Deed in Lieu Considerations

While foreclosure rates continue to rise, the use of the deed in lieu of foreclosure has once again become a standard means of realizing collateral value in the event of defaulted loans and distressed properties. Like many innovations, it has developed its own body of case law and commentary. In electing to use a deed in lieu of foreclosure, it is important to understand the history of the foreclosure action itself, and how the deed in lieu has come to operate as a viable alternative. Knowing where the original ideas of the deed in lieu arose will aid any lender in analyzing the pros and cons of electing to accept such a deed rather than proceeding with the lengthy foreclosure proceedings.

Classical Roots of Foreclosure

Classical foreclosure starts with the mortgage. The original mortgage was a straight deed from the borrower to the lender, and under common law principals, the lender already had legal title to the property form the date of the loan. The deed to the lender was generally a warranty deed and would contain a defeasance clause, which stated that should the borrower perform the obligations which were to be secured by the mortgage, there would be a defeasance of title, i.e. the title would revert to the borrower automatically. If on the other hand, the borrower did not perform as directed, then the "condition subsequent" which would have caused the defeasance would never occur, and the lender's title could become absolute without any further action on the part of the lender.

Often, however, the Borrower would eventually raise the necessary funds to discharge the debt at a later time, and would seek in the courts of equity (Chancery) to bring a "bill to redeem", which gave the Borrower a right to have the property reconvened to the Borrower for the value of the obligations owed in connection with the debt. As this debt was often less that the value of the property, this right, called the "equitable right of redemption" or "equity of redemption" carried a value equal to such excess, from which the modern use of "equity" comes.[1]

This equitable right of redemption made the lender's interest in the property unmarketable. Any party paying the full value of the property was subject to having the property repossessed in court under a bill of redemption for the loan amount. In order to eliminate this possibility, the lender, soon after the default by the borrower would seek to enjoin the borrower from seeking a bill to redeem by bringing a "bill to foreclose". This action was the precursor to the modern judicial foreclosure action, and therefore remains an option at common law in every state unless statutory overruled by election of remedies or "friendly foreclosure" statutes. In Mississippi and Tennessee, classical foreclosure is an option and is recommended where there might be issues surrounding the deed of trust or the pursuit of a deficiency claim. Originally, courts in equity would issue "strict foreclosure decrees" which provided for automatic foreclosure of any equity of redemption in the event payment of the redemption amount (loan

[1] A confusion between the legislative intent of the Tennessee enactment of TCA 66-8-101 providing a 2 year waivable statutory right of redemption (as opposed to the "equitable right of redemption") led to a legal tradition in Tennessee of requiring a waiver both of the equity of redemption as well as the statutory right of redemption in Tennessee deeds of trust, a situation finally clarified by an amendment to TCA 66-8-101 (3), but evidence of which still can be found in almost every Tennessee form deed of trust foreclosure section.

obligation) is not made within a certain time. Later, recognizing the value of the equitable right of redemption, the courts provided for "foreclosure by sale" through the sheriff or other officer of the court.

Because the foregoing procedures could become time consuming and costly[2], some creative lenders came up with the idea of having an unconditional deed to the property placed with a third party, to be delivered and recorded if a default occurred. This party would hold an unconditional deed to the property and upon certain events, was instructed to deliver the deed to the lender. Recording statutes caused this to be unworkable, as the deed was in escrow and not of record, allowing the borrower to enter into the same transaction repeatedly. Therefore, some record notice of a change in title to the third party was required. This "Trustee" would received the title in trust (thus taking it out of the borrower and establishing record notice of the lending transaction) under a "Deed of Trust" The conditions which had previously been the means of defeasance of the tile out of the lender and back to the borrower (i.e. payment of debt) were reversed (i.e. non-payment of debt) and made the conditions upon which delivery of the unconditional title to the lender would be made. As this took the concept of the mortgage out of the equity courts, foreclosure in the classical sense was avoided, i.e. became "non-judicial". However, the potential for abuse by the lender in destroying the value now attached with the borrower's equity, state legislatures either forbade the practice, or allowed it with strict statutory guidelines, requiring the title to be conveyed by sale rather than as a strict foreclosure (as discussed above). So arose the difference between what we now consider "deed of trust" (non-judicial foreclosure) versus "mortgage" (judicial foreclosure) states. Both Mississippi and Tennessee allow for Deeds of Trust and consequently, non-judicial foreclosure.

Affect on Title

Because the original concept of the mortgage is an actual deed, there is a conveyance of the real property on the date the mortgage is delivered. Traditionally individual state courts differed on the analysis of a mortgage as a conveyance ("title" states) or later, as the new idea of a monetary encumbrance ("lien" states). Today, the practical difference is of little consequence as even "title" states require further action to vest title in the lender in realizing on the collateral, and even "lien" states recognize that some interest has been conveyed which is superior to that of subsequent grantees of the property. What occurs at the mortgage, from a chain of title standpoint is that a "Y" valve or cutout is installed in the plumbing. Oddly, the switch for this cutout lies in the future, but when the condition is later met, the flow of title is redirected at the junction, and all subsequent connections are cut off. This is where the competing considerations for the lender are presented. **Does the lender want to wait the prerequisite time to conduct a formal foreclosure and eliminate any blemishes on the title occurring since the date of the deed of trust, or is there value in the subsequent chain which needs to be preserved?**

[2] In terms of residential mortgages, the time and cost of a foreclosure may well increase. Certain bills being considered by the Tennessee State legislature will significantly extend the 21 day foreclosure period (though it should be noted that as a practical matter, the notice of sale is seldom the first inkling a borrower has of recovery actions by the lender). Under Tennessee House Bill 0049 (Gilmore), foreclosures might be delayed by at least 60 days. Under house Bill 0099 (Moore), this period is extended to 90 days.

Intervening Liens

In the normal situation, any lien on the property subordinate to the lender's deed of trust is undesirable and must be eliminate either through a separate negotiated release or through the formal foreclosure process. Since these liens are "below" the Y valve, they are extinguished by the foreclosure and the deed of trust becomes a deed of conveyance in the chain of title. This type of cleaning of title is most commonly seen in the case of construction liens although it can also occur in bankruptcy situations where judgment liens and tax liens have attached to the property. Seldom are consensual liens the issue as most deeds of trust prohibit the filing of second mortgages, but they may occur as lenders cannot be expected to down date title on all of their collateral (nor should they be expected to do so).

Some consensual filings may be desirable however, and the lender may prefer to take a deed in lieu of foreclosure notwithstanding the intervening transactions. Three examples are plat filings, conditions, covenants and restrictions ("CCR's") and PILOT leases. In the case of plats and CCR's, most developers will request and obtain the mortgage holder's signature on the plat or CCR's to evidence the subordination or "joining in" of the mortgage holder. Thereafter, where there is a foreclosure and the lender continues to deed out the subdivided parcels, they remain subject to the plat and CCR's. However, it is not uncommon to see in the chain of title foreclosures by lenders won deeds of trust which predate the filing of the plat and where the lender has not joined in the plat. While technically, this takes the plat off the record, it is also common to see the lender continue to deed out the properly after foreclosure by reference to the very plat numbers voided by the foreclosure. It is arguable that in or referring to the plat the lender is "reincorporating" it into the chain of title or that each grantee takes the property subject to the plat restrictions per their deed (though the lender may not be so bound). The better practice would be to take the deed in lieu, if available and no other intervening liens apply. Similarly, the sale and leaseback common to bond finance transactions and especially to Payment in Lieu of Tax Leases ("PILOT's") may have a tax benefit which the lender wishes to preserve for the benefit of a qualified ultimate purchaser. Preserving the lease rather than eliminating it through the foreclosure may add value to the ultimate realization, and a deed in lieu may be the way to approach this (making sure that he deed includes the assignment of the right to purchase the property at the end o f the lease term.)

One further option in these cases is the subordination. Technically, a subordination is a diminution of the status of the prior mortgage, and if signed by the party whose lien is subordinated, should be enforceable at least against that party. This would imply that the lender might unilaterally subordinate his interest to the plat or the CCR's prior to foreclosure and thus preserve the structure of the development although not a party to the original agreements. Whether such a scheme might work in the PILOT lease is doubtful, as there is a transfer involved in the sale leaseback, and while it is easy to envision a lien applying regardless of the leg of the Y in the chain of title, a subsequent conveyance being applicable in either case is another mater.

Environmental Concerns

If a lender complies with the safe harbor rules of RCRA (which, after an uncertain start seem to generally apply to CERCLA as well), foreclosing on potentially hazardous properties

should be no issue. This is true whether the lender realizes on the property by a foreclosure or by a deed in lieu[3]. However, as a belt and suspenders measure, a lender may well wish to stay out of the chain of title altogether (other than as the beneficiary under the deed of trust). There are issues involved in negotiating with a purchaser to buy the property at foreclosure; pre-made deals may be considered antithetical to the realization of the greatest amount at the foreclosure (or at least such a claim could be made in hindsight during the pursuit of the deficiency). However, if a deed in lieu can be negotiated, there is no requirement that the deed be to the lender. The lender may have a third party purchaser who is willing to take the property in such a sale which avoids having the lender take, for example, gasoline station or dry cleaning operations into its REO.

Bankruptcy Considerations

In most cases of a deed in lieu, it is almost certain that the value of the property is less than the outstanding debt. Otherwise, the property would by definition be sellable at the amount of the debt, and the borrower could avoid the issue. Borrowers' concepts of value often are behind the curve in a recession, and the hope of some equity will hinder efforts at a consensual deed. However, as the fraudulent transfer provisions of the Bankruptcy Code require "reasonably equivalent value" where there has been a transfer within the state's applicable fraudulent conveyance period, it becomes important to establish this value either through the incorporation in the deed of lieu agreement of any offers made during this period, appraisals or (and least persuasive in the event of a third party claim) the agreement of the parties.

The other bankruptcy concern with the value of the property comes from the preferential transfer issue. The bankruptcy Code provides that a transfer within 90 (for non-insider) days of the filing can be voided in the event where (in addition to certain other conditions) made on account of an antecedent debt while the Debtor is insolvent. The important element of the transfer is that such transfer result in a recovery of more than the recipient would have received in the bankruptcy distribution. Assuming the loan documents are proper, and the debt is properly secured by the transferred property, the issue becomes making certain the Debtor in fact had no equity in the property at the time of the transfer.

Tax Consideration

Regardless of whether the borrower agrees to grant a deed in lieu or foreclosure proceedings are brought, the borrower will have a cancellation of indebtedness income issue. In the case of home mortgages, the Mortgage Forgiveness Debt Relief Act of 2007 generally allows the homeowner to exclude this income with certain imitations, but in the case of commercial properties, this income will generally be measured as the difference between the debt amount and the fair market value of the property. Cancellation of debt is not treated as income if the debtor is insolvent at the time or if the debtor is in bankruptcy, but otherwise the argument for a low fair market value in the bankruptcy situation could result in a higher tax consequence to the Borrower if not insolvent or in bankruptcy. On top of the income issue, a capital gains issue will result if the value of the property at the time of the foreclosure or deed in lieu is higher than the debtor's adjusted basis.

[3] U.S.C. Section 9601 (20) (G) (iii) (1) (bb)

"Front-end" Deeds in Lieu" and Recharacterization Considerations

The idea of getting the deed in lieu up front is not new. There is an old American Law Report article on the use of deeds placed in escrow to be delivered upon the failure of the borrower to pay the loan. 65 ALR 120 (1930) The deed in lieu was given at the closing of the loan as a security device and placed in escrow, very much as discussed in the history of the foreclosure above. In effect, these were "proto-deeds of trust" which later evolved into the modern deed of trust. What happened in these cases eventually is that they were recharacterized as mortgages (or as deeds of trust with power of appointment or power of sale). So recharacterized, these arrangements did not waive the equitable right of redemption, and as a result, even after the deed was delivered to the lender and recorded, the borrowers could defeat the title by tendering the loan amount into court, causing what is termed "clogging of title", but which really means that the record title becomes unreliable (as in the early history of the mortgage). Once the lender had to foreclose the equity of redemption along with the recording of the deed, no economy was derived from the structure.

Today, exhibiting such ingenuity may also leave the lender unsecured in a bankruptcy setting because the concept of the bankruptcy estate is strongly influence by the distinction between property interest and contract rights. To actually have a seasoned and properly recorded property interest (e.g., mortgage, security interest, judgment lien) is generally unassailable; while a mere contractual right or promise of security is worthless against the claim of a bankruptcy trustee or debtor in possession.

This procedure is most often employed in connection with a short term workout of a pre-existing debt, in which the lender seeks to avoid the almost certain foreclosure procedure as the consideration for granting the borrower one more extension. Most recent cases hold that the additional time is sufficient consideration for the waiver of the equity of redemption, but, it is in just such a situation the borrower may be soon to file for bankruptcy, and the effort to save a little in time and fees can jeopardize the ability to realize on the collateral. Fortunately, the lender has his original mortgage on which to rely, but the whole transaction becomes a waste. If the lender wants to take advantage of such a structure in a workout, it is recommended that a deed be recorded putting record title in a specially designated trustee with the object of taking the record title out of the borrower.

The Deed in Lieu Agreement

In order to properly do a deed in lieu, there should be an agreement addressing the concerns set forth above, as well as additional items discussed below. A proper agreement should address the following:

Everyday Considerations. First of all, the agreement is a contract for the sale of real property, and as such should contain the general warranties of title, environmental and physical condition one would expect in any transaction. Keep in mind that these may require negotiation and modification as the borrower may be limited in recourse against the breach of such warranties. In some cases, this will become a real negotiations hurdle, but in others, the borrower, recognizing himself as judgment proof has little qualms about the representations

made. In addition, there are appurtenance and other items relevant to the real property which should not be left out. For example in construction loans, there is often an assignment of contracts, plans, and warranties, assignment of which should be included in the agreement if the same are still applicable. In the even that the property is generating revenue, and in any event with respect to assessment, taxes and expense of maintenance and utilities, some attention needs to be given to the bookkeeping associated with the property, and a statement of expense and revenue prorations similar to that in any contract should be included. And while the agreement and the deed in lieu are almost always simultaneous, there is still room for default in the agreement as discussed in detail below.

Bankruptcy and Tax Considerations. While some commentators have recommended that value of the property be established as high as possible to avoid the suggestion of insolvency which is one of the elements of the preferential transfer, it would seem the better course to adopt the least reasonable valuation for the property in the deed in lieu. This not only reflects the depressed nature of the failing entity, but also supports the position that no equity exists in the property, that the property is being exchanged at least for reasonably equivalent value (fraudulent transfer considerations) and that the lender is receiving no more that he would in the event of a distribution on bankruptcy (preference considerations). The establishment of this value should be supported, because it will not be the borrower taking issue with the value. Rather, third parties or the trustee may take the position that the value attributed to the property is too low, and absent proof in the form of current appraisals or in the form of offer made for the property, a low valuation may be attacked. The adoption of a low valuation will, however, negatively impact the tax consequences of the deed in lieu. By lowering the value, the cancellation of debt income is higher (although the gains are lower). However, keeping in mind that the borrower may well be insolvent or in bankruptcy, again the forgiveness of indebtedness issue may not be relevant.

Hidden Intervening Liens Considerations. Notwithstanding the absence of any liens at the time of the deed in lieu, there is always the possibility that a properly filed mechanics' lien might be filed after the transaction. While this is of minimal concern in Mississippi, in Tennessee, where the relation back of lien priority dates the lien to the visible commencement of construction, this could become an issue. In order to cure this occurrence, it is wise in any jurisdiction to leave the deed of trust in place as a lien with priority predating the visible commencement of construction. In the event such a hidden lien should appear after the deed in lieu transaction, it is possible to foreclose the still extant deed of trust and clean the title. The ability to do so may result in a settlement of the lien at less than the face amount, avoiding the foreclosure. It is for this reason that the preservation of the deed of trust is combined with non-merger language in the agreement (as well as in the deed in lieu itself). Under the merger doctrine applicable to title, if the beneficiary of the deed of trust (or the mortgagee) and the fee title are in the same entity, those interests merge into fee simple, and the deed of trust is extinguished. Sometime this is avoided through the use of a third party controlled by the lender as a straw grantee for legal title in the deed in lieu. However, modern case law has become more favorable to giving effect to the stated intention in the deed in lieu that the deed of trust remain in existence until released by the lender or its assignee. Note that if such a provision has been made

and the lender does soon thereafter sell the property to a third party for cash[4], the deed of trust should be assigned to the transferee so that he might release the deed of trust when the time for filing mechanics liens or recapturing the property in a bankruptcy proceeding have passed. As a rule, more than one year should be used to "season" the deed in lieu before removing the deed of trust.

Default Considerations. Although the deed in lieu will generally accompany the settlement agreement in which the terms are set forth, there is a possibility that the transaction can be untraveled by a subsequent bankruptcy or a third party claim. For this reason, some lenders do not give a release in connection with the deed in lieu agreement, but rather a covenant not to sue. This would seem to be overkill, as under the general was of accord and satisfaction, when there has been a breach of the accord, there is no satisfaction of the original obligation, but if the borrower does not object, it may be beneficial (but not mandatory) to use the covenant not to sue approach. Whether or not a release or a covenant is used, there needs to be some provision for the resurrection of the underlying indebtedness if the borrower should fail to perform under the agreement.

Common Ancillary Considerations. Even if the borrower is not in bankruptcy, it is often the case that the deed in lieu is only a portion of the final winding up of the borrower's business. Often the borrower is a statutory entity in the process of winding up its debts and dissolving. If the borrower is not in good standing, and especially if the its articles have been administratively revoked, it is advisable to recognize the statutory power of the borrower to deed property in its winding up, or in its acts of liquidation in dissolution, avoiding a collateral attack on the title as ultra varies. In addition, there may be guarantors involved in the loan which the lender may wish to remain liable for any deficiency claims, and in such event, they should be made a part of the agreement in order to make certain that recourse against them is not adversely impacted. As always the case with buying form insolvent entities, successor liabilities should be addressed. The bulk sales provisions of the UCC no longer apply in most jurisdictions, but there are successor liability statutes in both Mississippi and Tennessee which could result in the lender inadvertently assuming liabilities not contemplated by the deed in lieu[5] . Finally, title insurance should be issued insuring the lenders fee title in the property (or the fee title of the directed recipient of the deed in lieu. Although the lender's mortgagee's policy will generally cover the lender in the case of a foreclosure, with certain qualifications, it should be noted that title is not being derived from the deed of trust in the event of a deed in lieu. Therefore, the policy does not cover the intervening acts between the time of the deed of trust and the time of the deed in lieu.

[4] If on the other hand the property is sold under another financing transaction, the lender may prefer not to assign the deed of trust, keeping control over thee same until all of the funds advanced by the lender on the security of this particular piece of property have been paid in full.

[5] See Bank of Commerce v. Woods (585 SW2d. 577 9Tenn)) and other "Hidden Liens" discussed in the Oct. 09 issue of the BMMAC newsletter.