<u>Deeds in Lieu of Foreclosure</u>

by Kelly W. McNulty
Gill Elrod Ragon Owen & Sherman, P.A.
425 W. Capitol Ave., Suite 3801, Little Rock, AR 72201
(501) 376-3800 mcnulty@gill-law.com

Lenders in Northwest Arkansas, and across the country, are beginning to prepare for the aftermath of the busted bubble. After years of record growth, more and more builders and other borrowers are defaulting on their loans or filing for bankruptcy protection. Lenders should be aware of the many tools available to them which will protect their interests.

Under Arkansas law, a deed in lieu of foreclosure is an attractive option to many lenders and borrowers. It is a quick, inexpensive alternative to the more traditional foreclosure actions. Nevertheless, a deed in lieu of foreclosure does present certain risks along with these benefits. This article will briefly outline the benefits and risks of deeds in lieu of foreclosure that every lender should know.

Benefits of Deed in Lieu of Foreclosure

Besides the benefit to the lender of immediately obtaining marketable title and avoiding what may amount to years of litigious foreclosure proceedings, the deed in lieu option also carries several benefits to the borrower. For one, the borrower may obtain a tangible economic concession in exchange for the deed, such as the release of personal liability for a deficiency. A second benefit the deed in lieu may afford the borrower is the opportunity to avoid the negative publicity and notoriety often involved in foreclosure proceedings. Finally, the lender, in exchange for a deed in lieu of foreclosure, may agree to grant the borrower limited possessory rights in the property, including the right to lease or manage the property or an option to purchase. The deed in lieu of foreclosure, however, is of limited utility to lenders in jurisdictions where a statutory power of sale or receivership option permits lenders to obtain title from a defaulting borrower simply and rapidly. Before agreeing to accept a deed in lieu of foreclosure, lenders and their counsel should weigh the potential risks of such a transaction. As a general matter and as seen below, these risks are greatest if (1) the outstanding amount of the loan is less than the current fair market value of the property, and (2) junior creditors hold liens on the property. Another risk for the parties in a deed in lieu transaction is the possibility that subsequent to the deed in lieu transaction, borrowers or third parties could make a wide array of arguments to have a court set aside such a transaction, arguing, for example, that the deed was obtained for inadequate consideration or pursuant to a transfer that may be avoidable as the result of the subsequent commencement of a bankruptcy case with respect to the borrower.

Bankruptcy Concerns

Given the poor financial health of defaulting borrowers and the broad powers of bankruptcy trustees and courts, bankruptcy-related risks are paramount in deed in lieu transactions. The main bankruptcy issue involves a potential attack on the transaction as a fraudulent conveyance under either section 548 of the United States Bankruptcy Code (the "Code") or similar state fraudulent conveyance laws.

Fraudulent conveyance laws, generally speaking, allow a trustee to set aside a transfer made within one (1) year before a bankruptcy filing (or six (6) years under most state statutes) if made either with actual intent to hinder, delay or defraud a creditor or pursuant to a "constructively" fraudulent transfer. A transfer may be deemed "constructively" fraudulent if the borrower made the transfer while insolvent and received less than the reasonably equivalent value for the property transferred. Several courts hold that if a borrower's equity in the property transferred exceeds thirty percent (30%) of the current property value, an outright transfer of the property to a creditor will be deemed constructively fraudulent. (By way of contrast, the Supreme Court has determined that, if the property is sold as a result of a judicial foreclosure, absent extenuating circumstances, the purchase price will per se constitute reasonably equivalent value.) Again, the key issue is valuation of the property, and a current appraisal is necessary to make the appropriate determination. Moreover, a lender may be well advised to obtain current financial statements from a borrower when contemplating a deed in lieu transaction in order to determine whether the borrower was insolvent at the time of the transfer.

Other protective measures a lender can insist on in a deed in lieu situation to lessen bankruptcy risks include obtaining an indemnity from the borrower against creditor liability claims and obtaining a pledge from the borrower not to file for bankruptcy within one (1) year of the deed transfer. The actual effects of these protective measures are questionable.

Even absent a bankruptcy filing, a borrower or a third party, following a deed in lieu of foreclosure, may seek to have the transfer voided or set aside for inadequate consideration. Courts will scrutinize such transactions carefully to determine if they were entered into through coercion or undue influence on the part of the lender. To protect themselves, lenders should recite, in any settlement agreement entered into in connection with the deed in lieu, a full list of the consideration received by the borrower, including the amount of the debt and any release of liability or obligation. Obtaining an independent appraisal would be helpful here as well.

Merger

Another risk for a lender in a deed in lieu of foreclosure transaction involves the common law doctrine of merger. Under this doctrine, if both title to property and title to a mortgage on the property are held under the same name, the mortgage, as a lesser interest, merges into the greater fee interest. As a result, the mortgage becomes extinguished, and any junior lienors are elevated to a higher priority security interest in the property. Unlike in a foreclosure proceeding, junior liens remain intact following a deed in lieu of foreclosure. Thus, if a merger occurs subsequent to a deed in lieu, a lender will lose its first priority lien status and will be unable to foreclose if the deed in lieu is set aside. To prevent this loss of priority, a lender should conduct a thorough title search to determine if junior liens exist. In addition, all of the conveyance documents should indicate that the intent is not to merge the mortgage into the fee and that the debt remains unsatisfied. Such an expression of intent is usually effective in averting merger. Finally, a lender may want to consider having the deed conveyed to a subsidiary or nominee in order to prevent a merger.

Environmental Concerns

Due to the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"), as well as other state environmental laws, a lender should not accept a deed in lieu of foreclosure without a valid and complete environmental assessment of the property. While this issue is more prevalent in commercial transactions, it is still a valid concerns when facing a defaulting home-owner.

If, after a valid and current environmental assessment, the lender discovers environmental concerns, it should proceed with caution. [say something about liability under the Act]. In either case, the lender should always procure an up-to-date environmental assessment prior to accepting a deed in lieu of foreclosure.

Title Insurance

One more hurdle that a lender must face when accepting a deed in lieu of foreclosure is obtaining an owner’s policy commitment. Title companies often will not issue an endorsement to the policy insuring against merger problems and fraudulent transfer claims until it satisfied that the amount of debt exceeds the fair market value of the property. Besides reviewing the title commitment, the lender will also obtain an up-to-date UCC search, which will reveal liens on the property. This review will help a lender decide whether it is willing to take the property subject to those liens, and, ultimately, if a deed in lieu of foreclosure would be appropriate in a given situation.

While considering whether to proceed with a deed in lieu of foreclosure transaction, the lender faced with a defaulting borrower must take all the steps that a diligent purchaser of the property would take before agreeing to a purchase. These steps include reviewing the physical status of the property, service contracts, insurance coverage, easements and other encumbrances, repairs, permits, zoning requirements, the borrower's organizational authority and existing leases.

Taken together, a number of significant risks facing a lender considering a deed in lieu of foreclosure may appear daunting. With reasonable precaution and diligence, however, a prudent lender can protect against these risks and avoid the lengthy and costly judicial foreclosure process.