Commentary

Deeds In Lieu of Foreclosure – a Lender's Perspective

By Ken Blumer

All too often the tendency is for lenders to commence to exercise their foreclosure remedies at the first indication that a loan is in material default. Believing that the situation may be irreparable, the decision is made to record a Notice of Default and Election to Sell under the deed of trust securing the loan and/or to file a complaint to judicially foreclose the deed of trust joined with a motion to appoint a receiver to manage and operate the property pending foreclosure. The foregoing is becoming the common occurrence in the present economic and lender regulatory environment. The lender becomes aware of a decline in value of the property and/or the borrower's refusal, unwillingness or incapacity to cover any development, operational or debt service short fall and the lender wants to get control of the property as quickly as possible. California statutory procedures provide the lender with the opportunity to foreclose a deed of trust in approximately 120 days from the date of a default. However, the borrower and/or others responsible for the debt, believing there to be equity in the property, will most likely attempt to gather their resources and endeavor to defeat or at least frustrate and delay a lender's efforts in expectation of a change in market conditions or concessions from the Lender, or a favorable judicial determination.

Such action by the borrower might include a complaint to stop the foreclosure based upon several alternate theories: (1) The loan documents are defective, (2) there is no material default, (3) the lender is also in default or has caused the borrower's default, (4) the lender has violated the implied covenant of good faith and fair dealing with the borrower, (5) the lender has committed other actions or omissions amounting to "lender liability" and/or (6) the lender has committed significant acts of control over the borrower's operation, management, leasing or marketing of the property thereby changing the lender and borrower relationship and the rights and remedies available to the lender. The other alternative by the borrower upon failure of its first offensive, is to file a petition for reorganization under the Bankruptcy Code–a so-called "Chapter 11" filing. This action puts all of the borrower's assets under the jurisdiction of the bankruptcy court and stays all proceedings against the property and the borrower pending the adoption of a plan of reorganization or the granting of a motion to lift the stay as to the property. Such a stay is only lifted upon proof of an absence of any substantial equity therein on the part of the borrower. These actions can often take two or more years to work their way through the state and federal court system. By the end of that time the borrower and lender have more than likely become bitter enemies and the property has also suffered from being the subject of hostilities with neither party in total control.

It is in this light that one must examine whether there is any practical alternative to the foreclosure process and at what stage of the process should these alternatives be pursued. Lenders often times reject out of hand a deed in lieu of foreclosure or agreements to the same effect because of the perceived inherent problems associated with them. Potential difficulties with junior lien claimants or the fear of an insolvency or bankruptcy proceeding often prevents the exploration of a creative solution at an early stage which might give the lender immediate control of and permanent dominion over the property. While there are potential risks associated with deeds in lieu of foreclosure, there are significant advantages as well and the most commonly thought of disadvantage can easily be avoided. To be totally effective, however, this alternative needs to be considered as soon as the determination of any possible loan restructure or other "work-out" has been abandoned.

The first and foremost advantage is that usually it can be accomplished more quickly and less expensively than the traditional trustee's sale. Although the amount of time and effort necessary to negotiate a careful and protective agreement should not be minimized, even foreclosures and the events leading up to them may involve a significant amount of time, negotiation and effort by lenders and their attorneys. A companion advantage, and perhaps one of the more significant ones, is that it provides the lender with quicker unfettered and total control over the property. Receivers are not always granted by California courts during the pendency of a foreclosure, even if the loan documents give lenders that absolute right, in the absence of active mismanagement, fraud or waste. Needless to say also, properties tend to deteriorate when devoid of a true entrepreneurial approach to management and operation.

The second most significant advantage is that when the negotiation process is over, the ultimate resolution can provide the opportunity for a relatively amicable relationship between the borrower and lender rather than casting both of them into the public arena as adversarial litigants. Presumably, the lender will also get the borrower's continuing cooperation and help in gathering all necessary information concerning value, leases, operating expenses and condition. One only need ask how many times and what cost of time, effort and money, have lender's taken over properties without any information or records concerning such matters.

The third advantage is that it provides a vehicle in which to settle all claims and potential claims between the parties. These might include claims regarding the lender's documents, interest (including default interest), late charges, and other fees and charges, prior actions or inactions by the lender, control by the lender over the property and other potential lender liability and hazardous waste issues. On the other hand, this approach has the potential disadvantage of causing the lender to give up what may be valuable rights against the borrower and any guarantor for any loan deficiency. Each situation must be carefully analyzed and the risks and rewards identified and quantified before a thoughtful decision can be made.

Fourthly, it has the potential advantage of keeping the details of the transaction relatively confidential for both parties. While the borrower should appreciate avoiding the publicity of notices of default and of a foreclosure sale, the lender also should deem it important not to have the property tainted with the publicity of a foreclosure and the fact that the borrower was unable to operate and manage it successfully.

Lastly, but no less significantly, the lender's acceptance of a deed in lieu of foreclosure may help to prevent the borrower from having to file or to be subjected to a petition in Bankruptcy; or, may keep the property out of the borrower's estate if the Bankruptcy filing is ultimately sustained. Obviously, the matter of inclusion or exclusion from the borrower's estate will turn on whether the transfer was a "voidable preference" or a "fraudulent transfer" under applicable Bankruptcy Law.

The determination of a voidable preference requires an affirmative finding of all five elements regarding the transfer: (1) It was to or for the benefit of the creditor; (2) it was for or on account of an antecedent debt owed by the borrower before the transfer was made; (3) it was made while the borrower was insolvent; and (4) within 90 days of the filing of the bankruptcy petition; and (5) enabled the lender to receive more than it would (i) under a Chapter 7 liquidation, (ii) if the transfer had not been made; and (iii) if the lender received payment of the debt to the extent provided under the Bankruptcy Code. The lender must only show that one of the five elements is not present to sustain the transfer. Usually the first three elements are automatically met in a deed in lieu of foreclosure transaction. However, the borrower's insolvency should not be accepted automatically. It is a balance sheet test to be made without regard to the transferred property and is not merely an inability to meet obligations as they mature for this purpose. The fourth element is just a matter of counting days. Delivery and perfection of the deed against third parties is the operative commencement date for the time period. The fifth element is the usual safe harbor for lenders. Presumably, the property is now worth less than the total unpaid debt (principal and interest) and the acceptance of the property by the lender in cancellation of the debt will not give it more than it would have received under a Chapter 7 distribution of the borrower's estate.

A trustee in Bankruptcy can also avoid any "fraudulent transfer" occurring within one year of the petition, if the trustee can demonstrate that the borrower, voluntarily or involuntarily, (1) made the transfer with the actual intent to hinder, delay or defraud any creditor to which the borrower was or became, on or after the date of the transfer, indebted; or (2) (A) received less than a reasonably equivalent value in exchange for such transfer; and (B) (i) was insolvent on the date that such transfer was made or became insolvent as a result of such transfer; (ii) was engaged in business for which any remaining property was unreasonably small; or (iii) intended to incur, or believed the borrower would incur, debts that would be beyond its ability to pay as such matured.

The critical issue will be to determine if the transfer to the lender was for "less than reasonably equivalent value." While not defined in the Bankruptcy Code, it does include the satisfaction of antecedent debt; and, if the borrower's liability exceeds the fair market value of the property, cancellation of the debt should satisfy this equivalency requirement. If the fair market value exceeds the amount of the debt, however, the transfer may constitute a fraudulent conveyance and efforts should be made to substantiate a lesser fair market value determination. In this Federal Circuit, absent fraud or collusion, the price bid at a regularly conducted foreclosure sale is deemed to be reasonably equivalent value. Since a deed in lieu of foreclosure is neither an arm's length sale nor a true distress sale under foreclosure sanctions, reasonable equivalence should be determined taking into account all relevant factors concerning value at the time of the transfer including the pendency of foreclosure, the existence of junior liens, the availability of substitute financing and the borrower's inability to successfully lease, operate and/or market the property for an amount greater than the debt to the lender.

The most commonly expressed reluctance to accept deeds in lieu of foreclosure is the perceived inability to foreclose out junior encumbrancers and lien claimants. Accepting a deed in lieu of foreclosure, it is argued, merely merges the owner's and lender's positions and without survival of the lien of the deed of trust, the lender has no means by which to wipe out any junior claimants. However, a conveyance to a different but related entity, if the lender's intent against such a merger is clearly expressed, will safeguard its right to subsequently foreclose. In the meantime the debt and lien are kept in place which might also facilitate a resale of the property.

Finally, before agreeing to a deed in lieu of foreclosure, the lender should conduct the same degree of due diligence as it would now conduct to underwrite a new loan. Environmental audits as well as a reexamination of zoning, special use permits, parking requirements, the status of subdivision conditions and other required permits and approvals should be investigated to determine whether the costs of owning and operating the property as well as perhaps completing its development make financial sense.

As with any unconventional transaction, a deed in lieu of foreclosure entails certain risks but has advantages as well in certain situations over foreclosure. The enumerated disadvantages or risks are not always insolvable or unique to deeds in lieu of foreclosure. Each course of action considered by a lender carries with it certain advantages and disadvantages which must be carefully examined in each defaulted loan situation in order to reach an informed decision as to the best alternative course to follow. Counsel can be most effective in these situations by assisting the lender in reaching an informed decision and in helping to structure the transaction to avoid, if possible, the enumerated as well as other potential issues in these types of transactions.

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