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Deeds in lieu are back, but they're complicated

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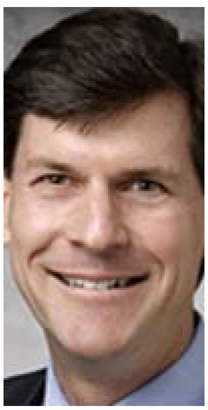
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In the current economic climate, deeds in lieu are back on the radar.

A deed in lieu of foreclosure, let's call it a DIL, gives the property to the lender and would seem to be a simple procedure for getting out of an underwater project. After all, a deed is signed only by the grantor, and the law presumes that the grantee accepts the deed if it is beneficial to the grantee.

But it's not that simple. For one thing, a lender can, and likely would, reject a borrower's unilateral attempt to give back the keys. The borrower simply wants to be released from liability for the loan, as he probably would be if the lender foreclosed under the most common non-judicial foreclosure procedure. The lender, however, has a number of concerns to consider. Here are some:

• Foreclosures are guided by statutes, which permit the borrower to cure defaults and/or pay off the loan before the foreclosure sale. After a deed in lieu, the borrower might argue that the lender somehow coerced the borrower to deed over the property so as to short-circuit his statutory cure rights. To forestall such an argument, before agreeing to a DIL transaction, the lender needs the borrower to beg and plead with the lender in writing to accept the deed.

• Before accepting a DIL, the lender will want to have a greater understanding of the physical and legal condition of the property, including the possibility of any environmental issues, which may necessitate an environmental study. Because the lender is at a disadvantage in not being as familiar with the property as the borrower, the DIL agreement will contain extensive representations and warranties from the borrower. The borrower will remain liable for such representations after deeding over the property.

• To be valid, a deed must be given in exchange for something of value. Since that value will determine the amount of the deficiency (which may be taxable to the borrower) and the loss to the lender, the parties will need to agree on the value of the property. They may require an independent appraisal of the property to establish the value.

• A foreclosure would wipe out subordinate loans and other junior liens and encumbrances (at the lender's discretion). By itself, a DIL does not do this. Worse, acceptance of a typical deed may prevent a lender from wiping out junior liens. That's because a subordinate lender might successfully claim that the senior lender's deed of trust “disappeared” into that senior lender's ownership upon acceptance of the DIL (the infamous “merger doctrine”). So, the DIL deed must expressly state that the merger doctrine will not apply to the DIL conveyance. Thus, the mortgage stays alive and the lender, who's now the owner, can still foreclose out the junior lenders.

• Similarly, a lender can't simply release the borrower from his obligations under the loan documents. If it did, the loan might be considered satisfied, which would prevent the lender from exercising a foreclosure remedy to wipe out junior liens. Instead, the lender would generally agree not to sue the borrower to enforce default remedies under the loan documents – a subtle but important distinction.

• If the borrower wants to retain a right to repurchase the property or an interest as, say, a tenant, the dollar amounts payable for those rights and interests must be based on the value of such rights, not the amount to satisfy the original debt. Otherwise, such an arrangement might be later attacked by the borrower as the lender's attempt to obtain the effective equivalent of a mortgage without having to use the statutory foreclosure process.

• If the borrower were to subsequently file for bankruptcy or become insolvent, unpaid creditors of the borrower might seek to undo the DIL transaction. The basis for such an attempt would be the recognized claim that the DIL transaction gave the property lender an unfair preference (over the borrower's other creditors) to payment from the borrower's assets. In view of this risk, the lender may demand the right to, in effect, reinstate the full loan if the DIL transaction is voided by a bankruptcy court.

This is the general theory and why something so seemingly simple probably won't be.

As Yogi Berra once quipped, “In theory, there's no difference between theory and practice; in practice, there is.” He could have been a lawyer.

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