

Beyond the Workout: Taking Control of Troubled Properties

The continuing recession has caused lenders to consider a wide range of workout options and remedies for mortgage loans. In circumstances where the borrower has demonstrated good faith and business acumen in dealing with a difficult market, lenders may be inclined to offer loan extensions or refinancings that allow the borrower to remain in control of the property. However, where the borrower offers no additional value or has demonstrated an unwillingness to cooperate, lenders are less likely to allow a workout and generally seek to take title to their collateral through a foreclosure proceeding or a deed-in-lieu of foreclosure transaction. In addition to examining certain important practice suggestions regarding a deed-in-lieu transaction, this article also examines the use of a friendly-foreclosure alternative that some lenders are employing to take control of defaulted properties during the pendency of a foreclosure. The friendly-foreclosure route combines elements of both standard foreclosure and deed-in-lieu of foreclosure transactions and thereby offers lenders a good option for taking ownership of real property collateral burdened with subordinate mechanic's liens, subordinate mortgages or other impediments to title.

The first step in evaluating the appropriateness of any particular remedy begins early in the process when the controlling lender orders a title search on the troubled mortgaged property to better understand the state of its title. While foreclosure generally offers the most certain method of clearing intervening liens, such proceedings are burdened by the vagaries of litigation and the possibility that the defaulted borrower may raise claims (e.g., lender liability) in an effort to gain a more favorable settlement or simply delay the inevitable. Notwithstanding the possible complications of foreclo-

sure, the resulting ownership interest is passed to the ultimate transferee free of any mechanic's liens, subordinate mortgages and other title impairments that may have encumbered the property since the date the lender recorded its mortgage lien. Transactional expenses of a foreclosure are dominated by legal fees and court costs, but also include applicable transfer taxes which must be paid by the transferee upon the referee's delivery of a deed. Still, despite the benefits of foreclosure, difficult borrowers can delay the process beyond the nine to twelve months that many lenders expect even for straight-

forward, uncontested foreclosures, causing additional delay to the lender's ultimate exit strategy.

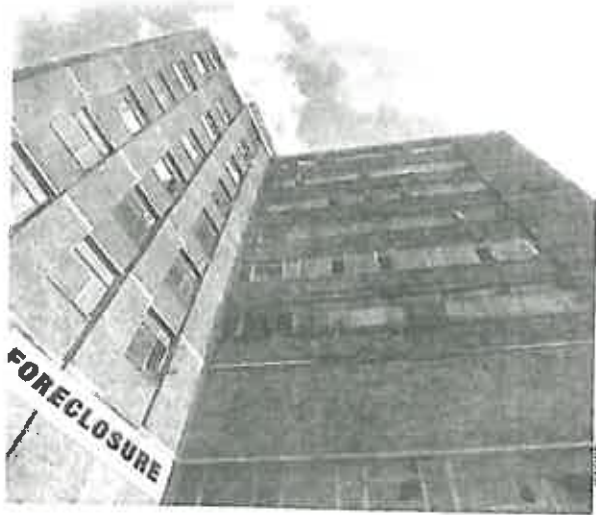
Similar to a standard acquisition, deeds in lieu are traditionally effected via a negotiated agreement, which may include conditions precedent, representations and warranties and an allocation of costs, pursuant to which title passes to the lender or its designee. Taking title through a deed-in-lieu of foreclosure quite literally avoids the foreclosure process and offers the lender an opportunity to take ownership in a relatively quick arms-length transaction that transfers title in its existing, possibly infirm, state, complete with mechanic's liens and other title encumbrances created subsequent to the recording of the original mortgage. As a deed-in-lieu of foreclosure is consensual in nature, the parties may negotiate whether the borrower will be responsible to clear any title defects prior to passing title or whether the lender will retain a claim for deficiencies or personal recourse to a sponsor after completion of the deed transfer. Legal fees and related expenses

would presumably be lower in a deed-in-lieu transaction, but applicable transfer taxes may well be higher than a foreclosure as the tax liability is generally based on consideration equal to the full amount of the outstanding mortgage debt, inclusive of all unpaid interest.

The difference between a foreclosure and a deed-in-lieu transaction was the primary issue in *Riley v. South Somers*,¹ a case in which the plaintiff (which was neither the borrower nor the lender), through a complicated set of circumstances, stood to benefit from the foreclosure of a mortgage encumbering the subject property. Alleging that the deed-in-lieu transfer amounted to a foreclosure, the plaintiff was rebuffed by the New York Appellate Division, Second Department, which held that a deed-in-lieu of foreclosure transfer is not the legal equivalent of a foreclosure. The primary distinguishing factor focuses on the extinguishment of the mortgagor's rights that occurs upon foreclosure, including a termination of the equity of redemption. In a deed-in-lieu transaction, provided the parties include a non-merger clause, thereby preserving the distinction between the mortgagee and the transferee, the mortgage lien remains intact and the mortgagor passes its interest, including its equity of redemption under the mortgage, to the transferee designated by the lender (which is typically an entity affiliated with the lender).

While taking advantage of a deed-in-lieu transaction or a friendly-foreclosure can expedite the title transfer process while cutting costs and expenses, the lender must be able to discern both the subtle and overt differences between the various available remedies and make its choice based on the facts of the particular situation.

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Keep in mind, however, that while the *Riley* plaintiff's ability to benefit from a foreclosure of the mortgage was not triggered by the deed-in-lieu transfer, the potential benefit, which amounted to a title burden, was still preserved following the deed-in-lieu and would become ripe upon any subsequent foreclosure of the mortgage.

In addition to the possibility of significantly higher

transfer taxes, lenders taking title by a deed-in-lieu of foreclosure will incur the additional expense of title insurance premiums for an owner's title policy since such lenders cannot rely upon their mortgage title policy for protection if they preserve the lien of the mortgage for purposes of a subsequent foreclosure. Foreclosing mortgagees (or those that take title by deed-in-lieu and release the mortgage lien), however, are protected by their original mortgagee's title policy that essentially converts to an owner's policy upon transfer of title albeit with an effective date as of the making or recordation of the original mortgage. The party taking title in a deed-in-lieu transaction would be prudent to obtain an owner's policy of title insurance on the date of the transfer of title since there are certain endorsements available for an owner that a lender's policy (even in its converted state) cannot carry.²

The use of a deed-in-lieu of foreclosure transaction does not usually prevent a lender from subsequently using the equitable remedy of foreclosure to clear intervening liens. Provided a lender maintains the lien of the mortgage following a deed-in-lieu, by, *inter alia*, inserting anti-merger language in the applicable mortgage instrument and deed-in-lieu documentation, lenders have generally been able to perform subsequent foreclosures to clear title of any intervening liens. Although it may seem counter-intuitive that a lender would effectively foreclose on itself (or the nominee entity established to hold the property transferred by deed-in-lieu), there are cases that support the proposition that provided the mortgagee's intention to preserve the lien of the mortgage is evident and a bona fide obligation is maintained, a transfer to a nominee based on a deed-in-lieu will not prevent a subsequent foreclosure.³ A lender contemplating a foreclosure action after obtaining title through a deed-in-lieu should specifically include a written statement of its intention to preserve the lien of the mortgage in the relevant documentation to avoid a possible merger of its interest as mortgagee and its ownership interest obtained pursuant to the deed-in-lieu. While courts have given some degree of scrutiny to the motivations behind a lender's expectation of a non-merger, in circumstances where

the lender's motivations are clear and without fraudulent intentions, preservation of the mortgage lien has generally been upheld.

Irrespective of the path selected, any third party transfer subsequent to either a deed-in-lieu transfer or a foreclosure will be subject to additional transfer taxes. The two-step deed-in-lieu followed by foreclosure route, however, will add an additional transfer and therefore, in many circumstances, a third layer of transfer tax. In some instances, the enforcing lender may be able to avoid tax liability by identifying a third party transferee prior to the lender taking title itself and causing the third party to take responsibility for payment when they take title directly from the foreclosure referee or the defaulted borrower. Finally, we note that in instances of very large transactions with cooperative borrowers, a Section 363 sale under the Bankruptcy Code (provided the sale occurs in contemplation of a plan under Section 1146) may be structured to avoid transfer tax liability though the transaction costs may well outweigh any benefits.⁴

The so-called friendly-foreclosure route combines the two previously discussed alternatives, offering the swift, transactional nature of the deed-in-lieu transaction with the title-cleansing benefits of the foreclosure. Under the most common conception, the borrower and lender enter into an agreement whereby the borrower will agree to stand down in a foreclosure proceeding, declining to raise defenses or counterclaims of any manner against the lender. The lender subsequently pursues its foreclosure action, foreclosing any mechanic's liens or other encumbrances which are subordinate to the original mortgage lien. Then, upon completion of the foreclosure, the lender or a successful bidder at foreclosure takes title free of any title issues and the mortgage debt is released. As with a deed-in-lieu, the lender may retain some claims for personal recourse to a sponsor after completion of the friendly-foreclosure, though relief from guaranty obligations frequently provides the incentive for a borrower to agree to cooperate in the first place.

In the case where a title search reveals extensive liens and encumbrances that need to be expunged prior to the transfer of title, lenders may be inclined to use the equitable nature of foreclosure to eliminate such intervening liens. As with a deed-in-lieu agreement,

the friendly-foreclosure option relies upon a willing borrower that the lender believes will effect the agreed-upon transaction. However, unlike a deed-in-lieu transaction, in which the lag between execution of the parties' agreement and passing of title will frequently be a matter of days (or perhaps simultaneously therewith) or weeks, the friendly-foreclosure takes significantly longer. Certainly the time frames will benefit from a borrower's agreement to forego any extensions of time for responses to pleadings but the subordinate lienholders being foreclosed are still entitled to statutory response times, and while the proceedings are generally accelerated, they are not without some degree of length. During the time necessary to complete a foreclosure proceeding, borrowers may become uncooperative or worse, file for bankruptcy, thereby disrupting the lender's expectation of a swift resolution. Personal sponsor guaranties to assure a borrower's compliance with its friendly-foreclosure agreement may cause a greater degree of compliance but in a distressed situation, such a guaranty may not be sufficient protection for a lender. In short, the friendly-foreclosure option relies upon a well-drafted agreement that gives the lender some degree of comfort that the borrower will ultimately perform its obligations.

Mortgage lenders' understanding of possible remedies for a troubled loan, and how those remedies may work in conjunction with one another, can have a dramatic effect on such lender's ultimate strategy for dealing with a troubled loan. While taking advantage of a deed-in-lieu transaction or a friendly-foreclosure can expedite the title transfer process while cutting costs and expenses, the lender must be able to discern both the subtle and overt differences between the various available remedies and make its choice based on the facts of the particular situation. The various factors we have discussed above, including the lender's relationship with the borrower (as well as the borrower's motivations), the state of title and the desired time-line, must each be carefully considered before a lender commits to any particular mortgage loan remedy.