

Deeds in Lieu of Foreclosure

ATA –Phoenix

April 11, 2006

Once upon a time there was a loan secured by a Deed of Trust, whereby the borrower faithfully made his payments for a period of two months. Then buyer's remorse and reality sunk in, whereby the borrower realized he had over-extended his standard of living and the house he had bought, hoping to flip in short order, was now going to become one of his biggest nightmares!

Despite Arizona's thriving economy and the wonderful opportunity to make money in real estate, every market has corrections and it is human nature to want today and pay tomorrow. A few changes in the market and increase in interest rates etc create the potential for a new wave of foreclosures.

Although we often feel sorry for borrowers, those of us who work in the business of supporting lenders and process Trustee Sales, have a somewhat different view towards a loan that has gone into default. Of course the lender, who neither receives its return on the loan, nor has possession of the property often loses the most, especially in a softening market, whereby many properties are taking more time to sell and often there is little or no equity to be lost by the borrower.

There are essentially three "remedies" available to the lender in its effort to obtain ownership to the property and have an opportunity to resell it in order to recover on its investment, or minimize its potential losses:

1. Non-Judicial Trustee Sale- most in our audience today
2. Judicial Foreclosure; and
3. Deed in Lieu of Foreclosure

Today we are going to briefly discuss the later, namely Deeds in Lieu of Foreclosure. One of the most significant advantages to a lender might be the reduction in total expense and the time to acquire title to the property.

That being said, we must recognize a lender's use of the Deed in Lieu of Foreclosure alternative is not always a practical solution for the lender, albeit the borrower might be very motivated to "give the property back to the lender" in exchange of the lender's "forgiveness of the debt."

Let us spend a few moments and identify some of the factors that should be considered as part of the borrower and lender agreeing on pursuing the "Deed in Lieu remedy":

Concerns to accepting a Deed in Lieu

1. Is the property subject to any encumbrances that are junior to the Deed of Trust in default?
2. If so, the Deed in Lieu approach will not work for a lender as clearly the lender would be taking title subject to ALL items of record, senior AND junior.
3. Before a lender would consider accepting a Deed in Lieu, it needs to secure a title report/commitment/ or Trustee Sale Guarantee from a title company to determine what the current condition of title is. Some of your customers may elect to pursue a Deed in Lieu instead of proceeding with a Trustee Sale, depending on the results of the Trustee Sale Guarantee.
4. Even if the report or Guarantee is "clean" with exception to the Deed of Trust in default, there are dangers of items being recorded prior to the Deed in Lieu that the parties maybe have worked on for weeks or months. Examples: Borrower goes out and takes an Equity Credit Line Deed of Trust; State or Federal Tax Liens get recorded just a week before the Deed in Lieu is ready to record; oh, the borrower forgot to tell you his total debt was so great, he elected to file for bankruptcy, but being an "honorable person" will still gladly sign the Deed in Lieu."

5. From the foregoing we can see even though a borrower might “mean well,” his actions, including those like tax liens can easily “capsize” the best structured Deed in Lieu transaction. Unfortunately, no one can be absolutely sure something will not be recorded, voluntary or involuntary before the Deed in Lieu gets recorded, hence title companies are very concerned about the risks associated with Deed in Lieu transactions.
6. Authority? Who has authority to bind the owner/borrower entity? If it’s an LLC, what does the Operating Agreement and any amendments say if anything regarding the execution of a Deed in Lieu? Oh, don’t know what the Operating Agreement says!
7. What about post-execution and recording Bankruptcy? A Deed in Lieu does not enjoy the many “protections” that Case law has provided to lender’s acquiring title pursuant to Trustee Sale or Judicial foreclosure. Hence, many title companies will show an exception for post Deed in Lieu bankruptcy in an owner’s policy issued to a lender.
8. Despite all of these concerns, let’s say the borrower and lender agree to pursue the “Deed in Lieu” of foreclosure alternative. What now?
9. Elements in the Deed in Lieu:
 - a. See sample.
 - b. Words of consideration
 - c. Be free of force or duress. We call this estoppel language.
 - d. Consideration usually release of the obligation to repay debt secured by Deed of Trust. Usually that includes recordation of a modified Release and Reconveyance of the Deed of Trust, usually executed by the lender and recorded concurrent with the Deed in Lieu. The recon is usually modified because whereas a standard Recon says the debt has been paid, a Recon for a Deed in Lieu stipulates repayment of the debt has been waived as “consideration” for the Deed in Lieu.
 - e. Some lenders in commercial transactions especially are being advised by their counsel to NOT release the Deed of Trust until a year has past in order to minimize risk in the event of post-Deed in Lieu bankruptcy.
 - f. Bear in mind even if the owner pledges not to file bankruptcy following the deed, this is ineffective against Creditors of the owner, who may cause an involuntary bankruptcy to be filed.
10. Experience has shown that while Deeds in Lieu are seemingly a fast and inexpensive way for borrower and lender to “unwind” their deal, we can see many potential risks and challenges to the lender that might otherwise be eliminated altogether, if not minimized. Clearly, Arizona’s laws and Case Law provide much more protection to a lender when it pursues its statutory default remedies of judicial or non-judicial foreclosure. Even post foreclosure bankruptcies are often unable to derail a properly conducted Trustee Sale or judicial foreclosure, whereas there is little protection on the later when a Deed in Lieu is used.
11. Bear in mind again the loss of time and money in pursuing a Deed in Lieu, when the title company conducts its date-down prior to recording the Deed in Lieu and discovers additional matters recorded that the owner may or may not admit being aware of.
12. As a general rule, most lenders will always want to secure a policy of title insurance, insuring the Deed in Lieu, notwithstanding the Continuation of Insurance coverage contained in the loan policy the lender may have gotten at the time of the loan. That Continuation of coverage is only as of the date the loan was originally made, hence all post loan events are not insured against.

So use of the Deed in Lieu as an alternative to Trustee Sale or Judicial foreclosure can present many challenges and risks to the lender and title insurer. But, since time is always of the essence, each party must decide: “it is a risk worth taking?”

Authored by:

Victor Rzepecki, Vice President-Underwriting & State Agency Manager
LandAmerica Arizona Agency Services

LandAmerica is the parent company of Commonwealth Land Title Insurance Company; Lawyers Title Insurance Corporation; and Transnation Title Insurance Company, all national title insurance underwriters represented by over 900 offices and over 10,000 Agent-partners across the U.S., Canada, Mexico, the Caribbean, Latin America and Europe