LLC*, 138 P.3d 316 (Id. 2006).

<sup>29</sup> *In Re All American Hold Corp*, 8 B.R. 459 (Bankr. S.D. Fla. 1981); See John C. Murray, *Clogging Revisited*, 33 REAL PROP. PROB. & TR. J. No. 2, 279 (Summer 1998).

<sup>30</sup> *Davis v. Stone*, 236 F. Supp. 553 (D.D.C. 1964).

property for the amount of the debt,<sup>31</sup> or retained possession and paid taxes, insurance, maintenance expenses, and utilities.<sup>32</sup> In determining whether an equitable mortgage exists, a court will consider whether a debt exists, presence or absence of counsel, the relationship of the parties, the parties' sophistication, adequacy of consideration and who retained possession of the property.<sup>33</sup> Rights to repurchase or profit sharing should be avoided. If the borrower manages the property after the conveyance, the engagement should be on daily basis terminable at will by the lender. The borrower should not be granted any authority to control the development, leasing or sale of the property. The best practice is to engage a new manager unaffiliated with the borrower to take over management of the property at closing. If the borrower is to lease any portion of the property after closing, the term should be short and rent at a market rate. Finally, the settlement agreement should clearly recite that the transaction is intended to be an absolute conveyance of the property and not a transfer for security purposes. If the conveyance is recharacterized as an equitable mortgage, not only will the lender have to resort to a judicial foreclosure to regain the property, but the lender will not have the benefit of the customary provisions and remedies, such as waivers of redemption, right to trustee's sale, or right to obtain a receiver. The equitable mortgage would have a different priority. As a mortgagee in possession, the lender could also be subject to claims by the borrower of mismanagement of the property.

E. Deed in Escrow. The borrower may seek to retain possession of the property for a certain period of time by proposing to place a deed into escrow with instructions to deliver it to the lender upon the failure to meet certain goals. This arrangement affords a borrower additional time to stabilize the situation. The lender should carefully consider the risks of a placing a deed in escrow before adopting any escrow arrangement.<sup>34</sup> The deed will be frozen in escrow if the borrower later asserts to the escrow agent any dispute regarding the transaction. Courts will closely scrutinize deeds in escrow to determine whether it clogs the equity of redemption. A transaction may be characterized as merely a refinance or continuation of the old loan and void the deed as an attempt to evade the foreclosure process.<sup>35</sup> Unenforceability is based upon the theory that the deed is merely security for the mortgage loan,<sup>36</sup> or that the borrower at the time of original loan transaction could not have waived its right of redemption,<sup>37</sup> or that the deed is voidable as a clog on the equity of redemption.<sup>38</sup> Other

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<sup>31</sup> *Beeler v. American Trust Co.*, 147 P. 2d 583 (Cal. 1944).

<sup>32</sup> *Striker v. Trans-West Discount Corp.*, 155 Cal. Rpt. 132 (Cal. Ct. App. 1970).

<sup>33</sup> *Flack v. McClure*, 565 N.E.2d 131 (Ill. App. Ct. 1990).

<sup>34</sup> John C. Murray, *Mortgage Workouts: Deeds in Escrow*, 41 REAL PROP. PROB. & TR. J. No. 2, 185 (Summer 2006).

<sup>35</sup> Any deed in escrow executed in connection with the original loan transaction is void and unenforceable, *First Illinois Bank v. Hans*, 143 Ill. App. 3d. 1033, 493 N.E. 2d 1171 (2<sup>nd</sup> Dist. 1986).

<sup>36</sup> *Katheiser v. Hawkins*, 645 P.2d 967 (Nev. 1982); *See also Hendrickson v JGR Properties Inc.*, 2008 WL 5053440, Ohio Ct. of App., December 2008) *discussed in* Roger Bernhardt, *Bad Timing for Deeds in Lieu*, ACMA ABSTRACT (Fall 2009).

<sup>37</sup> *Marple v. Wyoming Production Credit Ass'n.*, 750 P.2d 1315, 1320 (Wyo. 1988).

courts have held that an executory deed arrangement is an equitable mortgage which must be foreclosed in order to enforce the agreement.<sup>39</sup> A deed in escrow has been considered a mortgage because of a recital of the existence of debt, that the borrower retained management of the property and the documents allowed the borrower to recover the property when the debt was paid.<sup>40</sup> Parol evidence is admissible to show that an absolute deed on its face was intended as security for an obligation and should be considered a mortgage.<sup>41</sup> The parties' intention may be shown by their statements, a substantial disparity between the value received by the grantor and the actual value of the property, continued possession by the grantor, continued payment of taxes by the grantor, improvements made by the grantor, and the relationship of the parties before and after the conveyance, and existence of contingencies that could unwind the transaction.<sup>42</sup>

Under certain circumstances, however, a deed in escrow delivered in connection with a workout may be enforceable. There must be a default and fair and adequate consideration given to the borrower. In *Ringling Brothers*,<sup>43</sup> the court found that the mortgagor received valuable new consideration and upheld the executory deed. The mortgagor received new loan proceeds and the pending foreclosure proceedings were halted. The court also noted that the transaction involved commercial and not residential real estate, the mortgagor was represented by counsel, the mortgagor had no equity in the property and the mortgagor had acknowledged it could not pay and had made no attempt to pay the debt. In *Russo v. Wolbers*, the court stated that "the exchange must be fair, frank, honest, and without fraud, misconduct, undue influence, oppression or unconscionable advantage of the poverty, distress or fears of the mortgagor."<sup>44</sup> Forbearance to foreclose and acceptance of the property in full satisfaction of the debt,<sup>45</sup> and an extension of the loan and release of a borrower's personal liability<sup>46</sup> have been held adequate consideration.

Finally, the lender must analyze the risk that during the period the deed is in escrow, the borrower will file bankruptcy. A bankruptcy court will consider that the property remains part of the borrower's estate because title has not transferred to the lender under an escrow of an

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<sup>38</sup> *C. Phillip Johnson Full Gospel Ministries, Inc. v. Investors Financial Services LLC*, No. 115 (Md. Ct of App. Filed Jan. 31, 2011); Debra P. Stark, *Avoiding the Recharacterization of Certain Deed-in-Lieu Foreclosure Transactions: Ensuring That What You Draft is What You Get*, 110 BANKING L. J., 330 (1993).

<sup>39</sup> *McGuigan v. Miller*, 117 Cal. App 739, 750, 4 P. 2d 607, 611-12 (1931).

<sup>40</sup> *Wallace v. McCabe*, 245 N.Y.S. 2d 854 (Sup. Ct. 1964).

<sup>41</sup> RESTATEMENT THIRD OF PROPERTY (MORTGAGES) §3.2 (1997); *Compare* MINN. STAT. ANN. §559.18 (2010) and GA. CODE ANN. §44-14-32 (2011) which prohibits parol evidence to show a deed absolute on its face is a mortgage, unless there is fraud; *with* ARIZ. REV. STAT. ANN. §33-702(A) which permits parol evidence.

<sup>42</sup> John C. Murray, *Deed in Lieu of Foreclosure – Title Insurance Issues*, ACMA ABSTRACT (Spring 2011).

<sup>43</sup> *Ringling Brothers Joint Venture v. Huntington National Bank*, 595 So.2d 180 (Fla. Dist. Ct. Ap. 1992).

<sup>44</sup> 116 Mich. App. 327, 389 (1982).

<sup>45</sup> 297 Mich. 315, 297 N.W. 505 (Mich. 1941).

<sup>46</sup> *Verity v. Metropolis Land Co.*, 288 N.Y.S. 625 (N.Y. App. Div 1936).

executory deed.<sup>47</sup> The automatic stay of Section 362(d) of the Bankruptcy Code will also prohibit the delivery of the deed from escrow to the lender.<sup>48</sup> Of course, one method to bankruptcy proof an executor deed arrangement is to incorporate the escrow into an approved reorganization plan confirmed by the bankruptcy court.<sup>49</sup> Another alternative to the deed in escrow in judicial foreclosure states is a stipulation by the borrower that the foreclosure judgment can be entered in the future if the terms of the stipulation are breached.

F. Title Insurance. A lender should consider purchase of an owner's title policy to mitigate the risk of subordinate encumbrances. Who pays for a new policy is negotiable, but the expense probably falls on the lender more often than the borrower. A lender will want a new owner's policy whenever title is transferred to an entity controlled by the lender. If the lender anticipates resale of the property within a short period of time, a lender may want to inquire whether a binder is available. A new title policy is necessary to insure current title because, even if title is accepted by the lender, the existing mortgagee title policy covers title to the property only as of the date of the recording of the mortgage. A title company should be involved early in the transaction for review of title and to address its requirements. The title company will want to confirm the amount of the debt and review a copy of the appraisal, settlement agreement, deed, and sometimes financial information on the borrower. Title companies prefer an appraisal showing that the property value is at least 10-20% less than the debt.<sup>50</sup> The lender may want to obtain a non-merger endorsement to its mortgagee title policy where available, insuring that vesting of title in the lender does not invalidate or make the mortgage unenforceable, and an endorsement insuring the continued validity and priority of its mortgage lien.<sup>51</sup> Until last year, title insurers were deleting the creditor rights exception by an endorsement for loss or damage by the insured by reason of a fraudulent transfer or avoidable preference under federal bankruptcy or state insolvency laws, including costs of defense. However effective March 8, 2010, the American Land Title Association withdrew ALTA Forms 21 and 21.06 and shortly thereafter the equivalent California Land Title Association Forms 131 and 131-06 were also withdrawn. All major title insurance groups have ceased to issue a creditor rights endorsement.<sup>52</sup> As a result lenders must increase their scrutiny of bankruptcy risks of deed in lieu transactions.

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<sup>47</sup> *In re Sky Group International, Inc.*, 108 B.R. 86, 92 (Bankr. W.D. Pa. 1989); *Matter of Scanlon*, 80 B.R. 131, 134 (Bankr. S.D. Iowa 1987).

<sup>48</sup> *In re Stockbridge Funding Corp.*, 145 B.R. 797, 811 (Bankr. S.D.N.Y. 1992).

<sup>49</sup> *Matter of Howe*, 913 F. 2d 1138 (5<sup>th</sup> Cir. 1990).

<sup>50</sup> John C. Murray, *Deed in Lieu of Foreclosure – Title Insurance Issues*, ACMA ABSTRACT (Spring 2011).

<sup>51</sup> CLTA 107.11-06; SE-233 (D.C.).

<sup>52</sup> The creditor rights endorsement was never available in Florida, New Mexico, New York, or Texas; Title companies have ceased to issue in Florida and elsewhere ALTA 1970 Policy that contains creditors rights protection.

G. Taxes and Reporting Requirements. Tax considerations may also affect the transaction. If the loan is non-recourse, the borrower will realize the same gain whether the property is taken by foreclosure or transferred by a deed in lieu. However, if the loan is recourse, the transaction will be bifurcated with the portion of the debt equal to the value of the property treated as a disposition of the property and the remaining portion treated as personal debt which may be treated as cancellation of debt, unless the taxpayer is insolvent. The parties may be able to alter the timing of the impact of income taxes on the borrower with scheduling of the closing. Section 6050J of the Internal Revenue Code imposes a requirement upon the lender to report the acquisition of all property mortgaged as security for a debt, including by deeds in lieu of foreclosure. The lender must file Forms 1096 and 1099-A by February 28 of the year following the calendar year of the transfer. The lender should also obtain at closing a FIRPTA certificate to establish that the borrower is not a foreign entity for which withholding is required. With respect to state taxes, the lender should determine whether it needs upon taking title to the property to register to do business in the state or qualify the controlled entity taking title.

Transfer taxes can add substantial costs to the transaction. If the borrower is unwilling to pay this cost, the burden will fall on the lender. The parties should determine whether transfer taxes will have to be paid with recording the deed in lieu. Applicability varies by jurisdiction. Some states exempt foreclosures, but not deeds in lieu, some exempt both, and some impose taxes on foreclosures, but not deeds in lieu. In some states the exemption applies solely to the holder of the debt, so a conveyance from the borrower to the lender's controlled entity without transfer of the debt may not qualify for the exemption. The amount of the tax depends upon the value of the property, and there may be a deduction for the amount of the outstanding debt. Bankruptcy court is an option to avoid transfer taxes because conveyance of property from a debtor to a lender made pursuant to a confirmed bankruptcy plan of reorganization is exempt from state or local stamp and transfer taxes.<sup>53</sup> The lender should confirm that the borrower has paid all franchise taxes, income, sales, unemployment and other taxes which may become a lien against the property or impose liability upon a transferee. Some states have withholding or preclearance requirements for transferors.

#### IV. CONCLUSION

The delivery and acceptance of a deed in lieu of foreclosure can benefit all parties provided that proper due diligence is performed, risks are accurately assessed, and the documents are carefully and properly prepared. The transaction requires an absolute and voluntary conveyance with adequate consideration, anti-merger provisions, covenant not to sue with appropriate reservations and reinstatement, proper turnover of the property, title insurance and proper settlement of applicable tax and other obligations to protect the lender.

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<sup>53</sup> 11 U.S.C.A. §1146(a).

## ATTACHMENT 1

### CHECKLIST FOR ACCEPTING A DEED IN LIEU OF FORECLOSURE

#### A. Due Diligence Review

- Operating Statements, Books and Records, Rent Roll, Leases, Contracts, Licenses and Permits
- Inspect Property and Public Records for Compliance of Property
- Confirm Payment of Taxes and Insurance Premiums
- Current Title Commitment and Copies of all Exceptions
- Survey
- Confirm Proper Perfection of Liens and Adequacy of Loan Documents
- Determine No Subordinate Liens or Resolve Subordinate Liens
- UCC, Bankruptcy and Litigation Searches
- Confirm Amount of Debt and Default
- Current Financial Statement of Borrower and Guarantors
- Appraisal; Determine Risk of Reversal of Transaction in Bankruptcy
- Phase I Environmental Report
- Organizational Documents of Borrower; Determine Authority to Convey and Availability of Consents
- Relevant Local Law on Deeds in Lieu, Merger of Mortgages, Transfer Taxes, Withholding, Environmental Transfer Responsibilities etc.

#### B. Settlement Agreement

- Representations: Default, Debt Exceeds the Property Value; Status of the Property; Authority to Convey; Sophistication of Borrower and Representation by Counsel
- Recite Consideration for Transfer
- Recite Voluntary Offer by Borrower to Convey
- Recite Absolute Conveyance with Borrower Retaining no Property Interests or Control of Property
- Waiver of Rights of Redemption
- Operating Covenants Prior to Closing, leasing, turning over rents, etc.
- Release of Lender
- Covenant Not to Sue
- Anti-merger Provision and Recitation that Debt is Not Extinguished
- Form Separate Entity, if necessary, or Confirm Lender is Qualified to do Business in State

- Reaffirmation of Loan Documents
- Reinstatement of Loan Documents if Transfer Reversed in Bankruptcy.
- Establish Responsibility to Pay Expenses, Taxes, Title Insurance etc.
- Guarantor Consent to Transaction
- Confidentiality Provision

### C. Deliverables

- Tenant Estoppels
- SANDAs
- Third Party Estoppels
- Notice to Tenants and Vendors of Transfer
- Security Deposits
- Original Leases, Tenant Files and Continuing Contracts
- Original Permits, Licenses, Certificates of Occupancy, Warranties, Plans & Specifications etc.
- Keys, Security Codes
- Cancel Non-continuing Contracts
- Deed and Recording Forms
- Bill of Sale
- Assignment of Leases and Other Contracts and Rights
- FIRPTA Certificate
- Covenant Not to Sue
- Opinion Letter of Borrower's Counsel
- Evidence of Authority; Incumbency Certificate, etc.
- Owner Title Policy, and Endorsement of Mortgagee Title Policy
- Transfer Taxes, Forms and Payment, if applicable
- Assignment of Tax Appeals, if applicable
- Tax Withholding and Pre-Clearance Requirements, if applicable
- Forms 1099 and 1099A
- Bulk Sale Notice, if applicable
- Responsibility Property Transfer Form, if applicable
- Proration of Taxes, Revenues and Operating Expenses
- Transfer Utilities
- New Insurance Coverage
- New Management Contract
- Execute New Service Contracts
- Closing Statement

## ATTACHMENT 2

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Ned W. Graber is an Assistant General Counsel and Vice President of AIG Asset Management working with Commercial Mortgage Lending and Real Estate Investment. From 1993 to 2001 he was Associate General Counsel for American General Corporation with primary responsibility for all its mortgages and commercial real estate. He has extensive experience in real estate development, purchases and sales, mortgage loans, real estate investments, joint ventures, leases and workouts. Prior to joining American General Corporation, he was a partner in the Dallas office of Jones, Day, Reavis & Pogue and an associate with the law firm of Freytag, Marshall, Beneke, LaForce, Rubinstein and Stutzman.

Mr. Graber received his Bachelor of Arts, *magna cum laude*, from Wichita State University where he was elected to Phi Kappa Phi, Omicron Delta Kappa, Phi Alpha Theta, Delta Sigma Rho-Tau Kappa Alpha and Phi Sigma Alpha and was President of the University Debate Society. He received his Juris Doctor from Southern Methodist University where he served as Notes and Comments Editor of the Journal of Air Law and Commerce and was a member of Phi Delta Phi.

Mr. Graber has authored and presented the following papers to ACMA:

- “Deed in Lieu of Foreclosure Transactions” (2011)
- “Notes of the General Growth Properties Bankruptcy” (2009)
- “Forbearance Agreements” (2008)
- “The Completion Guaranty” (2007)
- “Letters of Credit Funding Agreements” (2006)
- “Ground Lease Financing” (2001)
- “Environmental Insurance Policies” (2000)

He is also the author of an Index of Articles Presented to The American College of Mortgage Attorneys (2000-Spring, 2011).

He is a fellow of the American College of Mortgage Attorneys, and member of the Texas Bar Association (Real Estate, Probate and Trust Law Section) and Houston Bar Association (Real Estate Section). He is a life member of the National Eagle Scout Association, Eagle Scout Advisor of Boy Scouts of America Troop 55 in Houston, Texas and has earned the Wood Badge.