STRUCTURING THE DEED IN LIEU OF FORECLOSURE TRANSACTION

BY MICHAEL F. JONES

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Michael F. Jones†

EDITOR'S SYNOPSIS: *This article analyzes the interrelationship of the Bankruptcy Code and state law involved in the delivery of a deed in lieu of foreclosure. It suggests planning and drafting techniques and the various methods of structuring the transaction to encompass the interplay of the Bankruptcy Code with the real estate aspects of a deal. There are many pitfalls, infrequently noted by the real estate practitioner, which must be countenanced and they are also explored in this article.*

I. INTRODUCTION

This article synthesizes the bankruptcy, negotiation and documentation considerations involved in a lender's acceptance from its borrower of a deed to real property in lieu of foreclosure of the lender's secured lien against the property. It assumes that the lender's counsel has reviewed local law to ascertain that the deed-in-lieu transaction is permitted, and that the lender's officer has made the decision to accept the deed in lieu as the lesser of a number of evils.[1]

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†Partner, Hansen Jones Maycock & Leta, Salt Lake City, Utah.

[1]Such as "work-outs" or judicial or nonjudicial foreclosure. *See generally* R. HARRIS, CONSTRUCTION AND DEVELOPMENT FINANCING ch. 6, Warren, Gorham & Lamont, 1982 (discussion of alternatives available to and travails faced by a lender upon loan default, with emphasis on the construction loan context [hereinafter cited as HARRIS]); Kane & Barrett, *Real Estate Workouts—Dealing with Third Parties,* REAL ESTATE BANKRUPTCIES AND WORKOUTS 225 A. Kuklin & P. Roberts, eds.), ABA Section of Real Property, Probate and Trust Law, 1983 [hereinafter cited as ABA HANDBOOK] (effect of different types of changes in the lender's relationship with the borrower on third parties such as title insurers and surety bond issuers; contractors, subcontractors and suppliers; architects; surveyors; and investors and other lenders); Seneker & Lewis, *Selected Bankruptcy Aspects of Real Estate Partnerships and Hybrid Debt-Equity Arrangements,* ABA HANDBOOK 177 (partnership aspects of concern to the lender, borrower-partnership, and nondebtor partner, including partnership agreement drafting, 177–95; effect of lender's acquiring as part of the loan transaction an interest in the value of the property securing the loan—e.g., a share of the project's cash flow or a share in appreciation of the project—on treatment of the lender in the borrower's subsequent bankruptcy case, 195–201); Seneker & Wetmore, *Structuring a Real Estate Loan Workout Agreement with Peripheral Vision of Possible Bankruptcy,* ABA HANDBOOK 241, especially notes 56–70 and accompanying text (bankruptcy and nonbankruptcy dangers inherent in exercising undue "control" of or influence on the debtor's affairs, including possible "insider" status under 11 U.S.C. § 547, exposing the lender to liability to disgorge loan payments made within the year [rather than 90 days] prior to bankruptcy filing to the extent that the debt exceeds the value of the collateral); Kelfer & Rocchi, *Federal Income Tax Considerations in Real Estate Foreclosure*

II. Analysis of Interests

Negotiation and consummation of a deed-in-lieu transaction contains an inherent acknowledgment by both the lender and borrower that each has, to some extent, failed in its judgment concerning the project. Thus, the egos of the people involved may intrude. Against this backdrop, it is imperative for the lender to have conducted a thorough analysis of its own interests and the interests of the borrower (including the interests of any persons or entitles who may be liable for a deficiency judgment in the event of foreclosure, and of any guarantors or sureties). The analysis must identify the alternatives to the deed-in-lieu transaction available to the parties, including the advantages and disadvantages of each of the alternatives from the standpoint of each of the parties.[2] Although there often is no time to stand on ceremony, it is preferable that the deed-in-lieu transaction be the borrower's idea, with the borrower having broached the subject to the lender. In such a case, the lender may be less susceptible to post-closing attacks on its good faith[3] and efforts to characterize it as an "insider."[4]

III. Bankruptcy Considerations

A critical element of a successful deed-in-lieu transaction is whether it will withstand attack based on involving either a voidable preference as to, or a fraudulent transfer of, the subject property in a bankruptcy case[5] filed by or against the borrower subsequent to consummation of the transaction.

A. *Voidable Preferences*

A "preference" may be broadly defined as a transfer by which an insolvent debtor favors a creditor or creditors over others. Generally,

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and Workouts, ABA Handbook 277 (federal income tax consequences of various foreclosure and workout transaction types for debtor, creditor, and third party considering acquisition of the property in question).

[2]While beyond the scope of this article, this writer heartily recommends to the reader an important book concerning the art of negotiation, Fisher & Ury, Getting to Yes, Houghton Mifflin, 1981. The book explores, among other things, the importance of entering a negotiating session with a knowledge of or at least insight into, the "best alternative to a negotiated agreement" ("BATNA") available to each of the parties to the negotiation, as well as the implications for the parties of their BATNA's, and the importance of and techniques available for the purpose of focusing on the parties' interests and avoiding positional negotiating where personalities become entangled.

[3]*See infra* notes 35 and 42 and accompanying text.

[4]*See infra* notes 19–23 and accompanying text.

[5]Unless otherwise noted, the terms "bankruptcy," "case" and "proceeding" will be used in a generic sense, and will include reorganization cases under chapter 11 of the Code, 11 U.S.C. §§ 1101 *et seq.*, and liquidation cases under chapter 7, 11 U.S.C. §§ 701 *et seq.* "Code" refers to the new title 11 of the United States Code enacted by the Bankruptcy Reform Act of 1978, Pub. L. No. 95–598, 92 Stat. 2549.

preferences are voidable only at the instance of a trustee in bankruptcy,[6] in order to promote equality of distribution among creditors of the debtor and discourage a race of diligence among them. Under the Code, a preference will be prima facie voidable by the trustee upon a showing that five elements have been met, namely, that the transfer is of property of the debtor, and that such transfer was:

(1) to or for the benefit of a creditor;
(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
(3) made while the debtor was insolvent;
(4) made—
  (A) on or within 90 days before the date of the filing of the petition, or
  (B) between 90 days and one year before the date of the filing of the petition, if such creditor, at the time of such transfer—
    (i) was an insider; and
    (ii) had reasonable cause to believe the debtor was insolvent at the time of such transfer; and
(5) that enables such creditor to receive more than such creditor would receive if—
  (A) the case were a case under chapter 7 of the Code;
  (B) the transfer had not been made; and
  (C) such creditor received payment of such debt to the extent provided by the provisions of the Code.[7]

If the lender-transferee can show that only one of the five requirements has not been met, then the transfer may not be avoided by the trustee. In determining whether a deed in lieu is a voidable preference, the key elements of the five referred to above are the last three.[8]

As to the insolvency element, the debtor must have been insolvent in the balance sheet sense at the time of the transfer. The test is whether the borrower's liabilities exceed its assets, "at a fair valuation," exclusive of fraudulently transferred property and property acquired post-petition which is exempted from property of the estate.[9] A debtor's inability to pay

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[6]A debtor-in-possession has the avoiding powers of a trustee, 11 U.S.C. § 1107(a).

[7]11 U.S.C. § 547(b). Even if the trustee can establish that the five elements are present, § 547(c) carves out certain circumstances under which the transfer may not be avoided; however, the provisions of the section have no application to the typical deed-in-lieu transaction.

[8]The antecedent debt requirement of § 547(b)(2) is not discussed, because this element will invariably be present where a lender is accepting a deed in lieu of foreclosure. However, passing mention should be made of the trap that exists for the real property lender who fails to perfect its mortgage or trust deed within ten days after closing of its loan, where the borrower files a petition within ninety days after such perfection. Such a loan would be deemed made for an antecedent debt, and would fall without the safe harbor of § 547(c)(3).

[9]11 U.S.C. § 101(26). In the case of a partnership debtor, the test is modified to include each general partner's net assets in ascertaining assets of the partnership.

its debts as they fall due does not render it insolvent for purposes of a preference action.

With respect to transfers occurring on the date of or during the ninety days preceding the date of the filing of the petition, the debtor is presumed[10] to have been insolvent. The presumption may be rebutted upon an affirmative showing by the transferee on the issue, whereupon the burden of going forward shifts to the trustee, who must show insolvency. The presumption does not exist beyond the ninety-day period. In a proceeding by the trustee against an "insider" for a transfer that occurred within the period between ninety days and one year before the date of the filing of the petition, the burden of proving insolvency is on the trustee in the first instance.

The second element is the requirement that the transfer has been made on or within ninety days before the date of the filing of the petition[11] or, in the case of an "insider" that "had reasonable cause to believe" that the debtor was insolvent at the time of the transfer, during the period between ninety days and one year after the date of the filing of the petition.[12] Whether a transfer is "made" is determined under section 547(e).[13] Under the section, a transfer is deemed made "when it takes effect between the parties if it is perfected within ten days thereafter, or when perfected, if it is perfected any later, or immediately before bankruptcy if it is never perfected,"[14] or at such later time as the debtor acquires rights in the property transferred.[15] Section 547(e)(1) prescribes when a transfer is deemed "perfected." Under this provision, a transfer of real property other than fixtures, but including the interest of a seller or purchaser under a contract for the sale of real property, is perfected when the transfer is valid against a bona fide purchaser,[16] and a transfer of a fixture or of personal property is perfected when valid against a judicial lien creditor.[17]

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[10]*Id.* § 547(f).

[11]*Id.* § 547(b)(4)(A).

[12]*Id.* § 547(b)(4)(B).

[13]*Id.* § 547(e).

[14]Countryman, *Bankruptcy Preferences—Current Law and Proposed Changes*, 11 U.C.C. L.J. 95 (1978).

[15]11 U.S.C. § 547(e)(3). The acquisition of rights provision will generally be inapplicable in the deed in lieu context. The provision is of primary significance with respect to security interests arising against property pursuant to an after-acquired property clause, and overrules two significant cases under the Bankruptcy Act, DuBay v. Williams, 417 F.2d 1277 (9th Cir. 1969), and Grain Merchants, Inc. v. Union Bank & Savings Co., 408 F.2d 209 (7th Cir.), *cert. denied*, 396 U.S. 827 (1969), in which the transfer of all of the respective debtors' accounts receivable had been deemed made to the secured creditors when the financing statements had been filed, more than one year before the filing of the respective petitions.

[16]11 U.S.C. § 547(e)(1)(A). Generally, recordation or similar public notice is required to prevent a subsequent purchaser from the debtor from acquiring bona fide purchaser status. 3 Powell on Real Property ¶ 904[2][c] (1981); *see* 4 Collier on Bankruptcy § 547.48 at 547–136.8–.10 (15th ed. 1983).

[17]11 U.S.C. § 547(e)(1)(B).

State law will be applied to determine whether a transfer has been so perfected.[18]

The insider[19] transfer provision of section 547(b)(4)(B) extends the preference period to a date one year after filing of the petition where the transfer is to an "insider," and in the case of transfers made "between ninety days and one year before the date of the filing of the petition" preserves the requirement of prior law that the (insider) transferee has "reasonable cause to believe that the doctor was insolvent at the time of such transfer."[20] The reasonable cause requirement is "substantively identical"[21] to that of prior law, with each case being decided on its facts, based not upon what the transferee actually knew or believed concerning the debtor's solvency, but rather whether he had knowledge of the facts that would put on notice "an ordinarily intelligent" and "reasonably prudent and honest businessman"[22] that inquiry was required. Although the trustee has the burden of proof in demonstrating "reasonable cause,"[23] the burden will generally be easily satisfied by the trustee in the case of a deed in lieu transaction, absent a detailed contrary showing by the lender (such as receipt of a financial statement demonstrating solvency, preferably certified, contemporaneously with acceptance of the deed).

The final element of practical significance is the requirement of section 547(b)(5) that the transfer enable the lender-transferee "to receive payment of a greater percentage of his claim against the debtor than he would have received if the transfer had not been made and he had partici-

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[18]"[T]he determination of when a transfer is perfected depends almost wholly on state law . . ." 4 COLLIER ON BANKRUPTCY, ¶ 547.46 at 547–136 (15th ed. 1983).

[19]"Insider" is a term new to the Code, defined in § 101(25), 11 U.S.C. § 101(25). In addition to including the various specific objective categories of persons there identified, insider includes a person "in control" of the debtor and any "affiliate" or insider of an affiliate. "An insider is one who has a sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arms [sic] length with the debtor." REPORT OF THE COMMITTEE ON THE JUDICIARY, BANKRUPTCY LAW REVISION, H.R. REP. NO. 595, 95th Cong., 1st Sess. 177 (1977) [hereinafter cited as "HOUSE REP."]. "Affiliate" is defined in § 101(2) to include, *inter alia*, an entity that owns, controls, or holds with the power to vote, 20 percent or more of the outstanding voting securities of the debtor, or a corporation 20 percent or more of whose outstanding voting securities are owned, controlled, or held with power to vote by the debtor (or by an entity that owns, controls, or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor), other than an entity that holds such securities "(i) in a fiduciary or agency capacity without sole discretionary power to vote such securities; or (ii) solely to secure a debt, if such entity has not in fact exercised such power to vote."

[20]11 U.S.C. § 547(b)(4)(B)(ii).

[21]Cook, *Preferences under the Bankruptcy Code*, ABA HANDBOOK 97, 110 [hereinafter cited as "Cook, *Preferences*"].

[22]Canright v. General Finance Corp., 35 F. Supp. 841, 844 (E.D. Ill. 1940), *aff'd* 123 F.2d 98 (7th Cir. 1941).

[23]For a detailed discussion of the nuances of "reasonable cause" and a representative compilation of case law on the subject, *see* Cook, *Preferences*, *supra* note 21 at notes 66–82 and accompanying text.

pated in the distribution of the assets of the estate."[24] Unlike the other elements that focus on the state of affairs as of the time of the transfer, the greater percentage requirement is that, as of the time of the ultimate distribution of the estate, the amount or value received by the transferee pursuant to the transfer is more than the amount to which such transferee would be entitled at the time of such distribution. It appears that a deed in lieu (or, for that matter, any transfer) will under this element be measured against the standard of whether the transfer "is accompanied by the release of an equivalent value to the estate."[25] Often, property transferred pursuant to a deed in lieu will have a value less than the lender's secured claim, so that this element is not present and the transfer would be immune from a preference attack. Indeed, if the lender anticipates relying upon such a value shortfall, it may be prudent for the lender to obtain a current appraisal establishing such value.

B. *Fraudulent Transfers*

In addition to the trustee's power concerning voidable preferences, the Code gives the trustee the right to avoid fraudulent transfers under section 548, and to avoid such transfers under applicable state law pursuant to section 544(b), such as the Uniform Fraudulent Conveyance Act[26] in force in approximately one-half the states. Under section 548, the trustee may avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that was made or incurred on or within one year before the date of the filing of the petition,[27] that either (i) is made with actual intent to hinder, delay or defraud a creditor,[28] or (ii) is for less than a reasonably equivalent value, and the borrower was insolvent or rendered insolvent, or was left with an unreasonably small capital, or intended to incur debts beyond its ability to pay.[29] While the first test is actual fraud,[30] the alternative second test may be said to be constructive fraud. Most deed-in-lieu transactions will withstand challenge under the constructive fraud test because satisfaction of antecedent debt is considered "value" under section 548,[31] and such debt will usually sufficiently approximate, or even exceed, the value of the property transferred to

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[24]House Rep., *supra* note 19 at 177.

[25]In re Zuni, 6 B.R. 449, 452 (Bankr. D.N.M. 1980). *Cf. infra* notes 43–50.

[26]Uniform Fraudulent Conveyance Act (Supp. 1980) [hereinafter cited as "UFCA"].

[27]11 U.S.C. § 548(a).

[28]*Id.* § 548(a)(1).

[29]*Id.* § 548(a)(2).

[30]*See* Cook, *Fraudulent Transfers under the Bankruptcy Code*, ABA Handbook 123 [hereinafter cited as "Cook, *Fraudulent Transfers*"], at notes 29–62 and accompanying text, for a thorough treatment of case law, *see also* Seneker & Wetmore, *supra* note 1 at notes 114–21, for a discussion of the common-law fraudulent conveyance doctrine of Dean v. Davis, 242 U.S. 438 (1917).

[31]11 U.S.C. § 548(d)(2)(A).

satisfy the threshold requirement of reasonable equivalency.[32] Where feasible, an independent appraisal or other verifiable evidence of value equivalency should be obtained.[33]

The one-year statute of limitation of section 548 is not contained in the UFCA. Thus, a bankruptcy trustee for which use of section 548 is time-barred may use section 544(b) to invoke the UFCA in jurisdictions where it is in force to challenge fraudulent transfers (as defined in the UFCA) within the generally longer time period permitted by the applicable state statute of limitation.[34] Moreover, even absent a section 548 time bar, the constructive fraud test of UFCA section 3 may be broader, because it requires that the transfer has been made in "good faith" in order to withstand trustee attack.[35] Case law has applied the "good faith" requirement in various ways to invalidate transfers to insiders, "particularly when the trustee could not rely on his or her preference avoiding power" (citation omitted).[36]

C. *Consequences of Avoidance*

Should the deed-in-lieu transaction ultimately be avoided under sections 544, 547 or 548, then the leader will be returned substantially to the *status quo ante* with its status being that of a holder of a prepetition claim existing at the time of the filing of the debtor's petition.[37] This would be so unless the lender is guilty of misconduct sufficient for the trustee to invoke section 510(c)[38] to subordinate the lender's allowed claim to other allowed claims or its allowed interest to other allowed interests,[39] to transfer the lender's lien to the debtor's estate and thereby render the lender unsecured,[40] or to disallow the lender's claim completely "in appropriate circumstances."[41] The test for application of section 510(c) is left by the

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[32]*See* Alden, Gross & Borowitz, *Real Property Foreclosure as a Fraudulent Conveyance: Proposals for Solving the* Durrett *Problem*, 38 Bus. Law. 1605, notes 22–33 and accompanying text (Aug. 1983), for a detailed discussion of case law construing this requirement.

[33]*Cf. infra* notes 43–50 and accompanying text.

[34]The Code does require that the avoiding action be commenced within two years of the trustee's appointment. 11 U.S.C. § 546(a).

[35]*See* Cook, *Fraudulent Transfers, supra* note 30, notes 77–83 and accompanying text.

[36]*Id.* at 146.

[37]Section 502(h), 11 U.S.C. § 502(h). *See* 3 Collier on Bankruptcy ¶ 502.08, note 6 and accompanying text (15th ed. 1983). The lender must have turned the property over to the trustee, § 502(d), 11 U.S.C. § 502(d). If the only basis for avoidance is section 548, section 548(c) adds a lien for any new value given by the lender as part of the deed in lieu transaction; the additional lien is not provided in the case of transfers avoided under section 544 or 547. In all events, section 550(d) grants the lender a lien for "improvements," including various defined post-closing amounts paid by the lender for the benefit of the project.

[38]11 U.S.C. § 510(c).

[39]*Id.* § 510(c)(1).

[40]*Id.* § 510(c)(2).

[41]House Rep., *supra* note 19, 15 359.

legislative history to "principles already announced by the cases and the commentators and by development in future cases."[42]

D. *Strategic Planning*

The lender should carefully plan its strategy concerning its position in a post-closing bankruptcy proceeding filed by or against the debtor. Such planning is made difficult by the shifting character of what position is in the best interest of the lender at different stages of the proceeding, particularly in the case of the single-property bankruptcy estate.

For example, on the one hand, proof that there is some equity may be necessary to prove solvency so that the insolvency element of section 547(b)(3)[43] is not present, or to avoid diminution of the amount of the lender's claim that would remain secured upon cram down[44] or so that the lender will be entitled under section 506(b) to interest on its allowed secured claim in the proceeding and to attorneys' fees and other costs provided under the loan documents.[45] On the other hand, demonstrating that the debtor has no equity may be important so that the greater percentage requirement of section 547(b)(5)[46] is met, or so that the automatic stay may be lifted under section 362(d)(2)[47] if the property is brought back into the estate through the trustee's exercise of its avoiding powers. In any event, the lender should generally be careful that the valuation attributed to the property by it, preferably supported by appraisal, be consistent with the valuation attributed to the property on any financial statements reviewed by and relied upon by the lender as evidence of the solvency of the borrower.

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[42] 3 Collier on Bankruptcy ¶ 510.04 at 510–8 (citation omitted) (15th ed. 1983). *See* Seneker & Wetmore, *supra* note 1, at 257–8 ("Perhaps the standard [of] . . . control *plus* mismanagement or other unfairness . . . comes as close as any to a succinct statement of the appropriate test") (citation omitted).

[43] 11 U.S.C. § 547(b)(3).

[44] Under § 1129(b)(2)(A)(i), 11 U.S.C. § 1129(b)(2)(A)(i).

[45] 11 U.S.C. § 506(b), under which the lender's recovery of such fees and costs is limited to the amount of equity, i.e., surplusage in the property's value over the amount of the allowed secured claim. S. Rep. No. 95–989, 95th Cong., 2d Sess. 68 (1978) adds the parenthetical "(including attorneys' fees)" after "reasonable fees."

[46] 11 U.S.C. § 547(b)(5).

[47] *Id.* § 362(d)(2). Relief under this section will be most relevant in liquidation cases where a rehabilitation is not being sought and there is no equity to be realized for junior interests. 2 Collier on Bankruptcy ¶ 362.07[2], at 362–50. *But cf.* In re Koopmans, 22 B.R. 395 (D. Utah 1982) (property may be "necessary to an effective reorganization" if it is necessary either to an effective rehabilitation or to an effective liquidation; footnote 2 of the court's opinion bears noting—the court identifies a divergence of opinion over what constitutes "equity," with the difference between the value of the property and all encumbrances against it being characterized as the predominant view, the other using the difference between the value of the property and the lien which is the subject of relief).

Under section 506, each determination of value is to be made "in light of the purpose of the valuation and the proposed disposition or use of such property."[48] "To illustrate, a valuation early in the case in the proceeding under sections 361–63 would not be binding upon the debtor or creditor at the time of confirmation of the plan."[49] Nonetheless, the lender who has accepted a prefiling deed-in-lieu might find itself arguing in a preference hearing that the appraisal demonstrates that the debtor has equity in the property which makes the debtor solvent and (presuming an adverse finding, resulting in the property being brought back into the estate) find the evidence adduced by it at such hearing used as an admission against it at the time of its subsequent efforts to establish that the borrower has no equity in the property so that the automatic stay will be lifted and the lender be permitted to proceed with foreclosure.

On balance, frequently the lender will be best served to seek to establish the lack of equity and, in turn, the adequacy of consideration. It may also often be advisable for the lender to establish its prospective basis or bases under section 362(d) for lifting the automatic stay,[50] although this writer is not aware of any widespread practice of or thinking about doing so. In all events, as the foregoing suggests, the lender should be judicious in structuring closing documents which best fit the facts and anticipated events.

IV. Documentation Considerations

It is important from the standpoint of both the lender and the borrower that the deed in lieu of foreclosure transaction be documented by a comprehensive written settlement agreement.[51] In negotiating and drafting the settlement agreement, as well as the ancillary closing documents, a tension will generally arise between the ways the lender and the borrower view the transaction that will tax the patience and skills of all involved.

The borrower will seek a "clean" transaction under which it transfers the property without any warranties of title or physical condition in full satisfaction of and in exchange for an outright release from any liability under the loan.[52]

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[48]11 U.S.C. § 506(a).

[49]House Rep., *supra* note 19 at 356.

[50]11 U.S.C. § 362(d). The no equity/not necessary test of section 362(d)(2) will generally apply only to liquidation situations; see *supra* note 47. Most frequently, the lender's ground for relief will be "cause" under section 362(d)(1), which is defined to include lack of "adequate protection" and its case law; *see* Murphy, *Administrative Powers of the Trustee in Bankruptcy*, ABA Handbook 11, 13–14.

[51]Hereinafter sometimes referred to as a "settlement agreement." *See* Roberts, *Negotiating and Drafting the Workout Agreement*, ABA Handbook 339, Appendix, Exhibit I, for a representative form of settlement agreement (note that the form contemplates in paragraph 8(b)(i) that the lender give the borrower a release, rather than the recommended covenant not to sue); *see id.* Exhibit K, for a particularly detailed closing checklist.

[52]One commentator has observed that:

Often a deed in lieu of foreclosure can be successfully arranged only after foreclosure

The lender will view the transaction as an arm's-length purchase of real estate, in which the lender is entitled to have the warranties, title insurance and other trappings commonly incident to the substantial purchase of commercial real estate. The lender should also ascertain any weaknesses of its loan documents, including ancillary documents such as guaranties. It should consider what weaknesses bear shoring up against the day that the lender might lose the property to the borrower's trustee in an avoidance action in a bankruptcy case and be relegated to its rights as lender. Indeed, any such weaknesses may influence the lender's bargaining strength where, for example, the lender is aware that its mortgage or guaranties are defective.[53] Preferably, the transaction will be effected at the instance of the borrower;[54] if true, the settlement agreement should so recite.

The recurring important structuring considerations primarily concern title matters. The lender's object is twofold: first, that all of the real and personal property (including intangibles, such as rights under important contracts) be transferred to it; and second, that such title be able to withstand any post-closing attack by the borrower's trustee in a bankruptcy case subsequently filed by or against the borrower or by an intervening lien claimant.

The transfer aspect is the same as in the case of any substantial purchase of commercial real estate. The lender should carefully identify all real and personal property that must be transferred to it in order that the lender obtain all rights necessary and appropriate to its ownership, use and occupancy of the project. Thus, in the construction context, the lender will often require an assignment of the borrower's rights under the architect's contract, construction contract, building and other permits, and the permanent loan commitment or buy-sell agreement, together with such consents or estoppel letters from the respective parties thereto as may be necessary and appropriate. Necessarily, the lender must also consider what liability, if any, may follow the project into its hands, whether pursuant to express or implied assumption, by statute, or as a matter of necessity.[55]

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proceedings, combined with an action against those personally liable on the indebtedness, have been started. A lender faced with a borrower who is unreasonable or unrealistic in negotiating for a deed in lieu of foreclosure, or who uses the negotiations for the purpose of delay, should not hesitate to commence foreclosure proceedings. Harris, *supra* note 1, at 6–19.

[53]*See* Seneker & Wetmore, *supra* note 1, notes 53–55 and accompanying text.

[54]*See supra* notes 3, 4 and 42 and accompanying text.

[55]Illustrative examples given by one commentator include obligations to release parcels on payment of the balance on individual purchase prices in the case of projects subject to the federal Interstate Land Sales Full Disclosure Act or state counterparts; to complete general project improvements, repair construction defects or add promised amenities; to discharge (alleged) promises by salesmen to "their wide-eyed prospects;" or to perform under a shopping center operating agreement or other like operating agreement. Kuklin, *The ABC's of Workouts*, ABA HANDBOOK 205, 208.

As to the bankruptcy aspect of protecting title, the settlement agreement and other closing papers should reflect the lender's thinking concerning its strategy in the event of a subsequent bankruptcy filing by or against the debtor.[56]

Analysis must be made as to whether there are or may be mechanic's lien claimants or other third parties asserting or that may assert an interest in the project or any portion thereof that would be junior to the lender's preexisting secured interests in the project but senior to the fee interest to be obtained by the lender pursuant to the deed-in-lieu transaction. If there are, it is often good practice for the lender to include language in the settlement agreement and all deeds, bills of sale and other conveyancing documents that all of the lender's loan documents remain in full force and effect after consummation of the transaction and that there shall not be any merger of the fee interest obtained by the lender with or into the lender's prior secured interests in the project. If the antimerger language is effective under applicable state law,[57] then the lender is in a position to conduct a subsequent foreclosure action to extinguish any such intervening interests. The foreclosure decree and sale should generally transpire more than ninety days after closing of the deed-in-lieu transaction and recording of the deed and any other documents involved, in order to fall outside the ninety day preference period of section 547.[58] A deed-in-lieu transaction followed by such a delayed foreclosure is to be preferred over a "friendly foreclosure."[59]

However, uncertainties surrounding the anti-merger language under some states' applicable law may prompt the prudent lender to prevent merger by having the borrower convey title to the project to a separate entity controlled by the lender. Where the separate entity is a corporation, the lender is insulated from the liabilities of ownership. Depending on local law, property ownership may necessitate that the entity qualify to do business and be subject to local taxation, service of process and other burdens. Use of a separate corporation that is locally qualified insulates the lender from these burdens.[60]

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[56]*See supra* notes 43–50 and accompanying text.

[57]*See* 3 POWELL, *supra* note 16, ¶¶ 459, 469.1[3], notes 12–14 and accompanying text ("since a conveyance [to the mortgagee] does not, of itself, cut off the junior liens or interests, their existence prevents a merger, the mortgage being kept alive in order to prevent foreclosure, against these subordinate claims" [citations omitted]); *see also* HARRIS, *supra* note 1, notes 32–35 and accompanying text, including sample antimerger language. Note that on subsequent sale of the project by the lender the lien may be lost, but see POWELL, *supra* note 16, ¶ 469.1[5] at 696.76[42], concerning a drafting approach at the time of such sale to avoid the result.

[58]Presuming that the lender is not an "insider," *see supra* note 19.

[59]*See* Roberts, *supra* note 51, at notes 40 and 41 and accompanying text.

[60]Indeed, one commentator has suggested that "an owner whose name does not contain the word "bank" is better able to avoid the deep-pocket problems of effectively negotiating terms with contractors." Roberts, *supra* note 51, at 349. A caveat here is that the lender using

The settlement agreement should establish the adequacy of the consideration given by the lender for the deed in lieu of foreclosure, so as to impart constructive notice under the applicable recording act. The conventional wisdom is that forebearance from collection of antecedent debt may not constitute the sort of "present" consideration that is required under many state recording statutes as a condition of causing recording of a deed under such statutes to be deemed to impart constructive notice to a purchaser of real property.[61] According to this school of thought, it is therefore good practice for the lender to pay some cash consideration to the borrower in connection with consummation of the deed-in-lieu transaction.[62] Nonetheless, it is submitted that where the debt is greater than, or substantially equal to, the value of the property, the more enlightened view should be that forebearance from collection of the debt constitutes a present change of position that should in fact constitute present consideration.[63] In any event, a detailed recitation of the consideration should be set forth in the settlement agreement.

The borrower may seek to negotiate a delay in closing or residual rights in the project. While the variations are many, one common approach proposed by borrowers is an escrow agreement pursuant to which the borrower deposits with an escrowee a deed to the lender with instructions to deliver the same to the lender on the happening of prescribed events (such as failure to pay prescribed amounts due or overdue under the loan prior to a particular date, failure to complete construction of the project in accordance with a stated progress schedule, or failure to achieve a certain level of unit sales within the project), such arrangement being calculated to afford the borrower additional time in which to put matters right. Another approach involves a present conveyance of the project to the lender with the contemporaneous grant to the borrower of an option to repurchase the project or a right of first refusal to purchase the same or a right to share in any profit from the project. A significant

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such a subsidiary should be mindful in capitalizing the subsidiary and documenting its formation and operating affairs of the need to avoid an "alter ego" attach that seeks to "pierce the corporate veil" of the subsidiary and reach the lender.

[61]*See, e.g.*, Kuklin, *supra* note 55, at 206 ("Under the recording statutes in many states, the recording of a transfer made . . . to satisfy a preexisting debt raises doubt that the recipient is a purchaser in good faith for consideration. The flaw is that antecedent debt is not valuable consideration, or so the cases generally hold" [citation omitted]).

[62]*See, e.g.*, Kuklin, *supra* note 55, at 206 (recommending payment of "various workout expenses such as the transfer and recording taxes"); Roberts, *supra* note 51 (recommending payment of "some cash consideration to the borrower, at least the amount of title, recording, and transfer charges that the lender may in any event be required to fund. This assures valuable consideration for the purpose of qualifying for the benefits of various recording statutes" [citation omitted]). In situations where the borrower does have the financial ability to pay such expenses, the lender should weigh the substantial amount of recording charges under some states' statutes determining its willingness to pay the same.

[63]*See* POWELL, *supra* note 16, ¶ 904[2], note 36 and accompanying text, and ¶ 904[3]).

danger in these approaches is that each may be considered the functional equivalent of an equitable mortgage[64] or may be deemed void or voidable as "clogging the equity of redemption."[65] In addition, because the latter approach involves putting the lender in title to and possession of the project, use of that approach may subject the lender to claims by or on behalf of the borrower that construction was completed improperly or too expensively or that the property was not properly operated or sold, as the case may be.

Release of the borrower from liability under the loan may constitute a satisfaction of the debt and thus extinguishment of the mortgage.[66] A lender needing to preserve its mortgage for purposes of possible future foreclosure[67] should prevent this through use of a covenant not to sue the borrower for a deficiency judgment. The covenant should contain an express condition subsequent that the covenant shall not preclude any such claim as covenantor may at any time thereafter have against the borrower on account of breach of any of the warranties contained in the deed.[68] The covenant should also contain a reservation of all claims against any persons other than the borrower.

The lender should consider obtaining an owner's title insurance policy as of the date the project is conveyed, because its preexisting lender's title insurance policy[69] only insures as of the date of the policy—not the date the lender acquires title—and the lender may not want to discharge or release its mortgage lien.[70]

A new policy is likely to contain a creditors' rights exception for attacks on title in federal or state bankruptcy and insolvency proceedings and for construction of the deed-in-lieu transaction as an equitable mortgage. Some title insurance companies will delete the exception for avoidance of preferences and fraudulent transfers in bankruptcy upon receipt of an appraisal showing that the loan amount exceeds the value of the project. However, lenders seldom take advantage of this procedure due to the time and expense involved and the uncertain results of such an appraisal. Also,

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[64]One commentator has observed that "the 'mortgage' the lender has thus acquired will lack all of the important lender-oriented mortgage provisions, such as authority for a receiver or mortgagee-in-possession and waiver of rights of redemption." HARRIS, *supra* note 1, at 6–22.

[65]*See* Kuklin, *supra* note 55, at notes 6–11, 34 and 35 and accompanying text.

[66]*See* 55 AM. JUR. 2d, *Mortgages* § 133 (1971).

[67]*See supra* notes 57–60 and accompanying text.

[68]Lender's subsidiary, if one is used; *see supra* note 60 and accompanying text.

[69]Section 2 of the Conditions and Stipulations to both the American Land Title Association Loan Policy—1970 (amended 10–17–70) and the American Land Title Association Construction Loan Policy—1975 provides for the continuation of title insurance afforded by the policy forms in favor of an insured who acquires title by deed in lieu of foreclosure.

[70]In order to preserve the flexibility to foreclose intervening liens, see *supra* notes 57–59 and accompanying text; section 2 of the Conditions and Stipulations to both the American Land Title Association Loan Policy—1970 (amended 10–17–70) and the American Land Title Association Construction Loan Policy—1975.

occasionally title companies will delete the exception based upon a probative affidavit from the borrower to the same effect. Even so, a policy containing such exception will be of some comfort to the lender if the title insurer will undertake to remove the exception in connection with bona fide sales to third parties and to insure the title of such purchasers free of exceptions arising from the deed in lieu transaction.[71]

The policy will show the existing mortgage as an exception, and may raise the issue of merger of the lender's two estates. Where an antimerger approach is being taken to known or anticipated intervening liens,[72] some title insurers will issue an endorsement insuring over any loss which the lender-transferee might suffer as a result of the merger of the lender's prior estate under its loan documents into its fee simple estate.

As the foregoing suggests, contact with the title insurance company from the outset of the deed-in-lieu transaction negotiations is important in order that the lender obtain the desired coverage. The settlement agreement should be submitted to the title company for its review. The lender should bear in mind that the policy expressly excludes coverage of any loss incurred by the insured by reason of defects, liens, encumbrances, adverse claims or other matters not known to the title insurer and not shown by the public records but known to the insured and not disclosed in writing by the insured to the title insurer prior to issuance of the policy.[73]

As in the case of any substantial real estate purchase and sale transaction, the deed-in-lieu transaction should generally be closed in escrow. If one or another of the lender's significant closing requirements are not satisfied, the transaction will be aborted and the lender will be free to foreclose its mortgage.

Finally, consideration should be given to the question (generally overlooked) of what opinions of counsel should be required by the lender. At a minimum, an opinion should be required regarding the borrower's due authorization and execution of the transactional documents. An opinion as to the validity and enforceability of the documents may also be helpful, if only to bring to light any hidden problems that may be discovered by the reviewing lawyer, and notwithstanding the likely presence of the standard bankruptcy qualification. An opinion that the mortgage and any related security interests arising under the loan documents are valid and perfected under applicable state law may provide comfort in the event of either the commencement of a subsequent bankruptcy case or of a foreclosure proceeding against junior lienors. The lender should consider, with a somewhat jaundiced eye the true worth of any opinion as to freedom from

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[71]For a form of title company letter of assurance, see HARRIS, *supra* note 1, Form 6.3, at 6–34.

[72]*See supra* notes 57–60 and accompanying text.

[73]Section 3(b) of the Exclusions from Coverage to both the American Land Title Association Loan Policy—1970 (amended 10–17–70) and the American Land Title Association Construction Loan Policy—1975.

attack under the bankruptcy trustee's avoidance powers, and should carefully examine the factual basis for any assumption therein concerning solvency or other similarly crucial matters.[74]

V. Conclusion

The deed-in-lieu transaction is a challenge that requires the lender's counsel to combine the qualities of "a prophet, a determined negotiator, a skilled drafter, and at times a father confessor"[75] to bring the lender and the borrower together. When such a transaction is effectively used, it can provide the lender with expeditious and enduring ownership and possession of the project, and avoid for all parties the burdens, delays and vagaries of foreclosure or bankruptcy.

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[74] *See generally* Seneker & Wetmore, *supra* note 1, notes 132–35 and accompanying text (citations to additional commentary, and identification of additional potential problems raised by opinions rendered on transactional documents in light of several provisions of the Code).

[75] *Id.* at 241.