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# A Deed-in-Lieu of Foreclosure Is a Valuable Tool, But Exercise Caution

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The current recession, which real estate professionals might be more inclined to call a depression, likely will continue generating an almost bottomless supply of mortgage defaults for several years to come. Consequently, we can expect to see an increasing number of cases in which mortgage lenders and borrowers may consider a deed-in-lieu of foreclosure as a way out of the foreclosure process.

A deed-in-lieu of foreclosure can have significant benefits for both parties. For lenders, it helps avoid or reduce the delay, expense and possible uncertainty of going through the foreclosure process. For borrowers, it can eliminate or reduce the embarrassment of a public foreclosure sale and provide a resolution of personal liability and guarantee issues with respect to the debt.

On the other hand, deed-in-lieu transactions pose risks to the lender and will have tax consequences for both parties. Therefore it is important that both parties consult experienced legal counsel and tax advisors in connection with the transaction.

## **Borrower considerations**

The borrower will want to negotiate for release of any personal or guarantor liability, for no negative reports by the lender to credit reporting agencies and for a covenant not to sue the borrower and guarantors. Obtaining representations from the lender that it is the holder of the promissory note and/or cancellation and return of the original promissory note is also

important.

The tax consequence of a deed-in-lieu is generally treatment as a sale of the property, with gain or loss determined by the difference between the amount of the debt and the adjusted tax basis of the property. Unless insolvent, the borrower might also have cancellation of debt (COD) income in certain circumstances.

Early consultation with a tax advisor is critical. The borrower may want to obtain the lender's agreement to permit the borrower to structure the transaction as a Section 1031 tax-deferred exchange. Acquiring replacement property in an exchange will require the borrower to come up with cash for the equity portion of the acquisition cost.

But if the borrower is going to incur income taxes anyway as a result of the loss of the mortgaged property, it may as well defer the tax and use the cash that would otherwise cover the taxes as a portion of the equity for acquisition of replacement property.

### **Lender considerations**

If the loan is recourse, the lender may want to require some cash payment from the borrower to satisfy some portion of the debt, or maintain the ability to pursue the borrower and guarantors for a portion of the debt.

The lender may require an environmental assessment report and continued borrower responsibility for future environmental liabilities. Consideration must be given to potential problems and liabilities relating to leases, especially for tenants with whom the lender does not have a subordination agreement.

Payment to the lender of current rents and common area maintenance charges, as well as tenant security deposits, should be addressed. The borrower should also be required to hand over possession of the property to the lender.

### **Same concerns as in a purchase transaction**

As in any acquisition transaction, numerous issues must be considered and addressed, such as service contracts, licenses and permits, plans and specifications, Internet domain names, property websites and telephone numbers.

The state of title to the property is critical from the lender's perspective. The existence of junior-lien holders or mechanics lien claims may torpedo a proposed deed-in-lieu and require that the lender foreclose in order to acquire title free and clear of such claims.

Junior-lien claims are not extinguished by a deed-in-lieu as they would be by a foreclosure. Consequently, preservation of the mortgage lien is desirable and the deed-in-lieu should include a provision disclaiming any merger of the lender's security interest with the fee interest.

The lender may also designate an affiliate to take title as grantee in order to preserve the mortgage. A title update should be obtained and the lender will want to require the issuance of a new owner's title policy as a condition to acceptance of a deed-in-lieu. The lender may also want to require a non-merger endorsement to its existing loan policy of title insurance.

Generally, title insurance companies will require detailed statements in the deed-in-lieu or a separate affidavit addressing, among other things, the solvency of the borrower, the absence of intent to defraud or hinder creditors, the adequacy of the consideration and the intent that the conveyance be absolute.

Notwithstanding the lender obtaining a new owner's policy of title insurance, it is difficult, if not impossible, to obtain creditors' rights coverage today. Thus, the lender will need to perform its own solvency analysis of the borrower. This is critical because the deed-in-lieu could later be attacked as a fraudulent conveyance, something the title insurance would not protect against. However, if the lender instead foreclosed, the foreclosure sale would not be vulnerable to such an attack.

### Arrangements to avoid

The discussion above examined a deed-in-lieu negotiated and granted after a mortgage default and recorded as an absolute conveyance. But what about a deed-in-lieu executed at the inception of the loan, or as part of a forbearance or workout, to be recorded only in the event the borrower defaults or fails to perform in the future?

A deed-in-lieu given at the inception of the loan is almost universally held to be void and unenforceable. A deed-in-lieu given after default, but intended to be held as security for future performance by the borrower, is subject to attack as a "disguised mortgage" or may be subject to rejection in bankruptcy.

Even a recorded deed-in-lieu that is subject to an agreement to reconvey title if the borrower performs as required will be vulnerable to attack as a disguised mortgage. Such arrangements are fraught with danger for lenders and should be avoided.

While there are many potential pitfalls for lenders in deed-in-lieu transactions and many circumstances in which a lender will not want to accept a deed-in-lieu, the potential benefits for lenders and borrowers in appropriate situations make them worth consideration.

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