

Deeds in Lieu of Foreclosure – Title Insurance Issues

By John C. Murray

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Deeds-in-lieu are often taken by lenders (especially in these difficult economic times) in connection with loan workouts of residential, agricultural and commercial properties, and are also done as part of bankruptcy workouts and “prepackaged” bankruptcy plans. Lenders considering such transactions may seek to obtain affirmative creditors’ rights coverage from the title insurer because of the risk of a fraudulent transfer or preferential transfer claim in a subsequent bankruptcy proceeding by or against the debtor. But such coverage is not the “norm,” and involves significant due diligence on the part of the title company and compliance with the internal requirements of title insurers with respect to such transactions.

Most lenders won’t accept a deed-in-lieu unless there are no other mortgage liens or encumbrances on the property and an appraisal (which, depending on the lender’s and/or title insurer’s underwriting requirements, may be either internal or external) has established that there is no equity in the property (i.e., the amount of the outstanding indebtedness exceeds the current appraised value of the property). The title insurance company will want a copy of the appraisal showing that the value of the property being transferred is less than the debt. (The title insurer usually will, upon request, supply the lender with a confidentiality letter with respect to the appraisal).

Most sophisticated lenders have a specific procedure for deeds-in-lieu, including a settlement agreement, deed with non-merger language, assignments, estoppels, etc. The title insurance company will want to receive and review these documents in advance of the scheduled closing to make sure they comply in all respects with the title insurer’s requirements. Many lenders will not cancel the note, but will instead give the borrower a covenant not to sue. A covenant not to sue, as opposed to cancellation of the note, also will avoid a subsequent argument that the mortgage should be deemed discharged or void because the underlying debt has been extinguished. (Consideration for a deed-in-lieu transaction can be either release of the borrower of personal liability or, in connection with a non-recourse loan, forbearance by the lender from exercising or activating its statutory and contractual legal rights and remedies, such as foreclosure and assignment of rents). The lender usually will keep the mortgage of record and not discharge or release it until the property is subsequently resold, or the mortgagee records a release or discharge of the mortgage.

The validity of attempting to preserve the mortgage lien may depend on whether other creditors would be prohibited from availing themselves of the normal methods of collection that they would otherwise have if the lien were extinguished, and will also depend to a great extent on the intention of the parties as stated in the settlement agreement and the deed. Most states, including Illinois, will enforce such a stated intention.

Lenders and title companies share the same concerns about deeds-in-lieu: re-characterization as an equitable mortgage; violation of the “clogging the equity” doctrine (i.e., the use of a deed-in-lieu as a means of preventing the borrower from exercising its statutory and/or equitable rights to redeem the property from a foreclosure sale); and setting aside of the transaction as a fraudulent conveyance or preferential transfer under federal bankruptcy or state

fraudulent transfer laws.

Lenders usually will (and certainly should) obtain a new Owner's Policy of title insurance upon completion of the transaction, rather than rely on continuation of the coverage under the existing Loan Policy (although the Loan Policy should be downdated if the parties express their written intention to keep the mortgage alive and the applicable jurisdiction enforces such intention). This is so because the Loan Policy only covers matters of record at the time of the original loan; it does not insure the validity of the deed-in-lieu transaction or provide coverage for creditors' rights issues in connection with the transfer of title; and it provides less claim coverage than a new Owner's policy (i.e., unlike an Owner's Policy, which provides for payment upon proof of loss because of the diminution in value of the estate caused by the title defect, a lender insured under a Loan Policy must first establish that a loan default and an actual impairment of its security as a result of foreclosure have occurred as a result of the defect before it will be entitled to recover under the Loan Policy).

The 1992 ALTA Loan Policy provides for continuation of coverage only if the insured acquires the land by "conveyance in lieu of foreclosure, or other legal manner which discharges the lien of the insured mortgage," but this specific requirement has been eliminated in the new 2006 Loan Policy, which policy is discussed below. *See* Janice E. Carpi, *Title Insurance Following Foreclosure, Beyond the Workout: Risks for Lenders Taking Back and Owning Real Estate*, Third Annual Spring CLE and Committee Meeting, Real Property Law Programs, American Bar Association, Section of Real Property, Probate and Trust Law, New York, NY (May 7-9, 1992) at A-3. The lender may, in addition to obtaining a new Owner's Policy in connection with a deed-in-lieu transaction, request certain endorsements to the existing Loan Policy such as a non-merger endorsement and an endorsement insuring the continuing validity, enforceability and priority of the mortgage lien upon consummation of the deed-in-lieu transaction.

As mentioned above, the lender may give the mortgagor a covenant not to sue and keep the mortgage of record when obtaining a deed-in-lieu in connection with a workout of a defaulted mortgage loan, in order to (i) maintain priority over subordinate liens and the ability to subsequently foreclose its mortgage to eliminate mechanic's or other liens, (ii) to preserve its first lien interest if the deed-in-lieu transaction is subsequently set aside as the result of a fraudulent-conveyance or preferential-transfer action by a bankruptcy trustee or other creditors of the mortgagor, and (iii) to avoid a subsequent argument by the mortgagor or another creditor that the mortgage has in fact been discharged and is void because the note evidencing the underlying indebtedness has been canceled.

Title insurers sometimes are requested to provide affirmative insurance against creditors' rights' claims in deed-in-lieu transactions. But as noted above, such coverage is not "standard" and would only be available on a case-by-case basis after carefully underwriting the transaction and tailoring such coverage to cover only certain risks.

On April 19, 2004, the ALTA adopted Endorsement Form 21, which insures against loss under an Owner's or Loan Policy because of the occurrence, on or before the date of the policy, of a fraudulent transfer or preference under federal bankruptcy law or state insolvency or creditors' rights laws. It also confirms that title insurers will pay all costs, expenses and attorneys' fees to defend the insured against such claims. It expressly excludes coverage for

such loss, however, if the insured knew that the transfer was fraudulent or was not a purchaser in good faith. The benefit of this endorsement is that it expressly provides affirmative coverage, so that the insured no longer has to request the removal of the existing policy exclusion for creditors' rights issues, or require a pre-1990 policy that did not contain the exclusion -- and then wonder if the insuring provisions of the policy (without the exclusion) provided coverage for creditors' rights matters. The Endorsement Form 21 may be issued only if, after thoroughly reviewing the transaction and chain of title (and perhaps certain off-record issues), the title insurer is satisfied that no creditors' rights issues exist.

The American Land Title Association ("ALTA") Forms Committee revised the standard, or "base," 1992 ALTA Owner's and Loan Policy forms and a number of related forms. These new forms were formally adopted by the ALTA Board of Governors at its meeting on June 17, 2006 and have been approved for use in almost all of the states. New Covered Risk 9(a) (Owner's Policy) and new Covered Risk 13(a) (Loan Policy) provide coverage for creditors' rights issues in the "past chain of title" (i.e., any fraudulent or preferential transfer prior to the transaction vesting title (Owner's) or creating the lien of the insured mortgage (Loan).

New Covered Risk 9(b) (Owner's Policy) and new Covered Risk 13(b) (Loan Policy) provide coverage for "preferences" resulting solely from the failure to timely record the transfer instrument or the security instrument or of the recording of the instrument to impart constructive notice to and bind third parties. Any other cause of a preferential transfer challenge arising out of the insured transfer is excluded from coverage by Exclusion 4(b) (Owner's Policy) and Exclusion 6(b) (Loan Policy)

Covered Risk 13 should be read very carefully. Section 13(a) of the 2006 Loan Policy insures against "The invalidity, unenforceability, lack of priority, or avoidance of the lien of the Insured Mortgage" resulting from a *prior transfer* constituting a fraudulent or preferential transfer, but does not cover that risk for the "transaction creating the lien of the Insured Mortgage." (Emphasis added.) Covered Risk 13(b) does give some limited coverage with respect to preferences for the insured mortgage itself.

Exclusion 6 of the 2006 Loan Policy makes it clear that it only applies to those creditors rights' issues affecting "the transaction creating the lien of the Insured Mortgage" that are not stated in Covered Risk 13(b).

To fill the "gap" created by Covered Risk 13(a) and Exclusion 6, the insured may request the ALTA Endorsement Form 21 (Creditors' Rights Endorsement) with respect to a deed-in-lieu transaction, where available based on the jurisdiction and strict compliance with title-company underwriting requirements.

The creditors' rights Exclusions (and applicable Covered Risks) in the 2006 Owner's and Loan Policy forms, respectively, read as follows:

Owner's Policy (Paragraph 4 of Exclusions from Coverage)

Any claim, by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws, that the transaction vesting the Title as shown in Schedule A, is
(a) a fraudulent conveyance or fraudulent transfer; or

(b) a preferential transfer for any reason not stated in Covered Risk 9 of this policy.

Owner's Policy (Paragraph 9 of Covered Risks)

Title being vested other than as stated in Schedule A or being defective

(a) as a result of the avoidance in whole or in part, or from a court order providing an alternative remedy, of a transfer of all or any part of the title to or any interest in the Land occurring prior to the transaction vesting Title as shown in Schedule A because that prior transfer constituted a fraudulent or preferential transfer under federal bankruptcy, state insolvency, or similar creditors' rights laws; or

(b) because the instrument of transfer vesting Title as shown in Schedule A constitutes a preferential transfer under federal bankruptcy, state insolvency, or similar creditors' rights laws by reason of the failure of its recording in the Public Records

(i) to be timely, or

(ii) to impart notice of its existence to a purchaser for value or to a judgment or lien creditor.

Loan Policy (Paragraph 6 of Exclusions from Coverage)

Any claim, by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws, that the transaction creating the lien of the Insured Mortgage, is

(a) a fraudulent conveyance or fraudulent transfer, or

(b) a preferential transfer for any reason not stated in Covered Risk 13(b) of this policy.

Loan Policy (Paragraph 13 of Covered Risks)

The invalidity, unenforceability, lack of priority, or avoidance of the lien of the Insured Mortgage upon the Title

(a) resulting from the avoidance in whole or in part, or from a court order providing an alternative remedy, of any transfer of all or any part of the title to or any interest in the Land occurring prior to the transaction creating the lien of the Insured Mortgage because that prior transfer constituted a fraudulent or preferential transfer under federal bankruptcy, state insolvency, or similar creditors' rights laws; or

(b) because the Insured Mortgage constitutes a preferential transfer under federal bankruptcy, state insolvency, or similar creditors' rights laws by reason of the failure of its recording in the Public Records

(i) to be timely, or

(ii) to impart notice of its existence to a purchaser for value or to a judgment or lien creditor.

A request to provide creditors' rights coverage places additional burdens on the title insurer, which may seek to be compensated for the additional risk by charging an additional risk premium for the endorsement. Normally, in a deed-in-lieu transaction, reasonably equivalent value will have been given for the deed because the value of the property will have been established by appraisal (supplied to the title insurer) to be less than the amount of the outstanding mortgage debt. Where a creditors' rights issue has been identified because a transfer

is being made without the transferor receiving reasonably equivalent value, the primary basis for underwriting the risk involves engaging in credit and finance underwriting. This is a significantly different approach to underwriting than what most underwriters are accustomed to, or prepared for, because it focuses on issues other than real estate. In such a situation, the title insurer probably would not be comfortable issuing affirmative creditors' rights coverage for the transaction, as it would need to conduct significant additional due diligence (of non-title-related matters) with respect to underwriting the transaction, including a detailed analysis of the following: the transferor's business and its financial statements; its payment history and ability to pay its business and trade debts as they are incurred; its capitalization both before and after the transfer; the amount of secured and unsecured credit obtained by the transferor both before and after the transfer; the incurrence of any large or unusual debt obligations, and a determination of whether the delivery of the deed in lieu of foreclosure will render the borrower insolvent. Even if the title insurer still could be persuaded to issue creditors' rights coverage in such a situation, it may need to tailor the coverage to the particular fact situation and may charge a significant additional risk premium to cover its potential liability.

The legal costs of defending an action based on a creditors' rights claim may be substantial even if the title insurer ultimately prevails on the merits. The title company may require that an independent third party with a demonstrated and substantial net worth indemnify the title insurer, at least for the costs of defense of any such claim (with, perhaps, the furnishing of security for such indemnity). Obviously, a "going concern" business (as would be the case with an entity that conducts a manufacturing or service operation) would require more due diligence than the typical passive real-estate bankruptcy-remote single-purpose borrowing entity (such as a limited liability company, limited partnership, or business trust) that has no personal liability for the mortgage debt and merely serves as an investment conduit vehicle for the equity holders.

The title insurer must also be careful, when issuing affirmative coverage for creditors' rights issues, to provide insurance only for the specific risks that it feels comfortable that it can assume after conducting its due diligence. For example, the title company may agree to provide affirmative coverage against a claim alleging that the transaction constitutes a fraudulent conveyance or preferential transfer. [Note: the coverage of equitable-subordination claims has been eliminated from the ALTA 2006 Owner's and Loan Policies, as this is a matter within the control of the insured]. The title insurer likely will – justifiably - specifically exclude coverage for any deliberate "bad acts" of the insured, i.e., any transfer or conveyance that the insured knew, at the time it acquired any estate or interest in the subject property, was actually intended to hinder, delay or defraud any creditor, or where the insured is found by a court not to have been a transferee or purchaser in good faith.

Generally, no continuing, contingent, or residual rights (including an option to purchase, right-of-first refusal, or even a long-term lease) should be given to the mortgagor-grantor, as courts may construe the proposed deed-in-lieu transaction as an equitable mortgage and the title insurer may refuse to provide coverage against any such recharacterization. The parties' intention (to actually create an equitable mortgage instead of deed) may be shown by:

- The statements of the parties.
- The existence of a substantial disparity between the value received by the grantor and the actual value of the real property at the time of conveyance.

- The fact that the grantor retained possession of the real property.
- The fact that the grantor continued to pay real estate taxes and other property expenses.
- The fact that the grantor made improvements to the real estate subsequent to the conveyance.
- The nature of the parties to the transaction and their relationship both prior to and after the conveyance.
- The fact that a contingency exists or a subsequent event could occur that would “unwind” the transaction or cause the mortgagor (or guarantors) to again become liable for all or a portion of the debt.

If the conveyance of the deed-in-lieu is not to the lender, but instead to a subsidiary of the lender or a special purpose entity created by the lender, the title insurer will probably have no problem with insuring the transaction, as long as the lender owns 100% of the entity actually taking title and the deed contains typical non-merger language to keep the mortgage alive.

Where available, and based on applicable law and facts, (and the circumstances of transaction), the title insurer may be willing to issue non-merger endorsement to the Loan Policy, insuring that the mortgage will not be deemed invalid or unenforceable by virtue of title to the property becoming vested in the lender. Recent case law generally supports the ability of a mortgagee to foreclose its mortgage after acceptance of a deed in lieu of foreclosure, at least where the settlement agreement and deed contain an anti-merger provision. *See* John C. Murray, *Deeds in Lieu – Subsequent Foreclosure of Mortgage* (2009), available at <http://www.firstam.com/listshortcut.cfm?id=3248&menu=676>. Courts may not be willing to enforce a non-merger provision in a deed in lieu of foreclosure where rights of innocent third parties may be affected – or even lost – because of fraud or inequitable conduct by parties to deed. (But this is rare and applies only in very complicated and unique factual situations.)

If the deed-in-lieu documentation (including a Covenant not to Sue, as described earlier in this article) contains an “unwind” provision that could place the respective parties back in their original positions in the event of a subsequent successful challenge to the validity of the deed-in-lieu transaction, such a provision may (depending on the facts) cause the title insurer to raise an exception to the provision because of the risk of a total failure of title under the Owner’s Policy issued to the lender.