

## **DEEDS IN LIEU OF FORECLOSURE: ADVANTAGES, DISADVANTAGES**

A deed in lieu of foreclosure (lieu deed) is a conveyance, by the owner of property encumbered by a mortgage, to the mortgagee, in full satisfaction of the obligation secured by the mortgage. The mortgagee takes title to the property subject to existing claims or liens affecting the property, but the mortgage is not merged with the lender's title to the property. Acceptance of a lieu deed terminates the liability of the borrower and all other persons liable for the mortgage debt unless there is an agreement to the contrary made contemporaneously with the lieu deed transaction. The terms and conditions under which a borrower will grant and a lender will accept a deed in lieu of foreclosure are highly negotiable and will depend on the relative bargaining positions of the respective parties. Because Illinois, Wisconsin, and Indiana case law on this topic is sparse, an examination of federal case law and case law from other states is helpful.

### ***Advantages to Lender***

There are several advantages to a lender in accepting a deed in lieu of foreclosure. First, the lender becomes the owner of the property, allowing the lender to control its operation, take immediate steps to maximize its economic value, use and obtain all its income, and preserve valuable contracts and tenants. Second, the transaction can be quickly negotiated and completed with fee title vesting in the lender upon recordation of the deed so that title is immediately marketable. Third, the publicity, time, and expense of a foreclosure action can be avoided. Finally, if there is no equity in the property above the amount of the outstanding debt, the transaction will not be susceptible to being set aside by a bankruptcy court or a court of equity if the borrower later files for bankruptcy or attempts to rescind the transaction based on fraud or coercion.

### ***Disadvantages to Lender***

Sometimes a lender should not accept a lieu deed. For example, the lender should not accept a partial conveyance of the property unless the entire mortgage debt is released as a result of the partial conveyance. Otherwise, the lender may face valuation and allocation problems, title problems, and/or problems in connection with subsequent foreclosure of the remainder of the property still subject to the mortgage, with all the additional cost and time involved. A lender should also hesitate before accepting a lieu deed where there are outstanding subordinate liens or judgments against the property. In such a situation, the lender will have to foreclose its mortgage, with the attendant expense and time involved to obtain clear title. Even if the debtor promises to remove subordinate liens and encumbrances prior to transfer of the property, he/she may not be able to do so, especially where there are numerous liens or judgments outstanding. Such matters are often outside the lender's control, and title matters must be cleared quickly in order to close the transaction expeditiously. The lender must also be careful in this situation that the lieu deed is structured in a manner that will not result in merging the mortgage lien with title to the property upon consummation of the transaction, thereby preventing the lender from foreclosing subordinate liens.

### ***Advantages to Borrower and Other Persons Liable on the Mortgage Debt***

Advantages to a borrower in offering a lieu deed include, first, the release of the borrower and all other persons who may owe payment or the performance of other obligations secured by the mortgage. However, such persons remain liable if they agree to do so contemporaneously with the lieu deed transaction. regardless of whether quitclaim deeds executed by mortgagors were viewed as deeds in lieu of foreclosure, mortgagors signed contemporaneous agreement indicating the intent that if deficiency existed, judgment would be entered against mortgagors; thus, bank was entitled to deficiency judgment against mortgagors). In addition, authority predating the Mortgage Foreclosure Law provides that a guarantor will not be discharged by the lender's acquisition of security for the loan if the guaranty so provides. Guarantors of a mortgage loan remained liable for any deficiency to the mortgagee up to the stipulated amount of the guaranty, notwithstanding that the mortgagee purchased the principal obligors' mortgaged property at the foreclosure sale for the full amount of the indebtedness, where the contract of guaranty specifically provided that it would not be affected by any sale or disposition of indebtedness or any security or collateral thereof. The second advantage to the borrower is the avoidance of the publicity, expense, and time involved in proceedings to enforce the mortgage loan and other obligations, with eventual loss of the property. Third, it is possible that the lender will agree to pay all or part of the expenses of the transfer or even additional monetary consideration if there is equity in the property over the mortgage debt. However, the amount that a lender will pay is generally less than a third party would pay, if one can be found. Finally, it is possible that the lender will grant certain limited possessory or other property rights back to the borrower, such as a lease of all or part of the property, an option to purchase, a right of first refusal, and the like. However, lenders generally resist granting such remaining rights to the borrower in order to obtain the property free and clear of all outstanding interests. If an option or a right of first refusal is granted, the lender will ordinarily limit the time within which it is available to a relatively brief period of time.

### ***Disadvantages to Borrower and Other Persons Liable on the Mortgage Debt***

The primary disadvantage to the borrower is the loss of the property, the income from the property, and the borrower's investment in the property. The conveyance of the property is also taxable.

### ***Offer to Deed***

A borrower's offer to convey mortgaged property back to the lender must be truly voluntary. There must be no pressure, actual or constructive fraud, unconscionable advantage, duress, undue influence, or grossly inadequate consideration on the part of the lender. If the borrower attacks the transaction on any of these grounds and wins, he/she will have the option to set aside the transaction and recover the value of the property, the equity of redemption, or the profits on resale of the property by the lender. In addition, punitive damages may be assessed against the lender if the lender's conduct is flagrant or outrageous. However, it must be clearly shown that the borrower's necessity was used to drive a hard bargain, and the borrower must conclusively prove wrongful conduct by the lender.

To avoid a claim that the transaction was involuntary, it is customary for the borrower to initiate the offer to deed the property back to the lender. Accordingly, the borrower mails a written offer to the lender, voluntarily offering to deed the property to the lender and stating the reasons therefor. This procedure also prevents the borrower from claiming that the lender did not act in good faith, or that the transaction should be set aside as an "insider" transaction under the Bankruptcy Code. The transaction must be closed promptly after the lender's receipt of the written offer to convey, or else the lender should proceed with foreclosure to avoid delay tactics by the borrower. After receipt of the offer from the borrower, the lender should send a reply letter acknowledging the offer, stating the express conditions under which the lender will accept a conveyance, and confirming that no contractual obligation to accept the property exists until all required documentation is fully executed and all considerations are paid and/or delivered. The borrower is not relieved of personal liability on the mortgage debt until the transaction closes. The mere tender of an executed deed by the mortgagor or the recording of a deed by the mortgagor to the mortgagee shall not constitute acceptance by the mortgagee of a deed in lieu of foreclosure.

Before accepting an offer for a lieu deed, the lender should be sure that, first, if he/she were to foreclose and obtain a deficiency judgment, the judgment would not have any practical value. Second, that there are no junior liens or encumbrances that will be outstanding on the property when it is conveyed to the lender, unless the lender is willing to take title subject to such liens or encumbrances. Third, that there are no conditions imposed on the offer, such as a reservation of possessory rights or a right of first refusal to repurchase, unless such rights are limited (and insured) to avoid the deed being construed as a continuing security device or equitable mortgage. Fourth, that the total expense (not including cost of title insurance) of accepting the voluntary conveyance will be less to the lender than the expense of pursuing a foreclosure action and bidding at the foreclosure sale to protect its investment. Fifth, that taking immediate possession of the property will be beneficial to the lender, considering the market for the property, any environmental cleanup work that must be done on the property, the tax aspects of taking possession, and any difficulties in retaining or evicting tenants and occupants of the property. Sixth, that the borrower has no equity in the property that could be realized by a sale to a third party within a reasonable time. A deed may still be taken if an appraisal indicates that there is equity in the property, but there is a risk that such a transaction may be set aside unless the borrower is adequately compensated for the equity. And finally, that an owner's policy of title insurance will be provided by the title insurance company without exceptions for equitable mortgage claims.