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Commentary

Deeds In Lieu Of Foreclosure: Is It Time To Dust Off Our Skills?

SAN FRANCISCO—Deeds in lieu can have benefits for both borrowers and lenders, including the ability to control expenses, writes Allen Matkins' Stephen P. Lieske in this EXCLUSIVE commentary.

By Stephen P. Lieske

SAN FRANCISCO—Regardless of where you think we are in the current economic cycle, it may be time to refresh our recollection with respect to secured lending remedies and alternatives. A useful tool is the deed in lieu of foreclosure, which is completely described by its name: the defaulting borrower acknowledges that it is game over, and transfers the property to the lender instead of forcing the lender to foreclose. Although it sounds defeatist, deeds in lieu have benefits for both borrowers and lenders.

Why do a deed in lieu of foreclosure? ***Expense***. Because the process is consensual, both parties can control expenses. ***Reputation***. Unless the borrower is getting out of the real estate business, cooperating with the lender will give them a better story to tell when the good times return. Borrowers also avoid bad publicity associated with a foreclosure.

Stephen P. Lieske

Documenting the Deal. A deed in lieu deal is usually documented with a Deed in Lieu of Foreclosure Agreement ("**DIL Agreement**"), which looks like a purchase and sale agreement, and makes the form of the transaction essentially a purchase deal.

Estoppel. The borrower acknowledges that the loan is in default, that the property is underwater and that there is no coercion to enter into the DIL Agreement. This provides the lender with an estoppel argument if the borrower tries to change its mind after the deal has closed.

Due Diligence. Although the lender presumably has a solid loan origination file, the lender must treat the transaction as an acquisition and, accordingly, update its due diligence with respect to title, survey, property condition, leases and environmental issues.

Releases. Typically, both parties release each other from future liability and sign a mutual covenant not to sue. For borrowers, this is especially important where the borrower owns other assets and/or the loan has been guaranteed. Lenders do not, however, release borrower parties from liability with respect to environmental issues. On the other side of the table, if the lender's behavior has not been perfect, a release from the borrower group is handy.

Title Insurance. The title insurance policy that insures the security instrument will likely continue, but will not provide true owner's title coverage. Accordingly, the lender should purchase an owner's policy of title insurance. A further standard practice is for the lender to keep its lien in place and obtain a non-merger endorsement to the lender's policy. In other words, if a title issue arises, the lender would retain the option of foreclosing on itself.

Consent to Foreclosure and Bankruptcy. Because the lender will retain the right to foreclose on itself, the DIL Agreement should contain a consent to foreclosure. Similarly, to protect against the contingency that the borrower subsequently files for bankruptcy protection, the Agreement should include a prospective grant of relief from the automatic stay. The effectiveness of these provisions is questionable, but the prudent lender should insist on them nonetheless.

Other Observations. Obviously, the ability of the parties to obtain other concessions (e.g., cash payments) depends on bargaining power. In other words, who wants it more. The loan-to-own lender who bought the loan from the originating lender with a view to acquiring the property may be more willing to grant concessions to obtain the property quickly. Similarly, the borrower who is in desperate straits may want to hand the lender the keys as quickly as possible to get the release.

Although we all hope that the good times continue, the time is now to sharpen the skills that may be needed when the real estate economy takes a tumble.

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