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Why Take a Deed in Lieu of Foreclosure? Why Not?

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So you're headed for receivership and foreclosure, when the borrower rep or your counsel asks, "What about a deed in lieu?" "I don't know," you think. "Getting a receiver appointed and foreclosing is what I'm most familiar with." Fair enough. But the benefits of a DIL might surprise you. You just have to put a good agreement in place that protects you.

Advantages of a DIL

An obvious advantage of a DIL in a judicial foreclosure state is avoiding the time and expense of drawn-out foreclosure procedures. But even in a nonjudicial state, a DIL may be the right call in the right situation. In Alabama, for instance, taking a DIL can avoid the dreaded one-year statutory right of redemption that otherwise arises from foreclosure. But beyond redemption issues, lenders and servicers often need to complete third party reports and may have legitimate concerns about misapplication of rents. Because a DIL is consensual, there is room to get what you want just by asking, instead of resorting to litigation.

Treat it like a property sale from borrower to holder

The important thing to remember about a DIL is that it is like a property sale - as if the holder is "buying" the collateral from the borrower in full or partial satisfaction of the debt. Thus, the first step in any DIL transaction is ordering title insurance. The benefits of title insurance go beyond the owner's policy itself. In addition to the standard title affidavits, the title company will require the borrower to provide an affidavit and indemnity attesting that the borrower is not completing the DIL under duress, that the transaction is fully authorized, and that the value of the property is less than the amount of the debt, among (many) other things. It's a built-in defense to rescinding the transaction.

Like any property sale, you also need a sale agreement - in this case, a Deed in Lieu of Foreclosure and Settlement Agreement - with all the terms you'd expect in a sale agreement: closing date, closing conditions, an inspection period (and just like that borrower has consented to give you access for an appraisal, phase I, phase II, PCA, and survey, all at once and within a specified timeframe), reps and warranties about title and authorization, and a catch-all covenant requiring "any documents or instruments required by the title company." The Agreement will also include typical closing documents: not just the deed, but also a bill of sale for the personal property and an assignment of leases and contracts, complete with a form rent direction letter borrower must send to the tenants.

Protect yourself with settlement terms

But a DIL Agreement is also a settlement agreement; after all, the holder is agreeing to forgive the debt. Ending the borrower/lender relationship calls for additional terms:

- a full release of claims against holder and its predecessors, servicers and representatives;
- a provision that the environmental indemnity survives closing;
- an acknowledgment that the holder can file a 1099 if required by applicable law;
- an accounting of rents and security deposits
- a "settlement payment" in the event borrower is holding or has diverted rents - this last point gives you something to negotiate and can sweeten the deal (for both sides).

Like any settlement agreement, a DIL allows the holder flexibility to protect its interests while still giving the borrower (and carve-out guarantors) incentives to do a deal.

As always, a DIL, like any remedy, should be appropriate in the given circumstances. If a title search reveals junior liens, a DIL might not be the way to go when you can extinguish them by foreclosure. If there is a tenant-in-common structure in place, it might not be feasible to get every TIC to sign a deed. But in the right circumstances, a DIL can be a quick and easy way to take title in a smooth transition while settling potential claims with the borrower, all without litigation.