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DEEDS IN LIEU OF FORECLOSURE: PRACTICAL AND LEGAL CONSIDERATIONS

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DEEDS IN LIEU OF FORECLOSURE: PRACTICAL AND LEGAL CONSIDERATIONS

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Editors' Synopsis: For reasons advantageous both to the borrower and the lender, loan defaults are frequently resolved by a deed in lieu of foreclosure, the transfer to the lender of title to the real estate securing the debt. This article presents an encyclopedic discussion of the relevant concerns in a workout effectuated by a deed in lieu of foreclosure.

I. INTRODUCTION
II. ADVANTAGES TO LENDER AND BORROWER
III. OFFER TO DEED
IV. DOCUMENTATION AND CONDITIONS
A. Deed in Escrow
B. Consideration
C. Retention of Interest by Borrower
D. Partial Conveyances and Outstanding Liens
V. BANKRUPTCY CONSIDERATIONS
A. Preferential Transfers
B. Fraudulent Conveyances
C. "Transfer" and "Reasonably Equivalent Value" Issues
D. Lien Subordination
E. State Fraudulent Conveyance Statutes
VI. TAX CONSIDERATIONS
A. Tax Effect on Lender
B. Tax Effect on Borrower
C. Special Rules
D. Section 6050J Reporting Requirements
E. Section 1445 Reporting Requirements
F. Section 6045(e) Reporting Requirements

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VII. OTHER CONSIDERATIONS
- A. Authority of Borrower to Convey
- B. Financial Statement of Borrower
- C. Merger Avoidance
- D. Environmental Issues
- E. Bulk Sales Act Reporting Requirements

VIII. COOPERATION WITH TITLE INSURER
- A. Need for Owner's Policy
- B. Policy Coverage and Requirements
- C. Closing Requirements and Transfer Taxes
- D. Compliance with State Statutes

IX. CLOSING THE TRANSACTION

X. CONCLUSION

I. INTRODUCTION

As a result of the recent phenomena of overbuilt urban office markets and reduced economic growth, commercial real estate lenders are frequently approached by delinquent borrowers with requests to consider alternatives to foreclosure. Often borrowers ask lenders to accept voluntary conveyances of the real property securing their loans in return for the release of all personal liability or monetary or other comparable consideration. The terms and conditions under which a borrower will grant, and a lender will accept, a deed in lieu of foreclosure vary greatly. Whether a lender accepts a deed often depends on the amount of leverage and the relative bargaining positions of both parties. This article provides an overview of the many important practical and legal aspects that real estate lenders and their counsel should consider when confronted with transactions involving deeds in lieu of foreclosure.

II. ADVANTAGES TO LENDER AND BORROWER

From a lender's standpoint there are many advantages to accepting a voluntary conveyance of real property from a borrower. Some of the most important include:

1. The lender or its nominee becomes the owner of the property and can control its operation and obtain all its income. The lender can preserve valuable contracts and tenants can immediately take steps to maximize the economic value of the property.

2. The parties can quickly negotiate and consummate the transaction, with fee title vesting in the lender upon recordation of the deed. The lender immediately obtains marketable title.[1]

3. The potential negative publicity, time (including redemption periods), and expense of a foreclosure action (including receivership) can be avoided. The lender's acquisition of the property makes it unnecessary to extinguish the borrower's interest through foreclosure and to wait until the end of the redemption period to acquire title.[2]

4. If the transaction is structured and documented properly and if the equity in the property does not exceed the amount of the outstanding debt, the transaction is not likely to be set aside by a bankruptcy court or a court of equity if the borrower later files bankruptcy or attempts to rescind the transaction based on fraud or coercion.[3]

Several advantages exist for the borrower who offers to convey to the lender real property securing a loan. These advantages include:

1. The borrower can obtain release of all or some of the personal liability under the mortgage indebtedness, whether such liability exists under the loan documents, separate guaranty agreements, personal undertakings, indemnities, or otherwise.

2. The borrower can avoid the publicity, notoriety, expense, and time involved in foreclosure litigation.

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[1] *See* Richard Kelly, *Foreclosure by Contract: Deeds in Lieu of Foreclosure in Missouri*, 56 UMKC L. Rev. 633 (1988); Elbridge D. Phelps, Comment, *Mortgages—Deed in Lieu of Foreclosure—Validity*, 36 Mich. L. Rev. 111 (1937); Paul E. Roberts & Howard J. Lazarus, *When the Workout Doesn't Work Out—An Outline*, 12 Real Prop. Prob. & Tr. J. 437 (1977).

[2] *See*, *e.g.*, Lowman v. Lowman, 9 N.E. 245 (Ill. 1886) (lender may accept a conveyance from the borrower to avoid the expense of proceeding with a foreclosure action); Stephen Benko, *A Mortgage Lender's Guide to Workouts*, Real Est. Fin. J., Spring 1991, at 6; Deborah M. Paris & Stephen A. Williams, *What Lender's Counsel Should Know About Deeds in Lieu of Foreclosure*, Prac. Real Est. L. Sept. 1990, at 57.

[3] In Sprunk v. First Bank Western Montana Missoula, 741 P.2d 766 (Mont. 1987), the mortgagor filed suit alleging fraud by the mortgagee in inducing him to give the mortgagee a deed in lieu of foreclosure to satisfy the debt. The court held that the mortgagee did not fraudulently induce the liquidation of the mortgagor's personal and business holdings. The court ruled in favor of the mortgagee in part because the mortgagee prepared documents that stated on their face the amount of the debt, and released the mortgagor, truthfully stated the total amount of the debt, and released the mortgagor from personal liability upon signing of the deed in lieu of foreclosure.

3. The lender might agree to pay all or part of the expenses of the transfer (for example, transfer titles, title costs, delinquent taxes, debts to trade creditors, attorney's fees, or recording fees) or might agree to pay additional monetary consideration for the voluntary conveyance of the property.[4]

4. The lender might grant certain limited possessory or other property rights to the borrower. These rights could include, for example, a lease, an option to purchase, a right of first refusal, the right to manage or lease the property, or the right to consult on certain aspects of the operation of the property.[5]

III. OFFER TO DEED

Unless the offer of conveyance by the borrower is voluntary, there is a significant risk that the borrower may later contest the transaction. Factors that taint a transaction include undue pressure, fraud (actual or constructive), unconscionable advantage, duress, undue influence, or grossly inadequate consideration. For example, if the borrower successfully argues duress or undue influence, the entire transaction may be set aside. In the alternative, the borrower may choose to recover the value of the property, the equity of redemption, or the profits realized on resale. Additionally, if the lender's conduct is flagrant or outrageous, courts may assess punitive damages against the lender. Before a court will set aside a transaction, the borrower must clearly show that the lender used the borrower's necessity to drive a hard bargain and must conclusively prove wrongful conduct by the lender.[6]

Because the right of redemption prior to foreclosure is cut off by a deed in lieu of foreclosure, the borrower may make a "clogging the equity" argument. Based on old case law, this doctrine holds "once a mortgage, always a mortgage." Consequently, no

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[4] In some states, there is a statutory exemption from real estate transfer taxes for real property conveyed to a lender pursuant to a deed in lieu of foreclosure. *See infra* text accompanying note 229.

[5] *See infra* text accompanying notes 18-19.

[6] *See*, *e.g.*, Heller v. Jonathon Investments, Inc., 495 N.E.2d 589 (Ill. 1986) (ruling that evidence of alleged duress and undue influence was not clear and convincing and was, therefore, insufficient to justify rescission of deeds or imposition of a constructive trust); Seymour v. Mackay, 18 N.E. 552 (Ill. 1888) (holding that when transaction if fair and not accompanied by oppression, fraud, or undue influence; and mortgagee has not used his position to obtain an advantage over mortgagor, bona fide agreement to transfer the property to mortgagee will be sustained); *Sprunk*, 741P.2d 766 (ruling that a release of a mortgage, in connection with issuance by a mortgagor of deeds in lieu of foreclosure, can be set aside only if it was obtained fraudulently or without adequate consideration. Mere suspicion of fraud is insufficient). *But see* Whitney v. Citibank, 782 F.2d 1106 (2d Cir. 1986) (holding that the mortgagee induced breach of fiduciary duty by two of three general partners when the mortgagee induced two of the partners to consent to a deed in lieu of foreclosure without informing the third partner in breach of partnership agreement); Bailey v. Arlington Bank & Trust Co., 693 S.W.2d 787 (Tex. Ct. App. 1985) (deciding that undue influence, sufficient to set aside both a trust agreement and a deed, was not established by evidence that grantor executed instruments in response to threat by grantor's wife that she would sell the property and spend the money if grantor died. The court held that to constitute duress a party must make a threat to take some act that the threatening party has no right to take, which causes the other party to do that which the other party would not otherwise do).

mortgage provision can allow the lender to obtain a "collateral advantage" or can prevent the borrower from redeeming and retaining ownership of the mortgaged property prior to entry of a valid foreclosure decree upon full payment of the indebtedness. Although the borrower, as part of the mortgage transaction, may not barter the equity of redemption, the borrower may, in the absence of fraud, undue influence, oppression or duress, convey the fee interest at a subsequent time for adequate consideration.[7]

To ensure that courts deem a transaction voluntary, the borrower should originate the offer to deed. The borrower or the borrower's attorney should submit a written offer to convey to the lender voluntarily offering to deed the property and stating the reasons for the offer. By establishing the voluntary nature of the offer, the lender will not be subject to later claims by the borrower that the lender did not act in "good faith" or that the transaction should be set aside because it constitutes an "insider" transaction under the Bankruptcy Code. After the lender receives the borrower's written offer to convey, the transaction must be closed promptly, or the lender should proceed with foreclosure to avoid delay tactics by the borrower. The lender should send a reply letter acknowledging the offer, stating the express conditions under which it will accept a conveyance. The letter should specify that no contractual obligation to accept the property exists until all required documentation is fully executed and all considerations are paid, delivered, or both.[8] A lender is under no obligation to accept a deed tendered by a borrower unless the borrower meets all conditions required by the lender.[9]

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[7] *See* Peugh v. Davis, 96 U.S. 332 (1877); Provident Trust Co. v. Metropolitan Casualty Ins. Co., 152 F.2d 875 (3d Cir. 1945), *cert. denied*, 327 U.S. 789 (1946); Harbel Oil Co. v. Steele, 318 P.2d 359 (Ariz. 1957); Williams v. Williston, 146 N.E. 143 (Ill. 1924); King v. King, 74 N.E. 89 (Ill. 1905); Felbinger and Co. v. Traiforos, 394 N.E.2d 1283 (Ill. App. Ct. 1979); Russo v. Wolbers, 323 N.W.2d 385 (Mich. Ct. App. 1982); 4 American Law of Property § 16.5 (A. Casner ed. 1952); 55 Am. Jur. 2d *Mortgages* § 1220 (1971); John C. Murray, *Clogging the Equity*, 8 Mich. Real Prop. Rev. 132, 132-33 (1981); Laurence G. Preble & David A. Cartwright, *Convertible and Shared Appreciation Loans: Unclogging the Equity of Redemption*, 20 Real Prop. Prob. & Tr. J. 821, 861 (1985); Laurence G. Preble & David A. Cartwright, *Clogging the Equity of Redemption: Old Wine in New Bottles*, 1 Prob. Prob. 6 (1987). In First Illinois National Bank v. Hans, 493 N.E.2d 1171 (Ill. App. Ct. 1986), the defendants executed an assignment of their interest as contract-for-deed purchasers for a parcel of land as security for a mortgage loan. The assignment provided that in the event of default defendants would "execute to the Assignee a Quit Claim Deed for the property, which shall stand as a deed in lieu of foreclosure." The court declared this provision null and void, holding that the transaction created an equitable mortgage that must be foreclosed by the mortgagee. The court reaffirmed the principle that parties cannot by an express stipulation in the mortgage transform the instrument into an outright conveyance upon default. Doing so would operate to deprive the mortgagor of his redemptive rights. Major title companies will issue endorsements over the clogging issue upon satisfactory documentation unless it is prohibited by state law.

[8] In Bank of Benton v. Cogdill, 454 N.E.2d 1120 (Ill. App. Ct. 1983), the court held that the mortgagee's written statement to the mortgagor did not constitute an offer that the mortgagor could accept. The court determined an alleged statement by the mortgagee's vice president that he would "start the paper work" did not constitute acceptance of the mortgagor's offer to convey the property. The court stated the mortgagee was entitled to a deficiency judgment absent a contract waiving its right to a deficiency judgment. *See also* Brookfield Centre Ltd. Partnership v. CFS Management Co. (*In re* Brookfield Centre Ltd. Partnership), 135 B.R. 23, 26, 27 (Bankr. E.D. Va. 1991) (deciding that the letter sent by the mortgagee in response to mortgagor's request for a deed in lieu of foreclosure, which contained numerous revisions to mortgagor's letter, was not a sufficient memorandum of the alleged oral contract between the parties); Hennesy v. Bell, 775 S.W.2d 650 (Tex. Ct. App. 1988) (ruling that when mortgagor executes and records deed to property in favor of mortgagee without mortgagee's knowledge or approval,

IV. DOCUMENTATION AND CONDITIONS

All terms and conditions of the voluntary conveyance, including waivers, estoppels, warranties, representations, and express recitals of consideration, should be set forth in a written agreement between the borrower and the lender entitled the "Settlement Agreement." The Settlement Agreement should be structured to retain the lender's rights against guarantors and any other parties secondarily liable for repayment of the loan, unless the lender intends to release such parties along with the borrower.

A. Deed In Escrow

In general, an agreement to give a deed in lieu of foreclosure in the future if certain conditions arise should be avoided. An example of this type of agreement is when a borrower places a deed in escrow with a third party such as a title insurance company. Courts might construe such an agreement as an equitable mortgage, and the borrower may claim that the lender must foreclose to enforce the provisions of the agreement.

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a presumption of note cancellation arises only when deed in lieu of foreclosure is delivered to and recorded by grantee).

[9] In Martin v. Uvalde Sav. and Loan Ass'n, 773 S.W.2d 808 (Tex. Ct. App. 1989), the mortgagor defaulted on a mortgage loan and executed and recorded a warranty deed conveying the property to the mortgagee. The mortgagee subsequently filed a foreclosure action. The mortgagor argued that he was not liable for any deficiency because the mortgagee had accepted the deed to the property. The court held that the mortgagee was not required to accept the deed executed and recorded unilaterally by the mortgagor because there was no evidence the mortgagee accepted the deed in satisfaction of the balance due on the note. The court stated that delivery requires either an express or implied acceptance of the deed. *See also* LaSalle Nat'l Bank v. Kissane, 516 N.E.2d 790 (Ill. App. Ct. 1987) (deciding that when deed is deposited with escrowee, an unauthorized delivery before compliance with escrow conditions does not convey title); *In re* Estate of Shedrick, 462 N.E.2d 581 (Ill. App. Ct. 1984) (holding that a deed must be delivered and accepted to pass title. Mere recordation or possession of deed by grantee is not necessarily an acceptance); havens v. Schoen, 310 N.W.2d 870 (Mich. Ct. App. 1981) (ruling that even though the deed was recorded, the burden of proving delivery of deed by preponderance of evidence remains with the party relying on the deed);CUNA Mortgage v. Aefedt, 459 N.W.2d 801 (N.D. 1990) (mortgagors argued, as defense to foreclosure action, that mortgagee should be directed to accept a deed in lieu of foreclosure previously recorded by mortgagors without mortgagee's knowledge. The court held that the mortgagee was not obligated to accept a deed in lieu of foreclosure because conveyance by deed takes effect only upon delivery of deed by grantor and acceptance by grantee. The court further stated that presumption of acceptance of a deed by its recording and by the grantee's failure to renounce a deed arises only when a deed is beneficial to grantee, not when a deed places burden on grantee. The court also noted that mortgagee had informed mortgagors that a deed in lieu of foreclosure would not be acceptable and mortgagee's ability to receive HUD-insured funds would be jeopardized if it accepted a quitclaim deed in lieu of foreclosure); Kottcamp v. Fleet Real Estate Funding Corp., 783 P.2d 170 (Wyo. 1989) (mortgagor argued that foreclosure by power of sale and advertisement constituted breach of agreement by mortgagee to accept a deed in lieu of foreclosure in full satisfaction of debt and also constituted deprivation of due process because participation by sheriff in foreclosure sale constituted "state action" for purposes of 42 U.S.C. § 1983 (1988). The court held that participation by sheriff in sale was not significant enough to constitute state action under the Fourteenth Amendment or § 1983 and that mortgagor's remedy for alleged breach of agreement to accept a deed in lieu of foreclosure remained unimpaired and thus carried no constitutional implications).

Courts of equity will closely scrutinize these types of transactions. In addition, title insurance companies may not provide coverage for this type of escrow arrangement.[10]

B. Consideration

The Settlement Agreement must recite actual and adequate consideration. The amount of debt canceled and any additional cash consideration given by the lender should normally equal or exceed the fair market value of the property. To substantiate the fair market value of the property, the lender should obtain a thorough appraisal by an independent professional appraiser or by a qualified appraiser employed by the lender. In addition, the Settlement Agreement should state that both the lender and the borrower

[10] *See* Annotation, *Deed Placed in Escrow to be Delivered to Grantee upon Failure to Pay Debt Due Him as a Mortgage*, 65 A.L.R. 120 (1930). In Basile v. Erhal Holding Corp., 538 N.Y.S.2d 831 (1989), the mortgagor gave the mortgagee both a new mortgage and a deed in lieu of foreclosure. The deed was not to be recorded unless the mortgagor defaulted. The mortgagor subsequently defaulted and demanded a right of redemption. The court held that the deed was not intended as an absolute conveyance, but instead was designed as further security for the loan and was, therefore, a mortgage. The court granted redemption rights to the mortgagor. In *In re* Sky Group International, Inc., 108 B.R. 86 (Bankr. W.D. Pa. 1989), the mortgagor placed a deed to the mortgagee in escrow prior to the filing of an involuntary bankruptcy petition against the mortgagee. The bankruptcy court held that under applicable state law the mortgagor had not relinquished either its legal or equitable interests in the real property by executing the deed an placing it in escrow. The court also ruled that title to the real property would remain in the mortgagor until the performance of the condition or the happening of the event upon which the escrow would be satisfied and actual delivery of the deed by the escrow agent tot he mortgagor had been made. Because delivery of the deed did not occur until after the involuntary petition had been filed, the mortgagor retained both legal and equitable title to the real property at the time of the filing and, consequently, the real property remained part of the bankruptcy estate. In Coffin v. Green, 185 P. 361 (Ariz. 1919), the court held that delivery of a deed into escrow by the mortgagor, with the stipulation that it would be delivered to the mortgagee if the mortgagor should fail to pay the pre-existing mortgage on the property before a specified date or else be delivered to the mortgagor if the mortgagor satisfied the mortgage before such date, constituted the delivery of an instrument of additional security for the mortgage rather than a conditional sale of the mortgaged property. In Messner v. Carroll, 159 P. 362 (Okla. 1916), a mortgagor in default delivered an executed deed into escrow shortly before the maturity date of the mortgage debt. The terms of the escrow purported to convey the property to the mortgagee with a stipulation that the deed and note would be returned to the mortgagor upon payment in full of the mortgage debt. The court held that this arrangement was not a conditional conveyance of the property, but instead it constituted additional security for the mortgage because the relationship of the parties continued to be that of debtor and creditor; *see also* Wallace v. McCabe, 245 N.Y.S.2d 854 (Sup. Ct. 1964) (court declared deeds absolute on their face to be mortgages; deeds delivered into escrow in settlement of debt constituted mortgage security for monies borrowed because agreement recited existence of debt, management of the properties remained in mortgagor, and mortgagor was entitled to recover properties upon payment of debt); Minn. Stat. Ann. § 559.18 (West 1988) (statutory presumption that a deed in lieu of foreclosure, if absolute in form, is not given as further or new security for the debt); 28 Am Jur. 2d *Escrow* § 10 (1966); *infra* text accompanying notes 17-19. *But see In re* O.P.M. Leasing Services, Inc., 46 B.R. 661 (Bankr. S.D.N.Y. 1985) (holding that, although under New York law legal title to property placed in escrow remains with grantor until occurrence of condition specified in escrow agreement, grantee has an equitable interest in property and judgment lien creditor with notice of escrow agreement is subject to equity of grantee); Verity v. Metropolis Land Co., 288 N.Y.S. 625 (1936) (upholding an arrangement in which mortgagor agreed, in consideration of an extension of a mortgage loan and release of mortgagor's personal liability, to deliver a deed in lieu of foreclosure to mortgagee in event of a subsequent default by mortgagor. The mortgagee had instituted an action to set aside waiver of personal liability and unwind transaction, but the court gave effect to agreement because it helped rather than harmed the mortgagor, notwithstanding its effect on mortgagor's equity of redemption).

acknowledge that the current value of the property is equal to or less than the outstanding indebtedness. The lender usually should not accept a voluntary conveyance unless the appraisal indicates the property is worth no more than the amount of the outstanding debt, including delinquent interest and advances.

A lender may accept a voluntary conveyance under certain circumstances if the value of the property exceeds the debt. However, there is a greater risk to the lender that the borrower will attempt to set aside the conveyance by filing bankruptcy or making a claim of duress or unfair advantage. Title insurers will also look very closely at voluntary conveyances. The lender should check with the title insurance company at the inception of the transaction and obtain an independent outside appraisal if required by the title company. If any consideration other than the property is paid or delivered to the lender by the borrower, the total value of all consideration should be less than or equal to the outstanding debt.

Most often the stated consideration in the Settlement Agreement consists of forgiving the personal indebtedness of the borrower, waiving the right to immediately foreclose against the property and exercise all other remedies, and releasing the lien of the mortgage, except when merger is not intended. In lieu of a statement in the Settlement Agreement releasing the borrower from personal liability, the lender should execute a separate covenant not to sue. A release might be construed as forgiving the underlying indebtedness and thus the mortgage, even though the lender does not intend to release the mortgage lien. Executing a separate covenant not to sue can help avoid a misinterpretation of a release.[11]

The covenant not to sue should release the borrower only from personal liability under the note and mortgage. It should not release the borrower or guarantor from any obligations, including covenants and warranties, contained in the Settlement Agreement or the deed. The covenant not to sue should be unambiguous and should clearly state the intention of the parties.[12] It is especially important to delineate the intention of the parties when the lender obtains a deed in lieu of foreclosure from a subsequent purchaser from personal liability on the note, the original borrower may also be released from liability on the note.[13]

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[11] *See* 55 Am. Jur. 2d *Mortgages* § 133 (1971 & Supp. 1990). The language in the Settlement Agreement or a separate covenant not to sue covering the nature and extent of a release of the mortgagor from personal liability should be carefully drafted. In Farm Credit Bank of St. Louis v. Whitlock, 560 N.E.2d 460 (Ill. App. Ct. 1990), the court construed a liability release given by the mortgagee to the mortgagors in connection with a deed in lieu of foreclosure as a general release. The court held that the release relieved not only the mortgagors but also the mortgagors' parents as accommodation parties. The court based its decision on the comprehensive language of the release, the fact that it placed the borrowers in immediate risk of default for their share of the payments under the debt instrument covering their parents' property, and the fact that the mortgagee had failed to expressly reserve recourse rights upon the release of the underlying debt instrument.

[12] In PPG Indus. V. Russell, 887 F.2d 820 (7th Cir. 1989), the plaintiff alleged that the defendant breached a covenant not to sue in connection with a failed attempt to purchase a division of a corporation. The court concluded that the agreement was ambiguous and remanded the case for further proceedings to ascertain the intention of the parties as to whether the plaintiff would incur additional costs from its dealings with the defendant or other parties.

[13] *See* Prigal v. Kearn, 557 So. 2d 647 (Fla. Dist. Ct. App. 1990) (ruling that release by purchase money mortgagee of subsequent purchaser's liability on promissory note when mortgagee accepted deed in lieu of foreclosure also released original buyer-mortgagor from liability on note); Thompson v. Smith, 793 P.2d 449 (Wash. Ct. App. 1990) (holding grantor was protected from personal liability under

If the borrower is not released from personal liability, it is possible that the borrower or guarantor may remain liable for the debt or for a deficiency when the property is later sold at a foreclosure sale by the lender.[14] However, some states have enacted statutes that prohibit or limit the availability of an action for a deficiency after the sale or transfer of the real property security or else require that the fair market value of the property be determined to establish the deficiency.[15] In other states, case law requires determining fair market value prior to the entry of a deficiency judgment against the borrower.[16]

In the case of a nonrecourse loan, a statement of consideration from the lender to the borrower to support the transaction is desirable. Examples of consideration from the lender to the borrower include waiving of forbearing the lender's legal and contractual right to accelerate the debt, foreclose the property, and exercise its other remedies under the loan documents; paying some or all of the expenses and costs of the transaction by the lender; or the direct payment of cash consideration to the borrower.

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antideficiency provisions of Washington Deed of Trust Act because beneficiary accepted deed in lieu of foreclosure from party who had purchased mortgaged property from grantor, then privately sold property. The court ruled the beneficiary had essentially carried out a nonjudicial foreclosure without following statutory procedures).

[14] In DuQuion State Bank v. Daulby, 450 N.E.2d 347 (Ill. App. Ct. 1983), the court held that the guarantors of the mortgage loan remained liable for any deficiency to the mortgagee up to the stipulated amount of the guaranty, notwithstanding the mortgagee's purchase of the principal obligors' mortgaged property at the foreclosure sale for the full amount of the indebtedness. The contract of guaranty specifically provided that it would not be affected by any sale or disposition of indebtedness or any security or collateral. It follows from this case that the lender may wish to condition the release of the borrower from personal liability on the agreement of the borrower not to subsequently contest the validity or enforceability of the voluntary conveyance. For example, the Settlement Agreement and any covenant not to sue could specifically provide that if the borrower, or a trustee in any subsequent bankruptcy filed by or against the borrower, seeks to set aside the transaction, the covenant not to sue or any release from personal liability will become null and void.

[15] *See*, *e.g.*, N.D. Cent. Code §§ 32-19-04, -06 to –07 (Supp. 1989) (allowing a deficiency judgment only under limited circumstances and then only for the amount by which the sum adjudged due exceeds the "fair value" of the foreclosed premises as determined by a jury). In Schiele v. First Nat'l Bank, 404 N.W.2d 479 (N.D. 1987), the court held that when a mortgagee chooses to foreclose against only one of several items of real estate collateral, the "fair value" of the foreclosed item must be determined by a jury before the remaining debt is enforced against the other items of real estate collateral. The court further held that the term "fair value" for determining the enforceable remaining debt under the North Dakota anti-deficiency statute is a broader concept than "fair market value" and means the value of the property that will produce a fair and equitable result between the parties. *See also* Metropolitan Fed. Sav. and Loan Assoc. v. Adams, 356 N.W.2d 415 (Minn. Ct. App. 1984) (foreclosing on land in North Dakota did not preclude later action in Minnesota to foreclose on properties of defendant sureties; defendant's properties used as surety collateral on mortgage are not exempt from foreclosure under North Dakota's anti-deficiency statute when defendants are not personally liable for mortgage debt); George E. Osborne et al, Real Estate Finance Law § 8.3 (1979).

[16] In Savers Fed. Sav. & Loan Assoc. v. Sandestle Beach Joint Venture, 498 So. 2d 519 (Fla. Ct. App. 1986), the court held that the entry of a deficiency judgment is left to the discretion of the trial judge. The trial judge may inquire into the reasonable and fair market value of the property, the reasonableness of the price at the foreclosure sale, and other equitable considerations. The trial court denied the mortgagee a deficiency judgment because the fair market value exceeded the debt owing on the property. *See also* Olney Sav. and Loan v. Farmers Mkt., 764 S.W.2d 869 (Tex. Ct. App. 1989) (holding that mortgagee, under a trust arrangement with the borrower, must make an honest effort to reduce loan by as much as possible by securing "fair price" for property in event of foreclosure; court implied that to meet this burden, mortgagee is required to bid an amount equal to fair market appraisal value of property at time of sale; issue of "fair and reasonable" is a question of fact to be decided by jury).

When no equity exists in the property, the lender will often require the borrower to pay all delinquent items (other than delinquent principal and interest) and some or all of the expenses of the transactions. Such expenses include:

1. title insurance
2. recording fees
3. current and delinquent real estate taxes and assessments
4. foreclosure expenses (if any)
5. attorneys' fees
6. escrow closing fees (if any)
7. transfer tax (if any)
8. survey (if required)

C. Retention of Interest by Borrower

Often the borrower will request the right to retain some type of leasehold, possessory, or equity interest in the property after the transfer. Borrowers also often request an option to purchase or a right of first refusal with respect to a future sale of the property. These remaining rights can be troublesome, but the borrower may demand them as a condition to conveying the property to the lender. In the event the lender grants a continuing right to the borrower, a court might conclude that a deed was not intended and that the conveyance actually constituted an equitable mortgage. If so, the court may void the deed.[17] Prior to granting any rights to the borrower, the lender should consult with the title insurer to determine if it will agree to insure title without raising an exception in the title policy for a possible equitable mortgage claim by the borrower.[18]

As a general rule, a lender should not grant an outright option to the borrower to repurchase the property. If any right is granted to facilitate closing the transaction, the lender should set the option price at market value, as established by an independent

[17] *See* Richard Harris, Construction and Development Financing, ¶ 6.5[2][b] (1982); Annotation, *Deed from Mortgagor or Privy to Mortgage Holder as Extinguishing Equity of Redemption*, 129 A.L.R. 1435 (1940).

[18] In Transamerica Title Ins. Co. v. Alaska Fed. Sav. and Loan Assoc., 833 F.2d 775 (9th Cir. 1987), the court held that the title insurer had no duty to defend the insured lender against an action alleging that the mortgagee's action resulted in an equitable mortgage instead of a conveyance of the mortgaged property to the mortgagee. The court found that the mortgagee, by taking a deed from the mortgagor coupled with a repurchase option, had "created" the alleged equitable mortgage. The mortgagee's action was intentional and, therefore, excepted from coverage under policy exclusions for "defects, liens, encumbrances, or other matters created . . . by the insured." *Id* at 776.

In Flack v. McClure, 565 N.E.2d 131 (Ill. App. Ct. 1990), the court stated that the burden of proof rests upon the party asserting a mortgage when a deed absolute was conveyed. The court also listed six factors that a court should evaluate in determining the existence of an equitable mortgage: whether a debt exists (which, the court noted, is the essential element to establish an equitable mortgage); the relationship of the parties; whether legal assistance was available; the sophistication and circumstances of each party; the adequacy of consideration; and who retained possession of the property. Based on its analysis of these factors, the court held that the evidence, especially that demonstrating the existence of a debt relationship and grossly inadequate consideration, clearly supported the trial court's finding of an equitable mortgage. *See also* Ill. Ann. Stat., ch. 95, para. 55 (Smith-Hurd 1987) ("Every deed conveying real estate, which shall appear to have been intended only as a security in the nature of a mortgage, though it be an absolute conveyance in terms, shall be considered as a mortgage.").

appraisal. If the lender grants a right of first refusal, it should only be available for a limited time. The lender should not grant a right of first refusal if the title insurer is unwilling to insure title without raising an equitable mortgage exception in the owner's policy. In any event, provisions added to the Settlement Agreement should provide that the continuing interest does not transform the deed obtained by the lender into a mortgage.

In addition, the Settlement Agreement should state that the borrower will not be entitled to equitable or injunctive relief and that the borrower will be limited to an action for damages for breach of contract. The lender should also require the borrower to waive any right to control the manner of use, development, or disposition of the property by the lender after the conveyance. If the lender leases the property to the borrower, the rental should be set at or near, but not in excess, of market rate. Title insurers are less likely to raise equitable mortgage exceptions for short-term leases back to borrowers, but insurers will probably make such decisions on an individual case basis.[19]

D. Partial Conveyances and Outstanding Liens

There are certain situations in which it may not be advisable for the lender to accept a voluntary conveyance from the borrower. For example, the lender should not encourage or accept an offer of a partial conveyance of property unless the entire debt is released as a result of the partial conveyance. Some reasons for rejecting partial conveyances include the following:

1. valuation and allocation problems[20]
2. potential title problems
3. additional cost and time involved
4. possible problems with subsequent foreclosure of the remainder of the property still subject to the mortgage.

In addition, lenders might not want to accept a voluntary conveyance when outstanding subordinate liens or judgments against the property exist. Under these conditions, the lender would have to foreclose the property, incurring added expense and delays to obtain clear title. Even if the borrower represents that all liens and encumbrances will be removed prior to the closing, the lender is likely to experience numerous difficulties and delays. Subordinate liens and judgments are often outside the control of the lender and pose significant threats to handling transactions expeditiously.

[19] The author has negotiated an agreement with a major title insurer providing that a lease back to the mortgagor upon conveyance for a term of two years or less at market rent will not result in the company's raising an equitable mortgage title exception.

[20] A proposed partial conveyance of the mortgaged property in satisfaction of the underlying debt poses special problems when offered by the debtor in a bankruptcy proceeding. In *In re* Walat Farms, Inc., 70 B.R. 330 (Bankr. E.D. Mich. 1987), the court denied confirmation of a Chapter 11 plan in which the debtor-mortgagor proposed in its plan to deed part of the mortgaged property to the mortgagee in full satisfaction of the entire outstanding indebtedness secured by the mortgage. The court held that the proposed conveyance to the mortgagee of a portion of its collateral did not provide the mortgagee with the indubitable equivalent of its claim under Bankruptcy Code § 1129(b)(2)(A)(iii). The court decided that the current market for real estate was too uncertain to establish with any precision that the value of the land offered would satisfy the indubitable equivalence test.

The lender must also be careful to structure the voluntary conveyance to avoid merging the mortgage lien with title to the property. A merger prevents the lender from foreclosing subordinate liens.[21]

V. BANKRUPTCY CONSIDERATIONS

Sections 547 and 548 of the Bankruptcy Reform Act of 1978[22] (Bankruptcy Code) make certain conveyances to creditors voidable. Under section 547(b), preferential transfers may be set aside if make within ninety days prior to the filing of a petition in bankruptcy. The conveyance may also be set aside if it is made between ninety days and one year before the date of the filing of the petition if the creditor was an insider at the time of the transaction and had reasonable cause to believe the debtor was insolvent at the time of the transfer.[23] In order to constitute a preferential transfer, the transfer must be made for the benefit of a creditor, made for or on account of an antecedent debt (which always occurs with a deed in lieu of foreclosure), made while the debtor was insolvent, and made to enable the creditor to obtain more than it would have received in a Chapter 7 liquidation if the transfer had not been made.[24] The date on which the bankruptcy petition if filed, not the date on which a turnover proceeding is brought to avoid the alleged preferential transfer, is normally the date on which the court will construct a hypothetical Chapter 7 distribution to determine whether the transferee received more as a result of the transfer than it would have if the estate had been liquidated.[25]

A. Preferential Transfers

Under § 101(32) of the Bankruptcy Code[26] "insolvent" means that the sum of the entity's debts is greater than the "fair valuation" of all of its property (including, in the case of a partnership debtor, the sum of the excess of the value of each general partner's nonpartnership property over the parties' nonpartnership debts) exclusive of property fraudulently transferred and property exempted under § 522 of the Bankruptcy Code. Under § 547(f), the debtor is presumed to have been insolvent "on and during the 90 days immediately preceding the date of filing of the petition."[27] When the bankruptcy trustee makes a claim of avoidability, the creditor or other party against whom recovery or

[21] *See infra* text accompanying notes 194-99.
[22] Pub. L. No. 95-598, 92 Stat. 2549 (1978) (codified at 11 U.S.C.A. §§ 101-151326 (West Supp. 1991)).
[23] *Id* S 547(b) (1988).
[24] *Id*.
[25] *See In re* Tenna Corp., 801 F.2d 819, 823 (6th Cir. 1986) (holding that date for testing whether payment can be avoided as preference is date petition is filed, and hypothetical Title 7 distribution must be performed as of that date. In the context of § 547(b) of the Bankruptcy Code, Congress's stated concern is only for those creditors with claims against debtor's estate on date petition is filed); Nelson Co. v. Amquip Corp., 128 B.R. 930, 937 (E.D. Pa. 1991) (deciding that a court should calculate the ninety-day period under § 547(b)(4)(A) of the Bankruptcy Code by starting backward from the date of the petition rather than forward from the date of transfer. The court noted that other decisions have differed on this point), *aff'd sub nom*. *In re* Nelson Co., No. 91-1695, 1992 WL 56243 (3d Cir. March 26, 1992).
[26] 11 U.S.C.A. § 101(32) (West Supp. 1991).
[27] *Id* § 547(f) (1988).

avoidance is sought may establish the nonavoidability of the transfer by using the exceptions in § 547(c) of the Bankruptcy Code.[28] The creditor also has procedural defenses available, such as § 546(a), which imposes time limitations on avoidance actions brought by the trustee.[29] The trustee has the burden of establishing the avoidability of the transfer, using the elements of a preference in § 547(b) of the Bankruptcy Code.[30]

The lender must only show that any one of the five tests for an avoidable preference set forth in § 547(b) has not been met in order to prevent avoidance by the trustee (for example, that the lender has not received more than it would be entitled to in a Chapter 7 liquidation[31] because the current market value of the property is less than the outstanding debt). Nevertheless, it is good practice for the lender to require a detailed and current financial statement (preferably certified by a certified public accountant) from the borrower, establishing that the borrower is not insolvent, prior to accepting a deed in lieu of foreclosure. In addition, the Settlement Agreement should contain a representation by the borrower that the borrower is not currently insolvent according to the balance-sheet test set forth in § 101(32) of the Bankruptcy Code and will not be rendered insolvent as a result of the voluntary conveyance of the property.

On July 10, 1984, the Bankruptcy Code was amended by the enactment of the Bankruptcy Amendments and Federal Judgeship Act of 1984[32] (the Amendments). The Amendments expanded § 362(b)(3) of the Bankruptcy Code by permitting, as an exception to the automatic stay provisions of § 362, acts that are accomplished within the period provided under § 547(e)(2)(A) of the Bankruptcy Code.[33] This section contains the definition of when a "transfer" is made for the purpose of determining preferential transfers under § 547. The definition provides that a transfer takes effect between the transferor and the transferee "is such transfer is perfected at, or within 10 days after, such time."[34] Thus, a lender could take a deed in lieu of foreclosure and record the deed after the debtor files a petition in bankruptcy, as long as the deed is recorded within ten days after delivery.[35]

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[28] *Id* § 547(c). *See In re* Chase & Sanborn Corp., 904 F.2d 588 (11th Cir. 1990) (holding that although creditor-transferee bears burden of establishing any affirmative defenses to voidable preference transfer claim under § 547(c), trustee-plaintiff bears the burden of proving elements of avoidability of transfer under § 547(b); *In re* Jet Florida Systems, Inc., 861 F.2d 1555, 1559 (11th Cir. 1988) (stating that the "creditor must . . . prove the specific valuation of the 'money or money's worth in goods, services, or credit' that the debtor received as 'new value' in the contemporaneous exchange").

[29] 11 U.S.C. § 546(a).

[30] *Id* § 547(b); *see In re* Kelton Motors, Inc., 130 B.R. 170, 179 (Bankr. D. Vt. 1991) (holding that in a preference suit, trustee must prove all the elements of his cause of action by a preponderance of the evidence).

[31] 11 U.S.C. § 547(b)(5)(A); *see In re* David Jones Builder, Inc., 129 B.R. 682, 694 (Bankr. S.D. Fla. 1991) (holding that whether a transfer constitutes a preference for the purpose of § 547(b)(5) of the Bankruptcy Code is determined by comparing what the creditor received as a result of the challenged transfer with what he would have received in the absence of the transfer in a hypothetical chapter 7 liquidation on the date of bankruptcy).

[32] Pub. L. No. 98-353, 98 Stat. 333 (1984).

[33] *Id* § 441(b), 98 Stat. 333, 371 (codified as amended at 11 U.S.C. § 362(b)(3) (1988)).

[34] 11 U.S.C. § 547(e)(2)(A).

[35] *Id*; *see In re* Holloway, 132 B.R. 771, 772-73 (Bankr. N.D. Okla. 1991) (holding that if there is a delay of more than ten days in perfecting, the creation of the security interest ordinarily will constitute a transfer on account of an antecedent debt and potentially an avoidable preference, even though applicable state law provides a longer grace period).

B. Fraudulent Conveyances

Under § 548 of the Bankruptcy Code, fraudulent conveyances may be set aside if make within one year prior to the filing of a petition in bankruptcy.[36] To constitute a fraudulent transfer under § 548, the transfer must be made with actual intent to hinder, delay, or defraud a creditor.[37] A transfer can also be fraudulent if the transfer was made for less than reasonable equivalent value and if the transferor (1) was insolvent at the time of the transfer, (2) became insolvent because of the transfer,[38] (3) was engaged in a business that maintained an unreasonable low level of capital, or (4) intended to incur debts beyond its ability to pay.[39]

Recovery of transfers under the preferential transfer[40] or fraudulent conveyance[41] sections of the Bankruptcy Code is originally vested in the trustee or, in a Chapter 11 case, in the debtor under § 1107.[42] Section 546(a) provides that any action by a trustee to set aside a transaction must be commenced within two years of the trustee's appointment or before the case is closed or dismissed, whichever is earlier.[43] The Bankruptcy Code does not have a similar provision for when a debtor in possession must commence suit. Under § 550, courts finding a fraudulent conveyance may either order the transferee, who has not taken for value in good faith and without knowledge of the voidability of the transfer, to recovery the property or pay the difference between the value of the property, as determined by the court, and the sales price.[44] A creditor does not have a right under the Bankruptcy Code to bring suit in a bankruptcy court to set aside a fraudulent conveyance, and therefore cannot utilize § 548 avoidance provisions.[45]

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[36] *Id* § 548(a). State fraudulent conveyance statutes, which normally do not contain a requirement that the transfer must have been made within one year prior to filing by the debtor of a petition in bankruptcy, should also be consulted by the mortgagee. *See infra* text accompanying notes 101-11.

[37] 11 U.S.C. § 547(a)(1).

[38] *Id* § 548(a)(2).

[39] *Id*.

[40] *Id* § 547(b).

[41] *Id* § 548.

[42] *Id* § 1107.

[43] *Id* § 546(a).

[44] *Id* § 550 (1988). *See*, *e.g.*., *In re* McClintock, 75 B.R. 612 (Bankr. W.D. Mo. 1987((refusing to avoid foreclosure sale but ordering mortgagee, who had successfully bid in its debt, to pay difference between its foreclosure bid and fair market value of property).

[45] *See In re* Sweetwater, 55 B.R. 612 (Bankr. C.D. Utah 1985) ("representative of the estate appointed for such purpose" as used in Bankruptcy Code § 1123(b)(3)(B) to describe person other than the trustee or debtor in possession who may assert claim or interest belonging to estate, means representative appointed by court and not debtor in possession's assignee); *cf.* Enserv Co. v. Manpower Inc./California Peninsula, 64 B.R. 519 (Bankr. 9th Cir. 1986); *In re* Xonics, Inc., 63 B.R. 785 (Bankr. N.D. Ill 1986); *In re* Tennessee Wheel and Rubber Co., 64 B.R. 721 (Bankr. M.D. Tenn. 1986). These cases appear to interpret broadly the language in § 550(a) that permits the trustee to recover property or its value for the benefit of the estate when the avoiding powers of §§ 554-549 are exercised. These cases also seem to suggest that recovery may be permitted if a direct or indirect benefit to the debtor, the estate, or any of the creditors will occur, and that possibly parties other than the debtor, including the committee of unsecured creditors, a secured creditor, or even a purchaser from the debtor, may seek such recovery. In any event, the creditor could bring an action under an applicable state fraudulent conveyance statute in the state court or in a federal court if diversity of citizenship of the parties exists.

C. “Transfer” and “Reasonably Equivalent Value” Issues

The issues of when a “transfer” occurs and whether a mortgagee’s purchase of the property at a validly held foreclosure sale satisfies the “reasonably equivalent value” requirements of § 548 have generated much litigation. Section 547(e)(1)(B) provides that a transfer occurs when any purchaser cannot acquire an interest superior to the transferee. Several courts have held that the date of the foreclosure sale or deed in lieu of foreclosure rather than the recording date of the mortgage is the proper date to commence the time periods under § 547 and § 548.

In *Durrett v. Washington National Insurance Co.*[46] and *In re Hulm*,[47] the Court of Appeals for the Fifth and Eighth Circuits, respectively, set aside foreclosure sales because the courts were unconvinced that the mortgagee obtained the property for valid consideration when the outstanding debt was bid at the foreclosure sale. The foreclosure sale, though validly held, resulted in a distress sale that reaped less than the actual appraised value.[48] To decide whether the price at a foreclosure sale constituted fair consideration, the court in *Durrett*, in dictum, cited a “seventy percent” rule, which states that reasonably equivalent value does not exist unless the sales price is at least seventy percent of the fair market value.

The *Durrett* court also held that a foreclosure sale was a transfer under § 67(d) of the former Bankruptcy Act and could be avoided because it occurred within one year prior to the filing of the bankruptcy petition and was made without fair consideration to the estate.[49] In contrast, the court in *Hulm* remanded the case with instructions to the bankruptcy court to hold an evidentiary hearing to determine the value of the property sold at the foreclosure sale.[50] The bankruptcy court determined that the market value of the property at the time of the sale was $100,000 and that this value would be used to determine whether reasonably equivalent value passed to the debtor.[51] The court, under an “all facts and circumstances” test, noted that the $64,449 bid by the mortgagee was only sixty-five percent of the fair market value set by the court and concluded that the mortgagee had not provided a reasonably equivalent value in return for the transfer.[52] Because the mortgagee subsequently sold the property, the court granted judgment in

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[46] 621 F.2d 201 (5th Cir. 1980).

[47] 738 F.2d 323 (8th Cir.), *cert. denied*, 469 U.S. 990 (1984).

[48] *See also* Abramson v. Lakewood Bank and Trust Co., 647 F.2d 547 (5th Cir. 1981), *cert. denied*, 454 U.S. 1164 (1982) (holding nonjudicial foreclosure sale is subject to being set aside if made without fair consideration); *In re* Smith, 21 B.R. 345 (Bankr. M.D. Fla. 1982) (ruling that sale of homestead for mere fraction of its stated value constituted fraudulent transfer); *In re* Coleman, 21 B.R. 832 (Bankr. S.D. Tex. 1982) (deciding that purchase by lienor of debtor’s equity in homestead for slightly more than 28% of market value of equity was less than reasonably equivalent value under § 548(a)(2)).

[49] *Accord In re* Marble, 40 B.R. 751 (Bankr. W.D. Tex. 1984); *In re* Yorketown Assoc., 40 B.R. 701 (Bankr. E.D. Pa. 1984); *In re* Richardson, 23 B.R. 434 (Bankr. E.D. Utah 1982); *see also* Butler v. Lomas & Nettleton Co., 862 F.2d 1015 (3d Cir. 1988) (under Pennsylvania law, “transfer” of debtors’ property occurred on date of sheriff’s sale, rather than date of recordation of sheriff’s deed); *In re* Buchanan, 35 B.R. 842 (Bankr. E.D. Tenn. 1983) (assuming foreclosure sale is a transfer for purposes of state fraudulent conveyance law, but finding the nominal price is the reasonable equivalent value when surviving claims against property exceed its fair market value); cases cited *infra* note 56.

[50] *In re* Hulm, 738 F.2d 323, 327 (8th Cir. 1984).

[51] *In re* Hulm, 45 B.R. 523 (Bankr. D.N.D. 1984).

[52] *Id*. at 529.

favor of the trustee in an amount equal to the difference between the amount bid at the foreclosure sale and the court's determination of the fair market value.[53] This decision clearly illustrates the importance of obtaining a bona fide appraisal of the property as close as possible to the date of the foreclosure sale or execution of a deed in lieu of foreclosure.[54]

The Amendments made foreclosure sales expressly subject to the fraudulent transfer provisions of the Bankruptcy Code.[55] Unlike *Durrett*, however, the Amendments created no presumption about the fairness of the price obtained at a regularly conducted foreclosure sale. Until congressional legislation is adopted to overrule *Durrett*, uncertainty will continue.[56]

In *In re Winshall Settlor's Trust*,[57] the court clearly rejected the *Durrett* rule. In *Winshall* the debtor trust filed a petition for Chapter 11 protection, allegedly to set aside the foreclosure of its real property pursuant to § 548(a)(2)(A). Significantly, the petition was filed after the expiration of the trust's right of redemption and sale of the property. The court, upholding the bankruptcy court's dismissal of the trust's petition, agreed with the holding of *In re Madrid*,[58] that even if the sale in question was a fraudulent transfer

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[53] *Id.*

[54] Several other cases have adopted a percentage test. *See*, *e.g.*, Lower Downtown Assoc. v. Brazosbanc Sav. Assoc. of Texas, 52 B.R. 662 (Bankr. D. Colo. 1985) (transfer for 87.5% of value was for reasonably equivalent value); *In re* Jacobsen, 48 B.R. 497 (Bankr. D. Minn. 1985) (transfer for at least 70% of value would be reasonably equivalent value); *In re* Willis, 48 B.R. 295 (Bankr. S.D. Tex. 1985) (transfer for at least 70% of value was for reasonably equivalent value); *In re* Wheeler, 34 B.R. 818 (Bankr. N.D. Ala. 1983) (transfer for 62.7% of value was not for reasonably equivalent value); Matter of Berge, 33 B.R. 642 (Bankr. W.D. Wis. 1983) (transfer for at least 70% of value was for reasonably equivalent value); *In re* Smith, 24 B.R. 19 (Bankr. W.D.N.C. 1982) (transfer for approximately 77% of value was for reasonably equivalent value); *In re* Perdido Bay Country Club Estates, Inc., 23 B.R. 36 (Bankr. S.D. Fla. 1982) (transfer for at least 70% of value was for reasonably equivalent value); *In re* Ocean Dev. Of Am., Inc., 22 B.R. 834 (Bankr. S.D. Fla. 1982) (transfer for 65% of value was not for reasonably equivalent value); *In re* Smith, 21 B.R. 345 (Bankr. M.D. Fla. 1982) (transfer for at least 70% of value was for reasonably equivalent value); *In re* Thompson, 18 B.R. 67 (Bankr. E.D. Tenn. 1982) (transfer for 80.8% of value was for reasonably equivalent value).

[55] 11 U.S.C. § 101(54) (1988).

[56] In *In re* Madrid, 21 B.R. 424 (Bankr. 9th Cir. 1982), *aff'd*, 725 F.2d 1197 (9th Cir. 1984), *cert. denied sub nom.* Calairo v. Pittsburgh Nat'l Bank, 469 U.S. 833 (1985), the court held that a transfer is deemed to take place on the date of recording of the real estate mortgage. The court also held, consistent with state foreclosure law, that mere inadequacy of price will not defeat a noncollusive, regularly conducted foreclosure sale, at least in the absence of fraud or unfairness that affects the price. The court upheld against attack by the bankruptcy trustee a foreclosure sale at a price that was 64% to 67% of the property's market value. *Accord In re* Reinboldt, 39 B.R. 677 (Bankr. D. Minn. 1983) (its holding was presumably overruled in *Hulm*); *In re* Alsop, 14 B.R. 982 (Bankr. D. Alaska 1981), *aff'd*, 22 B.R. 1017 (D. Alaska 1982) (ruling that transfer effected by foreclosure sale related to date of the perfection of original mortgage and not date of foreclosure sale, and, therefore, applicable transfer occurred outside of one-year statutory limit placed upon avoidance under § 548); *see also In re* Ewing, 36 B.R. 476 (Bankr. W.D. Pa.), *aff'd sub nom. In re* Calairo, 746 F.2f 1465 (3d Cir. 1984) (deciding that a transfer within the meaning of the Bankruptcy Code took place when the debtor pledged stock as collateral; transfer occurred more than one year before filing and was not avoidable), *cert. denied sub nom.* Calairo v. Pittsburgh Nat'l Bank, 469 U.S. 1214, (1985). *But see In re* Frank, 39 B.R. 166 (Bankr. E.D.N.Y. 1984) (deciding that *Madrid* rationale is inapplicable to sheriff's sale following execution of a judicial lien and that a transfer occurs when the sheriff's deed is recorded).

[57] 758 F.2d 1136 (6th Cir. 1985).

[58] 21 B.R. 424 (Bankr. 9th Cir. 1982), *aff'd*, 725 F.2d 1197 (9th Cir.), *cert. denied*, 469 U.S. 833 (1984).

under § 548, reasonable equivalence for the purposes of a foreclosure sale under § 548(a)(2)(A) should agree with the state law of fraudulent conveyances.[59] The court noted that mere inadequacy of price alone could not justify setting aside an execution sale.[60] The court also ruled that additional proof of fraud, unfairness, or oppression must exist to account for the inadequacy in price and that following the *Durrett* holding would radically alter these rules.[61] The Sixth Circuit cited two cases in support of its holding: "[T]he cloud created over mortgages and trust deeds by making foreclosure sales subject to being voided by a bankruptcy trustee will naturally inhibit a purchaser other than the mortgagee from buying at foreclosure. This tends to depress further the prices of foreclosure sales and thus increase the potential size of the deficiency in each foreclosure…."[62] "No support for this drastic upset of state laws and procedures is found in the Bankruptcy Code."[63]

Under the Amendments, an involuntary transfer of an interest in property can now be a fraudulent transfer under § 548 of the Bankruptcy Code.[64] The words "voluntary or involuntary" were added to § 548(a) and the phrase "foreclosure of the debtor's equity of redemption" was added to the definition of "transfer" in §101(48).[65] Reading the additions together, an argument can be made that, with respect to the issue of when a transfer occurs, the *Durrett* rule is now the law in all bankruptcy cases filed on or after October 8, 1984. Unlike *Durrett*, the Amendments create no presumption regarding the fairness of the price obtained at a regularly conducted foreclosure sale. However, the Amendments make it clear that collusive foreclosure sales are subject to attack as fraudulent transfers.[66]

In *In re Verna*,[67] the debtor sought to avoid a validly conducted noncollusive foreclosure sale as a fraudulent conveyance on the basis that it resulted in a transfer of his interest in the property for less than a reasonably equivalent value. The court held, in accordance with the Amendments, that foreclosure of the security interest clearly constituted a transfer under § 548 of the Bankruptcy Code.[68] However, the court also held that even though a transfer occurred as a result of the foreclosure sale, the transfer could not be avoided because the sale price would be deemed equal to the reasonably equivalent value of the property.[69] The court stated its belief that a rule establishing the

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[59] *Winshall*, 758 F.2d at 1139.
[60] *Id*.
[61] *Id*.
[62] *Winshall*, 758 F.2d at 1139 (quoting Abramson v. Lakewood Bank & Tr. Co., 647 F.2d 547, 550 (5th Cir. 1981) (Clark, J., dissenting)).
[63] *Id*. at 1140 (quoting *In re* Madrid, 725 F.2d at 1202).
[64] 11 U.S.C. § 548(a).
[65] *Id* § 101(48).
[66] Two courts that dealt with this issue in 1984 followed *Durrett* and avoided enforcement action. *See In re* Carr, 40 B.R. 1007 (Bankr. D. Conn. 1984) (strict foreclosure); *In re* Frank, 39 B.R. 166 (Bankr. E.D.N.Y. 1984) (sheriff's sale). These two courts declined to adopt the analysis of the bankruptcy appellate panel in *Madrid* that consideration received at a noncollusive, regularly conducted foreclosure sale constitutes reasonably equivalent value.
[67] 58 B.R. 246 (Bankr. C.D. Cal. 1986).
[68] *Id*. at 251.
[69] *Id*. at 252.

presumption of reasonably equivalent value a foreclosure sales would be in the best interest of debtors, creditors and third-party purchasers.[70]

In *In re Ruebeck*,[71] the court followed *In re Verna* by ruling that under the Amendments a "transfer" is defined under § 548 of the Bankruptcy Code to include foreclosure of the debtor's equity of redemption, and, therefore, a transfer includes a foreclosure sale.[72] The *Ruebeck* court refused to use an irrebuttable presumption of reasonable equivalence for noncollusive, regularly conducted foreclosure sales. Instead, the court held that the foreclosure sale, which was validly conducted under state law by the defendant and at which a third party purchased the property at substantially less than market value, constituted a fraudulent transfer.[73] The court stated that such sales would not be subject to attack as fraudulent conveyances if the conveyance met the following requirements: (1) a presale appraisal of the property that informs the parties of the market value of the property, (2) public advertisement if the appraisal reveals that substantial equity exists in the property above the outstanding debt on the mortgage, and (3) new advertisements and written notices to all interested or potentially interested parties for each continuance of the sale.[74] *Ruebeck* contains an excellent discussion and citations of the three lines of cases decided in districts that disagree on the issue of whether a foreclosure sale conducted in accordance with applicable state law constitutes a fraudulent conveyance under § 548 of the Bankruptcy Code.[75]

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[70] *Id*.
[71] 55 B.R. 163 (Bankr. D. Mass. 1985).
[72] *Id*.
[73] *Id*. at 171.
[74] *Id*. at 170-71.
[75] *See also In re* BFP, 748 (Bankr. 9th Cir. 1991) (deciding that a noncollusive, regularly conducted foreclosure sale conclusively establishes the reasonably equivalent value of property); Kerr v. Kerr, 908 F.2d 400 (8th Cir. 1990) (deciding that even though bankruptcy case has been dismissed, debtor was entitled to a hearing on its claim that the mortgagee's purchase of property at a sheriff's sale during bankruptcy proceedings was an avoidable transfer because fair value was not received); *In re* Littleton, 888 F.2d 90 (11th Cir. 1989) (upholding foreclosure sale because debtor had no equity due to junior liens); *In re* Bundles, 856 F.2d 815 (7th Cir. 1988) (deciding that sale price at regularly conducted, noncollusive foreclosure sale cannot automatically be deemed to provide reasonably equivalent value pursuant to § 548(a)(2)); Brown v. Vanguard, 119 B.R. 413 (S.D.N.Y. 1990) (rejecting a conclusive adequacy of price test and holding that mortgagee must make commercially reasonable efforts to achieve the best price); *In re* Barrett, 118 B.R. 255 (Bankr. E.D. Pa. 1990) (deciding that a foreclosure sale, which compared favorably to typical foreclosure sales in the area, resulted in reasonably equivalent value and was not avoidable at fraudulent transfer); Reece v. Scharf (*In re* Reece), 117 B.R. 480 (Bankr. E.D. Mo. 1990) (holding that although sale price at a regularly conducted foreclosure sale is not automatically deemed to be reasonably equivalent value, the transfer would not be set aside because mortgagee had submitted the only bid, which consisted of the appraised value of property less the amount of mortgagee's lien); Sims v. Talman Home Mortgage, 112 B.R. 259 (Bankr. N.D. Ill. 1990) (holding that a foreclosure sale that complied fully with state law sales was not determinative of whether debtor received reasonably equivalent value for property. The court also held that because purchase price was only 60% of fair market value, no appraisal was done prior to sale, and only minimum statutory publication requirements were met, foreclosure sale could be avoided as fraudulent transfer); *In re* Joing, 82 B.R. 495 (Bankr. D. Minn. 1987) (directing that in determining whether debtor received reasonably equivalent value for interest in property at foreclosure sale, bankruptcy court must hold evidentiary hearing to develop a record from which a reasonable equivalence evaluation can be made); *In re* Adwar, 55 B.R. 111 (Bankr. E.D.N.Y. 1985) (refusing to follow *Durrett* but holding that noncollusive, regularly conducted foreclosure sale could, nonetheless, constitute a fraudulent transfer based on a case-by-case factual analysis).

In *In re Ristich*,[76] the Bankruptcy Court for the Northern District of Illinois held that § 548 of the Bankruptcy Code applied to a mortgage foreclosure sale under both the Amendments and Illinois law. The court further held that the mortgagee's bid, nearly seventy-one percent of the proven equity in the property, constituted reasonably equivalent value.[77] In justifying its decision, the court noted that there was a judicial sale following mortgage foreclosure and that the sale was advertised to the public and open to bidding.[78] It also noted that Illinois law gives extensive procedural notice protections.[79]

The court stated that although the Seventh Circuit Court of Appeals had not yet directly decided a case on the issue of reasonable equivalence, the Seventh Circuit had expressed concern in *In re Tynan*[80] over the effect on title when bankruptcy intervenes following a foreclosure sale.[81] Therefore, to avoid a new title "cloud" over foreclosure sales the court applied the Illinois law standard to determine reasonable equivalence.[82] The court further stated that when the purchaser at a foreclosure sale is an unrelated third party, a presumption exists, absent evidence of actual fraud or collusion, that the sale was for a reasonable equivalence.[83] When the purchaser is the mortgagee, mere inadequacy of price is insufficient under Illinois law to set aside a foreclosure sale. Instead, there must be proof of "mistake, accident, surprise, misconduct, or irregularity."[84] Application of the "federal standard" of determination of reasonable equivalence expressed by the Eighth Circuit in *In re Hulm* would lead to the same conclusion.[85]

Durrett and *Hulm* should not apply to voluntary conveyances relating to the issue of reasonably equivalent value. In addition, bankruptcy exceptions based on potential preferential transfer and fraudulent conveyance claims should arguably not be raised by title insurance companies when: (1) a valid appraisal established the value of the property as less than or equal to the outstanding debt (including principal, interest, advances, attorney's fees, and costs), (2) the lender releases the borrower from all personal liability or the lender gives other valid consideration, and (3) if the preceding factors do not exist,

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[76] 57 B.R. 568 (Bankr. N.D. Ill. 1986).
[77] *Id*. at 580.
[78] *Id*. at 578.
[79] *Id*. at 576.
[80] 773 F.2d 177 (7th Cir. 1985).
[81] *Ristich*, 57 B.R. at 577.
[82] *Id*.
[83] *Id*.
[84] *In re* Ristich, 57 B.R. 568, 577 (Bankr. N.D. Ill. 1986) (quoting Block v. Hooper, 149 N.E. 21, 22 (1925)).
[85] In *In re* Wilson, 71 B.R. 728 (Bankr. C.D. Ill.), *aff'd*, 834 F.2d 173 (7th Cir. 1987), the court held that a letter from the transferee to the debtors stating that another party had offered the transferee more than $60,000 for the property did not justify overturning the bankruptcy court's enforcement of a foreclosure sale on the theory that the offer demonstrated that the foreclosure sale, which resulted in an actual sale price of $33, 276.35, did not yield a fair price under Illinois law. *See also In re* Ehring, 900 F.2d 184 (9th Cir. 1990) (ruling that creditor who purchased property at prepetition, nonjudicial, noncollusive foreclosure sale did not receive more from foreclosure sale than it would have under a Chapter 7 liquidation, and the transfer was not an avoidable preference although creditor resold property prepetition for more than amount of outstanding debt); Illini Fed. Sav. & Loan Ass'n v. Doering, 516 N.E.2d 609 (Ill. Ct. App. 1987) (holding that a foreclosure sale will not be set aside merely because property was purchased at an inadequate price. There must also be evidence of fraud or mistake in the conduct of the sale), *appeal denied*, 552 N.E.2d 1245 (Ill. 1988); Michael L. Walcott, Comment, *Avoidance of Foreclosure Sales As Fraudulent Transfers Under Section 548(a) of the Bankruptcy Code: An Impetus to Changing State Foreclosure Procedures*, 66 Neb. L. Rev. 383 (1987).

the borrower represents that he or she is not insolvent and will not be rendered insolvent as a result of the conveyance.[86]

From an underwriting standpoint, title insurers may still balk at lender requests to remove bankruptcy exceptions from the owner's title policy because of the anticipated cost of defending against potential claims. On April 6, 1990, the American Land Title Association (ALTA) adopted the "creditor's rights exclusion" for use with both ALTA loan and owner's policies.[87] This exclusion adds to the "Exclusions from Coverage" section of the policies any claims arising out of the transaction insured "by reason of the operation of federal bankruptcy, state insolvency, or similar creditor's rights laws."[88] The creditor's rights exclusion is very broad, and real estate lenders have widely objected to it. Lenders object because, in one fell swoop, it excludes from title policies all coverage arising out of federal bankruptcy, state insolvency, and creditor's rights laws. In addition, the exclusion raises the possibility that the title company might attempt to avoid liability for a bankruptcy claim based solely on the title company's own late recording of documents. The creditor's rights exclusion, however, does not exclude all claims arising as the result of bankruptcy or insolvency, because the exclusion applies only to claims "arising out of the transaction." Nonetheless, the exclusion would clearly apply to an owner's policy of title insurance sought by the lender in connection with a deed in lieu of foreclosure from the borrower.

Lenders seeking owner's title insurance coverage without the creditor's rights exclusion for deed-in-lieu transaction are likely to run into resistance from title insurers, but such requests are not unreasonable. In practice, eliminating the creditor's rights exclusion or obtaining an endorsement insuring the matters excepted by the creditor's rights exclusion should be available for a fee on a case-by-case basis and should be based on full disclosure.

Nevertheless, even in situations in which the value of the property exceeds the outstanding debt, courts have held that a transfer of property was made with "fair consideration" if made in satisfaction of an antecedent debt and the amount of the debt forgiven by the lender was not "disproportionately small" compared to the value of the

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[86] *See* Paul E. Roberts, *Deeds in Lieu of Foreclosure in* Modern Real Estate Transactions 1251 (ALI-ABA, 4th ed. 1983).

[87] ALTA, Owner's Policy of Title Insurance (April 6, 1990); ALTA, Loan Policy of Title Insurance (April 6, 1990). Both policies contain the creditor's rights exclusion, which ALTA promulgated April 6, 1990. The chief differences between the 1990 form policies and the 1970 form policies are the inclusion in the 1990 policies of the creditor's rights exclusion, claims arbitration provisions, and coinsurance requirements for Owner's Policies. *1990 ALTA Policies*, Customer News (Chicago Title Ins. Co., Chicago, Ill.) No. 15, 1991. The 1990 form policies are identical to the 1987 ALTA form policies except for the inclusion in the 1990 form policies of the creditor's rights exclusion. *Id.*

[88] The creditor's rights exclusion, which is in the Exclusions From Coverage in the 1990 ALTA owner's Policy, reads:

> Any claim, which arises out of the transaction vesting in the insured the estate or interest insured by this policy, by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws.

The exclusion is also contained in the 1990 ALTA Loan Policy as paragraph 7 of the Exclusions From Coverage, and reads:

> Any claim, which arises out of the transaction creating the interest of the mortgagee insured by this policy, by reason of the operation of federal bankruptcy, state insolvency, or similar creditors' rights laws.

debtor's interest in the transferred property.[89] The critical time for determining fairness is at the time the transfer is made—neither subsequent depreciation nor appreciation is relevant.[90] The market value of the property at the time of the transfer, not the book value, is the proper gauge to determine whether fair consideration has been given for the transfer of the property.[91]

Because a deed in lieu of foreclosure does not involve a public sale, it is arguable that the holding of the court in *In re Madrid*,[92] that price inadequacy alone is not sufficient to set aside a noncollusive foreclosure sale as a fraudulent conveyance, does not apply to a deed in lieu transaction. It is also true, however, that the *Durrett* "seventy percent rule" has not been expanded to cover transactions other than foreclosure sales.[93] In any event, the greater the amount of the debt relative to the value of the property, the greater the likelihood a bankruptcy court will not deem a fraudulent conveyance to have occurred, and the lesser the likelihood that the transaction will be attacked as a fraudulent conveyance by the trustee or debtor in possession.

Regardless of whether "reasonably equivalent value" is given, a fraudulent conveyance can also occur when a transfer is made with actual intent to defraud. A fraud claim will rarely be made in a deed in lieu transaction, because actual intent to defraud is very difficult to prove and is unlikely to occur in an arm's-length, voluntary conveyance transaction.[94]

D. Lien Subordination

If a lender's misconduct justifies subordination under § 510(b) of the Bankruptcy Code, the lender will be returned to its position prior to the date of the transfer. Under § 502(h) the lender's claim is treated as if it arose before the date of the filing of the petition. In addition, § 510(c) permits the court to subordinate, on equitable grounds, all or part of the lender's allowed claim or interest. Section 510(c) also allows the court to order the transfer of any lien securing a claim subordinated under § 510 to the bankruptcy estate or to disallow the claim entirely in appropriate circumstances.[95] Section 510

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[89] Aragon v. Chase Manhattan Bank, 457 F.2d 263 (1st Cir. 1972); *accord In re* Browning Tufters, Inc., 3 B.R. 487 (Bankr. N.D. Ga. 1980); Inland Sec. Co. v. Estate of Kirshner, 382 F. Supp. 338 (W.D. Mo. 1974).

[90] *In re* Randazzo, Inc., 34 B.R. 76, 78 (Bankr. N.D. 1983).

[91] *In re* Euro-Swiss Int'l Corp., 33 B.R. 872 (Bankr. S.D.N.Y. 1983).

[92] *See In re* Madrid, 21 B.R. 424 (Bankr. 9th Cir. 1982), *aff'd*, 725 F.2d 1197 (9th Cir.), *cert. denied*, 469 U.S. 833 (1984).

[93] *See*, *e.g.*, *In re* Allegheny, Inc., 86 B.R. 466 (Bankr. W.D. Pa. 1988) (preference); *In re* Edward Harvey Co., 68 B.R. 851 (Bankr. D. Mass. 1987) (fraudulent conveyance); Charles L. Edwards & David B. Sickle, *The Deed in Lieu of Foreclosure, in* Work Out Strategies and Restructuring Techniques for Lenders of Troubled Real Estate in the '90s, 1,4 (1990).

[94] For examples of transfers not involving deeds in lieu of foreclosure that were found to involve actual intent to defraud, see *In re* Porter, 37 B.R. 56 (Bankr. E.D. Va. 1984) (holding under § 548; a transfer of legal title to nominee to hold for debtor but debtor retained physical possession); Hummel v. Riordan, 56 F. Supp. 983 (N.D. Ill. 1944) (giving an unrecorded deed to realty under predecessor to § 548); Marmon v. Harwood, 16 N.E. 236 (Ill. 1888) (ruling under an Illinois statute on a transfer to daughters); Hardin v. Osborne, 60 Ill. 93 (1871) (ruling under an Illinois statute on a transfer that reserved use to transferor).

[95] *See*, *e.g.*, Pepper v. Litton, 308 U.S. 295 (1939) (ruling that bankruptcy court has exclusive jurisdiction with respect to subordination, allowance, and disallowance of claims, and may reject claim in whole or in part according to equities of case); *In re* W.T. Grant Co., 699 F.2d 599 (2d Cir. 1983) (distinguishing

generally becomes effective when the lender has engaged in "overreaching" or "lender control," stepping beyond the traditional role of a lender and participating in the debtor's business or engaging in other egregious conduct that justifies the use of the court's equitable powers. Although equitable subordination under § 510 is impossible to define with precision, a court may decide to subordinate or disallow a transaction that would not constitute a fraudulent transfer under § 548 or a preferential transfer under § 547.[96]

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between severity of conduct required for equitable subordination of fiduciary claims and nonfiduciary claims), *cert. denied sub nom.* Cosoff v. Rodman, 464 U.S. 822 (1985); *In re* Mobile Steel Co., 563 F.2d 692 (5th Cir. 1977) (describing "three part" test for equitable subordination—superseded in part by § 510(c) as stated in 121 B.R. 626 (Bankr. N.D. Fla. 1990)); *In re* Ambassador Riverside Inv. Group, 62 B.R. 147 (Bankr. M.D. La. 1986) (subordinating mortgagee's $4 million first mortgage on equitable principles because mortgagee's agent misrepresented availability of construction loan and take-out loan); *In re* Osborne, 42 B.R. 988 (Bankr. W.D. Wis. 1984) (holding that mortgagee's secured claims were subordinate to the unsecured claims of trade creditor as a result of mortgagee's misrepresentations regarding debtor's ability to pay trade creditor); *In re* Werth, 37 B.R. 979 (Bankr. D. Minn. 1980) (ruling that because of mortgagee's control of mortgagor's plant and cash disbursements, mortgagee had received voidable preference; court entered judgment against mortgagee, subordinating mortgagee's claim to other creditors); Helen D. Chaitman, *The Equitable Subordination of Bank Claims*, 39 Bus. Law. 1561 (1984); Andrew DeNatale & Prudence b. Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 Bus. Law. 417 (1985).

[96] For an excellent discussion of equitable subordination under § 510 of the Bankruptcy Code, see Daniel C. Cohn, *Subordinated Claims: Their Classification and Voting Under Chapter 11 of the Bankruptcy Code*, 56 Am. Bankr. L.J. 293 (1982). *See also* Steven M. Alden, *Real Property Foreclosure as a Fraudulent Conveyance: Proposals for Solving the Durrett Problem*, 38 Bus. Law. 1605 (1983). For examples of cases in which the courts have not permitted equitable subordination of a secured party's claim, see Kahm & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351 (7th Cir. 1990) (refusing to subordinate claim of lender because lender had acted within its contractual rights in terminating line of credit to debtor); *In re* Clark Pipe & Supply Co., 893 F.2d 693 (5th Cir. 1990) (court withdrew its original opinion in 870 F.2d 1022 (5th Cir. 1989) and held there was no basis for claims of inequitable conduct of lender to justify equitable subordination because lender had acted strictly in accordance with its rights under loan documents, had not exercised control over debtor's business, and had not misled other creditors); *In re* CTS Trust, Inc., 868 F.2d 146 (5th Cir. 1989) (rejecting doctrine of equitable subordination of an FDIC claim in bankruptcy proceeding because there was no showing that FDIC's security position improved as a result of bank's failure to fund); *In re* Pacific Express, Inc., 69 B.R. 112 (Bankr. 9th Cir. 1986) (holding that transaction, under which loan participants accepted stock of debtor as "equity sweetener" as part of the workout agreement with debtor, did not constitute conduct sufficient to subordinate claims of loan participants to claims of unsecured creditors); *In re* Branding Iron Steak House, 536 F.2d 299 (9th Cir. 1976) (ruling that subordination was not justified because creditor was not active in management or business affairs of debtor corporation and did not exercise control to detriment of other creditors); *In re* Pinetree Partners, Ltd., 87 B.R. 481 (Bankr. N.D. Ohio 1988) (refusing to allow claim for equitable subordination against mortgagee with participating loan, because mortgagee had never exercised its income participation rights or received any shared appreciation payments); *in re* Technology for Energy Corp., 56 B.R. 307 (Bankr. E.D. Tenn. 1985) (holding there could be no equitable subordination when mortgagee did not control debtor's contracts, personnel, or business decisions, and never exercised its voting control over debtor's stock); *In re* Teltronics Serv., Inc., 29 B.R. 139 (Bankr. E.D.N.Y. 1983) (holding that the subsidiary of a creditor had not, under New York law, breached its statutory duty to debtor or acted in "commercially unreasonable" manner in making use of certain self-help measures). *But see In re* Virtual network Services Corp., 902 F.2d 1246 (7th Cir. 1990) (holding that subordination of nonpecuniary tax law claims of the Internal Revenue service (IRS) was warranted, even though the IRS actions were within the law; court stated that equitable subordination no longer requires a showing of inequitable conduct on part of creditor whose claims are to be subordinated); *In re* Vitreous Steel Products Co., 911 F.2d 1223 (7th Cir. 1990) (ruling that lower court on remand should consider "all the circumstances" in determining whether mortgagee's claim should be subordinated to claims of general creditors; court stated that, in regard to *In re* Virtual Network

E. State Fraudulent Conveyance Statutes

Section 544(a) of the Bankruptcy Code gives a trustee appointed in a bankruptcy case many of the powers of a creditor, including the right to use a state fraudulent conveyance statute to avoid a transaction. Section 544(b) provides that fraudulent transfers may be voided pursuant to state law. Therefore, it is necessary to check state statutes that control debtor-creditor relations (for example, the ability of the debtor or another creditor to void the transfer) to define what can be considered adequate consideration and to determine which statutes prohibit conveyances that render the grantor insolvent. In some states, whether a conveyance is fraudulent is a question of fact.

If applicable, reference should be made to the Uniform Fraudulent Conveyance Act (UFCA)[97] of the state in which the property is located. The UFCA was adopted by the National Conference of Commissioners on Uniform state Laws in 1918 and is currently in effect in twenty-five states and the Virgin Islands.[98] The UFCA permits avoiding transfers made with actual intent to defraud[99] or transfers made under actual or impending insolvency without fair consideration.[100] State fraudulent conveyance laws do not require that the transfer be made within one year prior to filing of the petition in bankruptcy, because the action is independent of bankruptcy. However, if the trustee elects to proceed under state fraudulent conveyance laws, state statutes of limitation control.

For example, in *Copter, Inc. v. Gladwin Leasing, Inc*.,[101] the Third Circuit considered whether a state statutory preference provision could be used to avoid a transfer in a federal bankruptcy case. Section 544 of the Bankruptcy Code empowers a trustee to succeed to the rights of actual unsecured creditors under "applicable law" to avoid transfers. The state law provision in *Copter* applied when "proceedings in insolvency" commenced within four months of the transfer, as opposed to the ninety-day requirement of section 547.[102] The transfer in *Copter* occurred more than ninety days but less than four months before the debtor filed the bankruptcy petition.[103] The court held that "proceedings in insolvency" referred only to state insolvency proceedings, not federal bankruptcy proceedings, and that the state preference provision was not "applicable law" under § 544.[104]

In *Tcherepnin v. Franz*,[105] the court held that the Illinois fraudulent conveyance statute requires a voluntary act of the debtor.[106] In addition, under Illinois law, "a

Services Corp., it would not be necessary to find that mortgagee engaged in misconduct, and inquiry should focus on "fairness to the other creditors").

[97] Unif. Fraudulent Conveyance Act, 7A U.L.A. 427 (1985).
[98] *Id*.
[99] *Id*. § 7, 7A U.L.A. 509.
[100] *Id*. § 4, 7A U.L.A. 474.
[101] 725 F.2d 37 (3d Cir. 1984).
[102] *Id*. at 38.
[103] *Id*.
[104] *Id*. at 39.
[105] 457 F. Supp. 832 (N.D. Ill. 1978).
[106] *Id*. at 836.

foreclosure sale will not be set aside for mere inadequacy of price; there must be proof of mistake, accident, surprise, misconduct, fraud or irregularity."[107]

The Uniform Fraudulent Transfer Act (UFTA), which is designed to replace the UFCA, was approved by the National Conference of Commissioners on Uniform State Laws in 1984, and by the American Bar Association in 1985.[108] Section 3(b) of the UFTA contains strong anti-*Durrett* language that insulates transfers made pursuant to properly conducted, noncollusive, judicial or nonjudicial, foreclosure sales, from fraudulent conveyance attacks. However, under section 4(a)(1) of the UFTA, such transfers may still be avoided if a court finds an actual intent to hinder, delay, or defraud creditors. The revised language contained in the UFTA would only affect state fraudulent conveyance laws and not the federal fraudulent conveyance provisions in § 548 of the Bankruptcy Code, under which most of the cases in the *Durrett* line were decided.

The definition of "insolvency" in section 2 of the UFTA is virtually identical to the Bankruptcy Code's definition. Both use the "balance sheet" test, which compares the sum of the debtor's debts with all of the debtor's assets at their fair value. There is a rebuttable presumption of insolvency if, at the time the test is applied, the debtor is not paying debts as they become due. Section 4(b) of UFTA also contains a nonexclusive list of factors "appropriate for consideration by the court in determining whether the debtor had an actual intent to hinder, delay or defraud one or more of its creditors." Another controversial provision allows recovery of preferential transfers to insiders who had reasonable cause to believe the debtor was insolvent at the time the creditor received the alleged preference.[109] Although such preferences are not fraudulent transfers within the traditional meaning of the term, they are subject to challenge under section 5(b) of the UFTA.

In addition, the UFTA contains its own statute of limitations. Under sections 9(a) and (b), the UFTA extinguishes any claim not brought within four years after the transfer was made or the obligation was incurred. Under section 9(c), challenges to insider preferences must be brought within one year. Because the substantive claim terminates at the end of the specified time period, a bankruptcy trustee or an agent of the federal government, for instance, the IRS, may be barred from asserting remedies under the UFTA after expiration of the specified time period even though general statutes of limitations are unenforceable against the federal government in some cases.

The UFTA has been adopted in twenty-six states.[110] The version of the UFTA adopted in Illinois in September 1989, extensively revised the Illinois UFCA.[111] Under the new Illinois UFTA, the transfer of an interest in real estate is fraudulent as to a creditor if the debtor made the transfer with actual intent to hinder, delay, or defraud any creditor of the debtor or if the debtor made the transfer without receiving a reasonably

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[107] *In re* Ristich, 57 B.R. 568, 576 n.2 (Bankr. N.D. Ill. 1986); *see* Illini Fed. Sav. & Loan Ass'n v. Doering, 516 N.E.2d 609 (Ill. Ct. App. 1987), *appeal denied*, 552 N.E.2d 1245 (Ill. 1988); Block v. Hooper, 149 N.E. 21 (Ill. 1925).

[108] Unif. Fraudulent Transfer Act, 7A U.L.A. 639 (1985).

[109] *Id*. § 5(b), 7A U.L.A. 657.

[110] The UFTA has been enacted in Alabama, Arizona, Arkansas, California, Florida, Hawaii, Idaho, Illinois, Maine, Minnesota, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Dakota, Ohio, Oklahoma, Oregon, Rhode Island, South Dakota, Texas, Utah, Washington, West Virginia, and Wisconsin, and is currently being considered by other state legislatures. *Id*. at 133 (Supp. 1991).

[111] Ill. Ann. Stat. ch. 59, paras. 101-112 (Smith-Hurd Supp. 1990).

equivalent value in exchange for the transfer.[112] Under the Illinois UFTA, a transferee is deemed to have given "reasonably equivalent value" if the transfer is given pursuant "to a regularly conducted, noncollusive foreclosure sale . . . ."[113] The Illinois UFTA includes a broad definition of "insolvency" which adopts both the "balance sheet" and "equitable" tests of insolvency. The statute permits voiding preferential transfers to insiders, provides for injunctions against fraudulent transfers, and also allows a defrauded creditor to seek a money judgment from any transferee of the debtor's property.[114]

VI. TAX CONSIDERATIONS

Tax considerations for both the lender and the borrower are extremely important when structuring deeds in lieu of foreclosure. The Internal Revenue Service (the IRS) has successfully convinced the courts that a voluntary conveyance of the real property from a borrower to a lender in satisfaction of a mortgage debt is equivalent to payment in full of the mortgage indebtedness, including all accrued interest at the time of conveyance.[115] The courts have concluded that these conveyances constitute a taxable sale even if the borrower receives no consideration, the borrower is not personally liable (the debt is nonrecourse), and the market value of the property is less than the outstanding loan balance.[116]

A. Tax Effect on Lender

Delinquent interest, if not previously reported as income, is taxable as income to the lender to the extent the fair market value of the property exceeds the principal balance, plus advances.[117] The gain or loss realized by the lender upon accepting a deed in lieu of foreclosure is equal to the difference between the lender's basis for its note and the value of the property at the time of the conveyance.[118] The lender is treated as though it had received payment in cash on the debt to the extent of the value of the property.[119] If the value of the property exceeds the lender's basis in the debt and the lender is in the business of making mortgage loans, gain will be taxable as ordinary income from the collection of a debt. Gain will also be taxable as ordinary income to the extent the gain

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[112] *Id*. para. 105.
[113] *Id*. para. 104.
[114] *Id*. paras. 103, 108.
[115] *See* Commissioner v. Tufts, 461 U.S. 300 (1983); Allan v. Commissioner, 856 F.2d 1169 (8th Cir. 1988); Stokes v. Commissioner, 124 F.2d 335 (3d Cir. 1941); Commissioner v. Hoffman, 117 F.2d 987 (2d Cir. 1941); Freeland. v. Commissioner, 74 T.C. 970 (1980); Ivan Faggen, *et al*, Real Estate § 12.08 (6th ed. 1988); Sanford M. Guerin, Taxation of Real Estate Dispositions ch. 14 (2d ed. 1990); Ron Kahanek, *Tax Planning and Troubled Real Estate: Avoiding the Trap*, 1 Distressed Real Est. Law Alert 225 (1990), p.1; Alice Cunningham, *Payment of Debt With Property—The Two-Step Analysis After* Commissioner v. Tufts, 38 Tax. Law. 575 (1985).
[116] *See* cases cited *supra* note 115.
[117] Manufacturer's Life Ins. Co. v. Commissioner, 43 B.T.A. 867, 874 (1941), *acq*., 1947-1 C.B. 3.
[118] Treas. Reg. § 1.166-6(b)(1).
[119] *See* United States v. Santa Inez Co., 145 F.2d 667 (9th Cir. 1944), *cert. denied*, 324 U.S. 879 (1945); Nichols v. Commissioner, 141 F.2d 870 (1944); I.T. 3548, 1942-1 C.B. 74; Treas. Reg. § 1.166-6(b)(1) (as amended in 1967).

represents delinquent interest, prior write-offs, or the collection of a debt when the lender purchased the debt at a discount.[120]

For the delinquent interest, discount, or recovery of prior write-offs to be taxed as ordinary income, the lender must show that the property received was worth at least as much as the principal of the mortgage note plus the interest, discount, or prior write-off.[121] The mere fact that the borrower's liability for overdue interest has been discharged as part of the transaction will not alone force the lender to recognize income.[122] Conversely, the lender will realize a loss, which qualifies as a bad-debt deduction under §166 of the Internal Revenue Code, equal to the excess of the lender's basis in the debt over the fair market value of the property transferred.[123] The lender's basis in the transferred property will be the fair market value of the property.[124] Because there is no foreclosure proceeding, deficiency, or redemption period, the lender recognizes the gain or loss in the year of the conveyance, regardless of the accounting method used.[125] The lender will have the burden of proof as to the actual market value of the property, and an independent, professional appraisal may be required.[126]

Under § 1038 of the Internal Revenue Code, a special rule applies when the lender was the original seller of the property that it reacquires as a result of a voluntary conveyance. In general, loss is not recognized, and gain is recognized only to the extent that the amount of money received by the lender from the borrower prior to the reacquisition exceeds the gain reported on the original sale.[127] The gain is limited to the original selling price of the property reduced by the sum of the gain previously reported by the lender on the sale and the amount of money and fair market value of other property paid by the lender in reacquiring the property.[128]

B. Tax Effect on Borrower

The amount realized by the borrower is the amount of the debt satisfied through the exchange of the property.[129] If the lender agrees to waive any deficiency, the amount realized as gain by the borrower equals the full amount of the outstanding debt obligation.[130] If the amount of the canceled debt is less than the borrower's adjusted tax basis in the property, the loss incurred is deductible by the borrower only if the mortgage indebtedness was incurred in connection with property either held for investment or used

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[120] *See* Hale v. Helvering, 85 F.2d 819 (D.C. Cir. 1936); Atlas v. Commissioner, 4 T.C.M. (CCH) 111 (1945); *Manufacturer's Life*

[121] *See* Helvering v. Missouri State Life Ins. Co., 78 F.2d 778, 780 (8th Cir. 1934).

[122] *Id.*

[123] *See* Commissioner v. Spreckels, 120 F.2d 517 (9th Cir. 1941); Bingham v. Commissioner, 105 F.2d 971 (2d Cir. 1939); I.T. 3548, 1942-1 C.B. 74; Gerald J. Robinson, Federal Income Taxation of Real Estate, ¶10-07 (5th ed. 1988).

[124] Kohn v. Commissioner, 197 F.2d 480 (2d Cir. 1952); Bennett v. Commissioner, 139 F.2d 961 (8th Cir. 1944).

[125] *Kohn*, 197 F.2d at 482.

[126] *See* Main Properties, Inc. v. Commissioner, 4 T.C.364 (1944), *acq*, 1945 C.B. 5; Hecker v. Commissioner, 17 B.T.A. 874 (1929).

[127] I.R.C. § 1038(b) (1988).

[128] *Id.*, § 1038(b)(2).

[129] United States v. Davis, 370 U.S. 65 (1962).

[130] *Id.*

in the borrower's trade or business.[131] This type of loss would be capital in nature and reportable by the borrower in the year of the transfer of the property.[132] The gain or loss is realized by the borrower in the year the transfer occurs.[133]

It may be possible to accommodate the borrower's tax planning objectives by, for example, structuring the transaction to provide that the transfer is in consideration of the fair market value of the property, and that the additional indebtedness is canceled, assuming the property is worth less than the outstanding debt. This approach may benefit a borrower who is insolvent, because that borrower may be required to recognize any gain upon the sale of an asset but may not be required to recognize cancellation of indebtedness income.[134]This result occurs even if the borrower is personally liable for the loan, except to the extent that the cancellation of indebtedness renders the borrower solvent.[135] In some instances, however, the borrower may wish to structure the transaction to provide that the transfer is in exchange for the full amount of the outstanding debt. This approach provides for long-term capital gain treatment on income realized.

The Tax Reform Act of 1986[136] contains important changes in the treatment of capital gains. Section 301(a) of the Tax Reform Act repealed the individual long-term capital gains exclusion formerly provided in § 1202 of the Internal Revenue Code. Gain on all capital assets and assets used in a trade or business is now taxed at ordinary income rates.[137] However, the Act retains the concept of capital gain, allowing for the possibility that rates for ordinary income may be raised in the future and the capital gains preference restored. Capital losses are still allowed in full against capital gains, and the characterization of gains or losses as "capital" remains important because capital losses may not offset more than $3,000 of ordinary income annually.[138]

A borrower will realize a gain or loss from a voluntary conveyance of the property to a lender equal to the difference between the outstanding loan balance and the borrower's basis in the property regardless of the value of the property and regardless of whether the borrower is personally liable for the debt.[139] This tax treatment also applies when the debt is secured by a purchase money mortgage.[140] If the fair market value of the property is

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[131] I.R.C. §§ 165(c), 1001.

[132] *Id.* §§ 1221, 1231(b)(1). *See*, *e.g.*, United States v. Kirby Lumber Co., 284 U.S. 1 (1931); Kaufman v. Commissioner, 119 F.2d 901 (9th Cir. 1941); Commissioner v. Union Pac. R.R. Co., 86 F.2d 637 (2d Cir. 1936); Lutz & Schramm Co. v. Commissioner, 1 T.C. 682 (1943).

[133] Commonwealth, Inc. v. Commissioner, 36 B.T.A. 850 (1937).

[134] *See* Turney's Estate v. Commissioner, 126 F.2d 712 (5th Cir. 1942); Lakeland Grocery Co. v. Commissioner, 36 B.T.A. 289 (1937); Rev. Rul. 90-16, 1990-1 C.B. 12 (requiring insolvent debtor, who conveyed residential subdivision to creditors in satisfaction of secured debt on which debtor was personally liable, to recognize gain on transaction to extent that fair market value of property exceeded his basis in the property); Michael T. Madison & Jeffry R. Dwyer, The Law of Real Estate Financing § 12.03(3)(a) (1981).

[135] M. Madison & J. Dwyer, *supra* note 134.

[136] Tax Reform Act of 1986, Pub. L. No. 99-514, § 301, 100 Stat. 2085, 2216 (repealing 26 U.S.C. § 1202 (1988)).

[137] *See id.*

[138] I.R.C. § 1211 (1988).

[139] Commissioner v. Tufts, 461 U.S. 300 (1983); United States v. Kirby Lumber Co., 284 U.S.1 (1931).

[140] *See* Commissioner v. Tufts, 461 U.S. 300 (1983); Chilingirian v. Commissioner, 918 F.2d 1251 (6th Cir. 1990); Millar v. Commissioner, 577 F.2d 212 (3d Cir. 1978); Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950), *cert. denied*, 341 U.S. 926 (1951); Freeland v. Commissioner, 74 T.C. 970 (1980); Treas. Reg. §

less than the outstanding debt and the borrower is personally liable, however, the IRS may seek to bifurcate the transaction into: (1) an exchange, with the amount realized being the fair market value, and (2) a discharge of indebtedness to the extent the debt exceeds the fair market value and is forgiven by the lender. Under this treatment, if a borrower voluntarily conveys the property to completely satisfy a recourse loan, the borrower will achieve both a gain and ordinary income as a result of the discharge of indebtedness. However, § 108(e)(5) of the Internal Revenue Code may apply to reduce the purchase price and the borrower's basis, instead of causing income to be realized from the discharge. If the mortgage debt is nonrecourse, the debtor will realize the entire amount of the outstanding debt as a gain, but the debtor will not realize income from discharge of indebtedness.[141]

Generally, a solvent borrower must recognize income to the extent of any canceled debt.[142] However, in the case of indebtedness incurred or assumed by a corporation or by an individual relating to property used in the borrower's business, canceled debt income could formerly be excluded provided the borrower made an election under § 108 and § 1017 of the Internal Revenue Code to reduce the borrower's basis in certain depreciable property. Section 822 of the Tax Reform Act repealed this exclusion for solvent taxpayers, and the forgiveness of debt by the lender will result in the current recognition of income to all borrowers except insolvent borrowers with purchase money mortgage debt.

C. Special Rules

A special rule applies for gain or loss on voluntary conveyances of real property accepted by mutual savings banks that do not have capital stock represented by shares, domestic building and loan associations, and cooperative banks that do not have capital stocks organized and operated for nonprofit mutual purposes.[143] Generally when these organizations acquire property that is security for payment of indebtedness, the property assumes the same basis in the hands of the lender as the debt obligation and it retains the same character as the debt obligation.[144] When the property is subsequently sold, no gain or loss is recognized and no debt is deemed worthless or partially worthless as a result of acquisition of the property.[145]

1.1001-2(b); Rev. Rul. 76-111, 1976-1 C.B. 214. *Cf.* Crane v. Commissioner, 331 U.S. 1, 14 n.37 (1947) (if debt exceeds the value of property and loan is nonrecourse, gain would be realized only to the extent of property's value).

[141] *See* Treas. Reg. § 1.1001-2(a)(1), (c); Michael E. Axelrod & Steven A. Fetter, *Amount and Type of Taxable Gain on Real Estate Foreclosures Can be Controlled by the Parties*, 43 Tax'n for Accts. 206 (1989); Eric C. Green & Ray Sparkman, *Consequences of Discharge of Nonrecourse Indebtedness*, 67 J. Tax'n 18 (1987); Robert C. Ricketts & Alan E. McNally, *Discharge of Indebtedness: The Tax Consequences Differ Depending on the Nature of the Debt and the Form of the Cancellation Transaction*, 21 Tax Advisor 648 (1990).

[142] I.R.C. § 61(a)(12).

[143] I.R.C. § 593(a).

[144] I.R.C. § 595(b)-(c) (1988).

[145] I.R.C. § 595(a), 1038(f) (provisions of I.R.C. § 1038 regarding recognition of income upon reacquisition of real property by the original seller of the property do not apply to the types of financial institutions described above).

D. Section 6050J Reporting Requirements

Section 148 of the Tax Reform Act of 1984[146] added § 6050J to the Internal Revenue Code to encourage consistent reporting by real estate lenders and borrowers of both income from any discharge of indebtedness in recourse debt cases and gains on foreclosures or abandonments of property that is security for indebtedness. Section 6050J requires real estate lenders who acquire an interest in property that is security for the loan, in full or partial satisfaction of the indebtedness, to report the acquisition to the IRS and to provide a statement to the debtor.

Section 6050J applies to all acquisitions and abandonments occurring after December 31, 1984, including deeds in lieu of foreclosure. Pursuant to temporary regulations issued by the IRS,[147] the lender acquires an interest in property on the earlier of the date title is transferred or on the date possession and the burdens and benefits of ownership are transferred to the lender.[148] In a deed in lieu of foreclosure transaction, the date of acquisition is the date of delivery of the deed to the lender.[149]

The lender must file informational return Form 1096 (Annual Summary and Transmittal of United states Information Return) and Form 1099-A (Acquisition or Abandonment of Secured Property) with the IRS on or before February 28 of the year following the calendar year in which the acquisition of an interest in the property occurs.[150]

Form 1096 must include the name and address of the borrower and a general description of the property.[151] It must also include the amount of indebtedness outstanding on the date of acquisition or abandonment and, in the event of a foreclosure (and, presumably, a deed lieu of foreclosure), the amount of indebtedness satisfied.[152] If the borrower is personally liable for repayment of the indebtedness, the return must also show the fair market value of the property at the time the interest is acquired.[153]

The lender must send the debtor a copy of Form 1099-A, with a legend stating that the information is being reported to the IRS, by January 31 of the year following the calendar year in which the acquisition of the property occurs.[154] To protect the lender, a provision should be inserted in the Settlement Agreement setting forth the lender's obligation to comply with section 605J and to require the borrower to provide a taxpayer identification or social security number.[155]

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[146] Pub. L. No. 98-369, § 148(a), 98 Stat. 494, 687 (1984) (codified at I.R.C. § 6050J (1988).
[147] Temp. Treas. Reg. § 1.6050J-1T (1984).
[148] *Id*. § 1.6050J-1T Q & A 10.
[149] *Id*.
[150] *Id*. Q & A 25, 33.
[151] *Id*. Q & A 26, 30.
[152] *Id*. Q & A 26.
[153] *Id*. Q & A 26, 27.
[154] *Id*. Q & A 36, 40.
[155] *Id*. Q & A 26. *See generally* R. Clark Morrison & David F. Abele, *Reporting Real Estate Transactions to the IRS*, *in* Prac. Real Est. Law. 63 (ALI-ABA, March 1992).

E. Section 1445 Reporting Requirements

The Tax Reform Act of 1984 added § 1445 of the Internal Revenue Code[156] as a means of enforcing the tax imposed on foreign investors by the Foreign Investment in Real Property Tax Act (FIRPTA), which was enacted in 1980.[157] Under § 1445, purchasers of real estate must withhold from the purchase price ten percent of the "amount realized on the disposition" to cover the possible income tax liability of a foreign seller. The purchaser must then remit this amount to the IRS unless the transaction falls within a specific exemption.[158] Transactions are exempt if the seller is not a "foreign person" and that discloses the seller's social security number or taxpayer identification number.[159] If the seller is a legal entity, it must certify that it is not a "foreign entity" and must disclose its taxpayer identification number.[160]

On December 31, 1984, the IRS published temporary regulations interpreting and implementing FIRPTA.[161] The temporary regulations specifically treated a deed in lieu of foreclosure like any other buyer-seller real estate transaction: unless an exemption applies or a withholding certificate is secured, the grantee is required to withhold and remit.[162] On December 24, 1986, the IRS issued final regulations on the withholding tax the IRS collects when foreign persons dispose of United States real property interests.[163] The 1986 final regulations replace the temporary regulations issued in 1984.[164] The final regulations generally apply to transactions occurring on or after January 1, 1985.[165] For tax years beginning after December 31, 1986, the withholding tax rate has been increased to thirty-four percent.

The final regulations also revised the rules regarding transfers of a United States property interest pursuant to a deed in lieu of foreclosure. Generally, a transferee must withhold ten percent of the amount realized by the debtor-transferor on the transfer.[166] However, no withholding is required if: (1) the transferee is the only person with a security interest in the property, (2) no cash or other property (other than incidental fees incurred with respect to the transfer) is paid, directly or indirectly, to any person with respect to the transfer, and (3) the notice requirements of section 1.1445-2(d)(3)(iii) are satisfied.[167] If this exception does not apply, the transferee may request a certificate of

[156] Pub. L. No. 98-369, § 129(a)(1), 98 Stat. 655 (1984) (codified as amended at I.R.C. § 1445 (West Supp. 1992)).

[157] Pub. L. No. 96-499, 94 Stat. 2682 (1980). For a discussion of this topic, see David M. Richards, *Reporting and Disclosure Requirements for the Foreign Investor in U.S. Real Estate*, 25 Real Prop. Prob. & Tr. J. 217 (1990).

[158] I.R.C. § 1445.

[159] I.R.C. § 1445(b).

[160] *Id*.

[161] Temp. Treas. Reg. § 1.1445-1T to –7T (1986).

[162] *Id*. § 1.1445-2T (d)(3).

[163] 51 Fed. Reg. 46,620 (1986).

[164] *Id*. at 46, 621.

[165] Treas. Reg. § 1.1445-1 (1991).

[166] *Id* § 1.1445-1(a).

[167] *Id*. § 1.1445-2(d)(3)(i(B).

reduced withholding.[168] Any amount withheld must be reported and paid to the IRS not later than the twentieth day following the date of transfer.[169]

Regulation 1.1445-2(d)(3)(iii) requires the transferee to provide notice of such transactions to the Assistant Commissioner (International) at the address provided in regulation 1.1445-1(g)(10). Filing notice does not relieve a creditor of any § 6050J filing obligations. However, a person required under § 6050J to file Form 1099-A, which includes a lender who obtains a deed in lieu of foreclosure, does not have to comply with the notice requirement of regulation 1.1445-2(d)(3)(iii)(A) if the alternative amount is zero. In that case, filing Form 1099-A satisfies the notice requirements of regulation 1.1445-2(d)(3)(iii)(A). Regulation 1.1445-2(d)(3)(iii)(A) requires that the following information must be included in the notice to the IRS:

1. a statement that a transfer pursuant to a deed in lieu of foreclosure was made under regulation 1.1445-2(d)(3);

2. the name, identification number, and home or office address of the purchaser-transferee;

3. the name, identifying number, and home or office address of the debtor-transferor;

4. the date the property was transferred to the purchaser-transferee;

5. a brief description of the property;

6. the amount realized by the transfer pursuant to the deed in lieu of foreclosure; and

7. the alternative amount.[170]

A transferee, however, is not required to withhold tax or provide notice pursuant to regulation 1.1445-2(d)(3) if the transfer of the property does not create a substantial withholding liability. If the debtor-transferor provides the transferee with a certification of nonforeign status, pursuant to regulation 1.1445-2(b), no substantial withholding liability exists relating to the acquisition of the property. In that case, the transferee is not required to withhold tax or give notice to the IRS.[171]

If the parties transfer the property interest by a foreclosure or by a deed in lieu of foreclosure primarily to avoid the requirements of § 1445(a), then regulation 1.1445-2(d)(3) does not apply and the transferee will be fully liable for any failure to withhold. The regulations presume that the purpose of the transfer was to avoid § 1445(a) if all of the following apply:

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[168] *Id.* § 1.1445-2 (d)(2)(B)(ii)(B).
[169] *Id.* § 1.1445-2(d)(3)(i(B).
[170] *Id.* § 1.1445-2(d)(3)(iii)(A).
[171] *Id.* § 1.1445-2(d)(3)(iv).

(A) The transferee acquires property in which it, or a related party, has a security interest;

(B) The security interest did not arise in connection with the debtor/transferor's or a related party's or predecessor in the interest's acquisition, improvement, or maintenance of the property; and

(C) The total amount of all debts secured by the property exceeds 90 percent of the fair market value of the property.[172]

The parties may rebut this presumption based on the facts of the case.[173]

To protect the lender, a provision should be inserted in the Settlement Agreement requiring the owner to furnish at the closing any certification necessary to establish an exemption under § 1445. If no exemption applies, the lender must collect and withhold the proper amount at the closing of the transaction.[174]

F. Section 6045(e) Reporting Requirements

Section 1521(a) of the Tax Reform Act amended Internal Revenue Code § 6045[175] by adding subsection (e). Subsection (e) requires real estate brokers to report real estate transaction to the IRS. Prior to the Tax Reform Act, real estate brokers were not included in the limited class of brokers required to file information returns on the business they transact for customers. However, § 6045(e) of the Tax Reform Act subjects real estate brokers to similar reporting requirements for real estate transactions. Section 6045(e)(1) requires real estate brokers to file a return under subsection (a) and a statement under subsection (b) of § 6045 regarding each transaction. This requirement applies to all real estate transactions. The requirement applies to brokers, lenders, individuals responsible for closing the transaction, and anyone designated by the Secretary of the Treasury.[176] This requirement is in addition to the requires report of gain or loss from any sale of real estate on the seller's tax return.

On March 27, 1987, the IRS issued a notice of proposed rulemaking[177] and temporary regulations[178] to implement the real estate reporting requirements of § 6045(e). The temporary regulations limit reporting to sales or exchanges of one- to four-family real estate for money, indebtedness, property other than money, or services.[179] The IRS also stated in the temporary regulations and in an accompanying information release[180] that future regulations would probably expand the requirements to include gains that were at that time not being reported from other types of real estate sales.

[172] *Id.* § 1.1445-2(d)(3)(v).
[173] *Id.*
[174] *Id.* at 1.1445-1(c).
[175] Pub. L. No. 99-514, § 1521, 100 Stat. 2746 (1986) (codified as amended at I.R.C. § 6045 (West Supp. 1991)).
[176] I.R.C. § 6045(e) (West Supp. 1991).
[177] LR-95-86.
[178] T.D. 8135, 1987-2 C.B. 312.
[179] Temp. Treas. Reg. § 1.604503T (1987).
[180] I.R.S. News Release iR-87-41 (March 27, 1987).

On December 12, 1990, the IRS issued final real estate reporting regulations under § 6045(e), which replaced the temporary regulations and became effective for real estate transactions with closing dates after December 31, 1990.[181] The final regulations require filing information returns for sales or exchanges of one- to four-family real estate as well as sales and exchanges of other structures (including commercial, industrial, and multiunit residential structures), and unimproved land.[182]

Under the final regulations, a "real estate transaction" is defined as a transaction which consists, in whole or in part, of the "sale or exchange" of "reportable real estate" for money, indebtedness, other property, or services.[183] A "sale or exchange" is any transaction included as a sale or exchange for federal income tax purposes, "whether or not currently taxable."[184] "Reportable real estate" is defined as "any present or future ownership interest" in:

(i) Land (whether improved or unimproved) including air space;

(ii) Any inherently permanent structure, including any residential, commercial or industrial building;

(iii) Any condominium unit, including appurtenant fixtures and common elements (including land); or

(iv) Any stock in a cooperative housing corporation. . . .[185]

Under regulation 1.6045-4, an ownership interest includes fee simple title, life estates, reversions, remainders, perpetual easements, and possessory interests (for example, leaseholds, easements, or timeshare interests) with a term in excess of thirty years.[186] This definition of ownership interest excludes an option to acquire reportable real estate.[187]

Under the new regulations, all transfers in full or partial satisfaction of any indebtedness secured by the property transferred including foreclosures, transfers in lieu of foreclosure, and abandonments, are exempt from the reporting requirements.[188] These transactions are exempt because real estate lenders are subject to similar reporting requirements under § 6050J of the Internal Revenue Code if they acquire real estate by foreclosure or by deed in lieu of foreclosure. Reporting requirements include the timely preparation and filing of Information Return Form 1096 and Form 1099-A with the IRS, not later than February 28 of the year following the calendar year in which the acquisition occurs.[189] The lender must also furnish Form 1099-A to the debtor by January 31 of the year following the calendar year in which the acquisition of the property occurs.[190] The

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[181] Treas. Reg. § 1.6045-4 (1991).
[182] *Id*. § 1.6045-4(b) (1991).
[183] *Id*.
[184] *Id*. § 1.6045-4(b)(1).
[185] *Id*. § 1.6045-4(b)(2).
[186] *Id*.
[187] *Id*.
[188] *Id*. § 1.6045-4(c)(1)(ii).
[189] *Id*. § 1.6050J-1T Q & A 25, 33.
[190] *Id*. § 1.6050J-1T Q & A 39-40.

final regulations do not provide an exception to the reporting requirements for transactions required to be reported under § 1445 of FIRPTA, including deed in lieu of transactions. Some commentators suggested, however, prior to promulgation of the final regulations, that the regulations should provide an exception for transactions subject to § 1445 because information furnished under § 6045(e) would duplicate information furnished under the FIRPTA provisions.[191]

VII. OTHER CONSIDERATIONS

A. Authority of Borrower to Convey

If the borrower is a partnership or trust, the lender should obtain an executed copy of the partnership or trust agreement. In addition, if the borrower is a partnership, the lender should obtain a certified copy of the recorded certificate of partnership. The authority of persons designated to sign documents should be established and confirmed. When applicable, the consent of partners other than the signatory should be obtained, including limited partners.

If the borrower is a corporation, the lender should obtain a copy of the corporation's articles of incorporation and bylaws, any amendments, and a current certificate of good standing from the state of incorporation. If the borrower is incorporated in a state other than the state where the property is located, the lender should obtain written evidence that the borrower is qualified to do business as a foreign corporation in the state where the property is located. The lender should also obtain a copy of the corporate resolution authorizing the borrower to enter into and to consummate the transaction. The resolution should name the corporate officer or officers chosen to execute all documents on behalf of the borrower, relating to the transaction. A verified incumbency certificate establishing the identity and authority of the officers executing documents on behalf of the borrower is also recommended.

B. Financial Statement of Borrower

Before accepting the borrower's offer to convey the property, the lender should, if possible, obtain a recent, detailed statement showing the borrower's financial condition. The statement should be prepared and certified by a certified public accountant or the chief financial officer of the borrower-corporation. The lender can use the financial statement to verify the solvency of the borrower and to avoid being charged with knowledge of a fraudulent transfer or preference.[192]

The lender may also wish to consider obtaining an estoppel affidavit from the mortgagor to verify solvency or else make the estoppel part of the Settlement Agreement. Often, one-asset limited partnerships and other borrowers seeking to return properties to

[191] 55 Fed. Reg. 51,282, 51,283 (1990).

[192] In Illinois, the lender should obtain a written acknowledgment from the accountant who prepared the financial statements, indicating the accountant's acceptance of the lender's reliance on the financial statements, because by statute the accountant will otherwise not be liable to the lender for the professional services rendered. Ill. Ann. Stat. ch. 111, para. 5535.1, § 30.1 (Smith-Hurd Supp. 1990).

secured lenders are insolvent. Even under these circumstances, the lender should not be subject to a preferential transfer or fraudulent conveyance challenge if the lender has otherwise clearly established that the debtor has no equity in the property and the transaction was not fraudulent or collusive.[193]

C. Merger Avoidance

Unless prohibited by state law, a deed in lieu of foreclosure should be consummated, in most circumstances, without extinguishing the first mortgage lien. This preserves the priority of the mortgage as it relates to mechanics' liens and other encumbrances, as well as the lender's first lien position in the event that the deed is later set aside.

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. It may also depend, at least in part, on the intent of the parties as stated in the Settlement Agreement and the deed. Most states will enforce such a stated intention. In Illinois, for example, case law makes clear that a merger is not necessarily the exclusive result of the union of two estates in the same person.[194] Rather, the intention and interest of the party who unites the two estates will determine whether a merger occurs.[195]

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[193] *See supra* text accompanying notes 36-45.

[194] Hooper v. Goldstein, 168 N.E. 1, 4 (Ill. 1929).

[195] *See* Hooper v. Goldstein, 168 N.E. 1 (Ill. 1929); Biehl v. Atwood, 502 N.E.2d 1234 (Ill. App. Ct. 1986); Miller v. McDonough, 141 N.E.2d 749 (Ill. App. Ct. 1957); Winters v. Polin, 33 N.E.2d 497 (Ill. App. Ct. 1938); Chicago title & Trust Co. v. Kesner, 16 N.E.2d (Ill. App. Ct. 1941); *see also In re* Universal Farming Indus., 873 F.2d 1334 (9th Cir. 1989); First Am. Title Ins. Co. v. United States, 848 F.2d 969 (9th Cir. 1988); Crane v. Danning, 397 F.2d 781 (9th Cir. 1968); Federal Land Bank v. Colorado Nat'l Bank, 786 P.2d 514 (Colo. Ct. App. 1989); Lassiter v. Kaufman, 581 So. 2d 147 (Fla. 1991); Ennis v. Finanz Und Kommerz-Union Etabl.,565 So. 2d 374 (Fla. Dist. Ct. App.1990); Byerlin v. Shipp, 451 N.W.2d 565 (Mich. Ct. App. 1990); Union Bank & Trust Co. v. Farmwald Dev. Corp., 450 N.W.2d 274 (Mich. Ct. App. 1989); Tidwell v. Dasher, 393 N.W.2d 644 (Mich. Ct. App. 1986); North Tex. Bldg. & Loan Ass'n v. Overton, 86 S.W.2d 738 (Tex. 1935); Altabet v. Monroe Methodist Church, 777 P.2d 544 (Wash. Ct. App. 1989); Cleary v. Batz, 273 N.W. 463 (Wis. 1937); Annotation, *Deed from Mortgagor to Mortgagee or from Purchaser to Vendor as Merger of Mortgage or of Vendor's Lien as Regards Intervening Liens*, 148 A.L.R. 816 (1944); *infra* test accompanying notes 198, 230-34; *cf* United States v. Polk, 822 F.2d 871 (9th Cir. 1987) (citing Best Fertilizers, Inc. v. Burns, 570 P.2d 179 (Ariz. 1977), the court held that under Arizona law, a mortgagee's interest does not survive the discharge or satisfaction of the underlying debt, regardless of the mortgagee's intent); *In re* Fluharty, 23 B.R. 426 (Bankr. N.D. Ohio 1982) (deciding that the second mortgage holder's acquisition of property and assumption of the first mortgage evidenced an intent to merge the second mortgage into the deed); Janus Properties, Inc. v. First Fla. Bank, N.A., 546 So. 2d 785 (Fla. Dist. Ct. App. 1989) (holding that as a result of the first mortgagee's acceptance of a warranty deed in lieu of foreclosure from the mortgagor and the execution of a satisfaction of the mortgage, the mortgage was merged into the title of real property and the second mortgage was elevated to the status of a first mortgage lien; the court rejected the argument by the first mortgagee that it had demonstrated an intent to preserve its first mortgage lien priority); Koch v. Wasson, 161 N.W.2d 173 (Iowa 1968) (establishing the general rule that when a mortgagor deeds mortgaged property to a mortgagee, the deed is presumed to be a continuation of security; mortgagor's right of redemption is presumed to continue; the presumption is against merger and the burden of proof is on the mortgagee to prove the transaction is a bona fide conveyance and not a security transaction; presumption is rebutted only if the deed or other instrument clearly provides that it is an absolute conveyance in satisfaction of the mortgage and also provides for the release of the mortgagor from liability under the note).

As added protection, the lender should consult a title insurer. Based on applicable law and the inclusion of specific antimerger language in the Settlement Agreement and deed, the title insurer may be persuaded to issue an endorsement to the owner's policy insuring any loss incurred by the lender if a court subsequently rules that the fee and the mortgage merged as a result of the voluntary conveyance. Further, a prudent lender should not release the mortgage of record after the voluntary conveyance until the property is subsequently sold, conveyed, or transferred by the lender. The Settlement Agreement and the deed should not state that the mortgage debt is canceled or extinguished. Instead, these documents should provide that the lender agrees not to bring a personal action on the debt against the borrower or that the lender will execute a separate covenant not to sue the borrower.[196] In those states holding that a merger occurs regardless of the intention of the parties as expressed in the Settlement Agreement and the deed, the lender should consider requiring the borrower to convey the property to a separate subsidiary corporation or other legal entity controlled by the lender[197] Of course, this assumes that the lender has an appropriate entity and that it is properly registered and qualified to do business in the state where the property is located.

Sometimes, to obtain immediate possession and to collect the income from the property, the lender may wish to obtain title from the borrower subject to the mortgage securing any defaulted loans in which subordinate liens or judgments remain against the property. Under some state statutes, the lender may engage in a "friendly" foreclosure in order to deal with subordinate liens or judgments.[198]

The lender must exercise caution if the borrower has filed a bankruptcy petition, has waived all redemption rights, and has agreed to have the trustee convey to the lender by a trustee's deed all interest in the secured property as part of a liquidation or reorganization

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[196] In Clark v. Federal Land Bank, 423 N.W.2d 220 (Mich. Ct. App. 1987), the court upheld the validity and enforceability of a quitclaim deed executed by the mortgagor in connection with a loan workout after the mortgagor defaulted on the mortgage. *Id*. at 220. The deed contained a clause stating that it was the intention of the parties that the mortgage would survive and not merge with the fee interest transferred by the deed. *Id*. The parties also executed a workout agreement simultaneously with the mortgagor's execution of the quitclaim deed, which provided for the release of the mortgagor from personal liability on the note but did not discharge the debt. *Id*. at nn.2-3. The court held that, because both parties assented to the agreement, which expressly reserved the right of the mortgagee to look to the property for satisfaction of the debt, it was binding and enforceable. *Id*. at 222.

[197] *See* Ann M. Burkhart, *Freeing Mortgages of Merger*, 40 Vand. L. Rev. 283, 342-62 (1987); Michael F. Jones, *Structuring the Deed in Lieu of Foreclosure Transaction*, 19 Real Prop Prob. & Tr. J. 58, 68 (1984); James R. Stillman, *Alternative Deed in Lieu of Foreclosure Agreements: Special Concerns, in* Real Estate Workouts and Turnarounds 142, 148 (1989).

[198] *See* Iowa Code Ann. § 654.18 (West Supp. 1991) (providing that the mortgagor and mortgagee may enter into a mutual agreement for foreclosure in which the mortgagor shall convey the real property to the mortgagee and the mortgagee shall waive all deficiency claims against the mortgagor; the mortgagee shall have immediate access to the property; the mortgagor and mortgagee must then file a jointly executed document with the county recorder stating that they have elected to follow this alternative foreclosure procedure, and the mortgagee must notify all junior lienholders that they have 30 days from the mailing of notice to exercise their statutory rights of redemption) *see also* Ill. Ann. Stat. ch. 110, para. 15-1402 (Smith-Hurd Supp. 1990) (providing a consent foreclosure procedure by which the court will enter a judgment vesting title in the mortgagee free and clear of all claims of the mortgagor and other persons with subordinate claims; provided that the mortgagee waives all rights to a personal judgment against the mortgagor and all other persons liable for the debt before the foreclosure sale, all mortgagors with an interest in the property consent to the entry of a personal judgment, and no other party objects to the entry of a personal judgment).

plan. Unless the trustee's deed and any related agreements between the parties clearly state that the parties do not intend to extinguish the mortgage lien and the personal liability of the debtor for a deficiency, a merger may occur. If a merger occurs, the lender will not be entitled to assert a claim for participation in the debtor's estate as an unsecured creditor for the portion of the debt exceeding the value of the mortgaged property conveyed by the trustee.[199]

D. Environmental Issues

Before consummating the voluntary conveyance transaction with the mortgagor, the lender should make a thorough assessment of any existing or potential environmental hazards on the property, including the presence of asbestos, underground storage tanks, and the storage or use of hazardous waste materials. If hazardous substances exist, the lender should carefully consider whether to accept a conveyance of the property or instead to forfeit the collateral. The lender could become primarily liable for any future cleanup costs mandated by federal, state, or local environmental laws.

Under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 (CERCLA or Superfund)[200] and the Superfund Amendments and Reauthorization Act of 1986 (SARA),[201] a real estate lender who acquires title to and possession of the mortgaged property through conveyance by a deed in lieu of foreclosure can become an "owner or operator." CERCLA can make a lender, as an owner or operator, liable for hazardous waste cleanup unless the lender can establish the "innocent landowner" defense.[202] To do so, the lender must show that, at the time it acquired the property, it did not know and had no reason to know that the property contained any hazardous substance and that it had conducted an appropriate inquiry into the previous ownership and uses of the property consistent with good commercial or customary practice to minimize liability.[203] A commercial real estate lender will be held to an especially high standard of diligence with regard to ascertaining the existence of hazardous substances on the property.[204]

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[199] *See In re* Fox, 808 F.2d 552 (7th Cir. 1986) (deciding that under Wisconsin law, mortgagees relinquished their unsecured deficiency claims by accepting conveyance of mortgaged property from the trustee because the documents did not express a contrary intent by the mortgagees); *cf. In re* Kelley, 53 B.R. 961 (Bankr. W.D. Ky. 1985) (upholding a farm reorganization plan that provided that creditor's exclusive remedy for default by the debtor would be to foreclose on its collateral with no resulting personal liability of the debtor; by failing to pay, debtor merely elected to relinquish secured property); *In re* R-B Co., 59 B.R. 43 (Bankr. W.D. La. 1986) (ruling that a clause in the Chapter 11 plan, in which the debtor reserved the right to abandon property after confirmation in full satisfaction of claims secured by property, did not put the creditor on notice that it would be forced to accept property; the clause was not given effect even though creditor participated in confirmation of the plan; abandonment is not a sale under the Bankruptcy Code and creditor is entitled to full satisfaction of its claim).

[200] Pub. L. No. 96-510, 94 Stat. 2767 (1980) (codified as amended at 42 U.S.C. § 9601 (1988)).

[201] Pub. L. No. 99-499, 100 Stat. 1613 (1986) (codified as amended at 42 U.S.C. § 9601 (1988)).

[202] 42 U.S.C. § 9607(b) (1988).

[203] *See id* § 9601 (35) (B) (1988).

[204] *See id*; *see also* United States v. Fleet Factors Corp., 901 F.2d 1550 (11th Cir. 1990) (holding that secured creditor can be liable for cleanup costs under CERCLA with out being an operator, if the creditor participates in financial management of a facility "to a degree indicating a capacity to influence an entity's treatment of hazardous wastes"), *cert. denied*, 111 S. Ct. 752 (1991); Guidice v. BFG Electroplating and Mfg. Ct., 732 F. Supp. 556 (W.D. Pa. 1989) (ruling that by taking sheriff's deed to

The Illinois legislature recently enacted the Illinois Responsible Property Transfer Act (IRPTA).[205] IRPTA requires recordation and filing of a completed environmental disclosure statement if certain specific environmental conditions are known to exist or are known to have previously existed at the property.[206] IRPTA does not exempt deed in lieu of foreclosure transactions, but it does exempt foreclosures.[207] If the transferor fails to deliver a completed disclosure statement within thirty days after the execution of a contract, or if the disclosure reveals a previously unknown environmental defect in the property, any party to the contract, including a lender, may void the contract or the commitment for financing.[208] Many states have enacted statutes similar to the Illinois statute.[209]

The lender should always conduct a thorough investigation of the property prior to acquisition to assess any environmental hazards. The lender should hire a reputable and experienced independent environmental consulting firm to assess the property and issue a "Phase 1" report on its condition. The lender's potential liability justifies the cost of an investigation, especially because the lender may be the only party with the financial resources to clean up any hazardous contamination of the property.

To protect itself further, the lender should negotiate for an express warranty from the borrower regarding environmental conditions at the property. The lender should have the warranty placed either in the Settlement Agreement or in a separate agreement that survives the closing. The document should warrant that there are no environmental hazards, waste materials, or underground storage tanks on the property and that the borrower has received no notice of any violation of any federal, state, or local environmental laws, rules, or regulations. The lender should further attempt to negotiate an agreement that the borrower will remain personally liable for any costs incurred by the lender for the cleanup of any hazardous materials on the site and for any corrective measures subsequently taken by the lender to comply with environmental laws. The

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property, mortgagee forfeited its right to assert secured creditor's exemption in CERCLA's definition of "owner or operator"; mortgagee foreclosed mortgage and held title for eight months before selling it to third party); United States v. Maryland Bank & Trust Co., 632 F. Supp. 573 (D. Md. 1986) (holding that mere ownership of property by mortgagee was sufficient to nullify security interest exemption and impose CERCLA liability on mortgagee); United States v. Mirabile, 15 Envtl. L. Rep. (Envtl. L. Inst.) 20992 (E. D. Pa. Sept. 4, 1985) (dismissing action against mortgagee for recovery of Superfund money to clean up paint manufacturing site; mortgagee took title at foreclosure sale, secured property against vandalism, and sold property within four months of foreclosure; court found that mortgagee did not participate in direct management or operation of mortgagor's business); *cf. In re* Bergsoe Metal Corp., 910 F.2d 668 (9th Cir. 1990) (deciding that mortgagee had not lost its secured creditor protection under CERCLA even though it had rights to inspect property and take possession upon foreclosure because it had never exercised those rights; secured creditor must exercise actual management authority before it can be held liable under CERCLA).

[205] Ill. Ann. Stat. ch. 30, para. 901-910 (Smith-Hurd Supp. 1991).

[206] *Id*. at para. 906.

[207] *Id*. at para. 903(g).

[208] *Id*. at para. 904(c).

[209] *See also* Cal. Health & Safety Code §§ 25359.7, 25230 (West 1984 & Supp. 1991); Conn. Gen. Stat. Ann. §§ 22a-134aa to -134hh (West Supp. 1990); Ind. Code Ann. § 13-7-22.5 (Burns 1990); Iowa Code Ann. § 455B.430 (West 1990); Ky. Rev. Stat. Ann. § 224.876(16) (Michie/Bobbs-Merrill Supp. 1990); Mich. Comp. Laws Ann. § 299.610c (West Supp. 1991); Minn. Stat. Ann. § 115B.16(2) (West 1987); Neb. Rev. Stat. § 81-15, 102 (1987); Pa. Cons. Stat. Ann. § 6018.405 (Purdon Supp. 1990); W. Va. Code § 20-5E-10 (1989).

liability of the borrower under such an indemnity agreement should arise upon discovery of an unacceptable environmental condition, not upon realization of a loss.[210]

It is unlikely that the lender will be able to obtain title insurance coverage for adverse environmental matters. In 1984, the ALTA standard loan policy form was amended to provide that the policy excludes from coverage any law, ordinance, or governmental regulation relating to environmental protection.[211] The new ALTA title policy form promulgated in 1987 continues to exclude coverage for environmental matters.[212] However, the ALTA forms do not exclude environmental liens or encumbrances recorded in the public records prior to the date of the transaction.[213]

E. Bulk Sales Act Reporting Requirements

Deeds in lieu of foreclosure may be subject to reporting requirements under Article 6 of the Uniform Commercial Code or under certain tax collection statutes. For example, chapter 120 of the Illinois Income Tax Act, commonly known as the Bulk Sales Act (BSA),[214] was amended in 1984 to include the sale or transfer of a major part of the real property of any business outside the usual course of its business.

The purchaser or transferee of this type of real estate must file a report of the transaction with the Illinois Department of Revenue (Department) not later than ten days after the sale or transfer.[215] The report must contain: (1) the name and address of the seller or transferor, (2) the name and address of the purchaser or transferee, (3) the date of the sale or transfer, (4) a copy of the sales contract and financing agreements, (5) the amount of the purchase price or other consideration for the transfer, (6) the terms of payment, and (7) other information as the Department may reasonable require.[216] If the purchaser or transferee fails to file the required report on time, the purchaser shall be personally liable to the Department for any unpaid amount assessed under the BSA, up to the amount of the reasonable value of the property.[217]

Interested parties have the option of filing this report with the Department at least ten days before the actual closing date.[218] The interested party can request information on whether the seller or transferor has any assessed but unpaid penalties, or interest due under the BSA.[219] The purchaser or transferee is required to withhold a portion of the purchase price until the Department certifies that there is no outstanding balance due on

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[210] *See* Allen P. Vollmann, *Double Jeopardy: Lender Liability Under Superfund*, 16 Real Est. L.J. 3, 17 (1987).

[211] Hugh A. Brodkey, *Title Insurance, in* 2 Modern Real Estate Transactions 1287, 1386 (ALI-ABA 6th ed. 1985).

[212] D. Barlow Burke, Jr., Law of Title Insurance 365, 370 (Supp. 1991).

[213] Paragraph 1(f) of the Conditions and Stipulations section of the 1987 policy form defines public records as "records established under state statutes at Date of Policy for the purpose of imparting constructive notice of matters relating to real property to purchasers for value and without knowledge." *Id*. at 380. This definition emphasizes whether the records provide constructive notice rather than emphasizing where the records are located.

[214] Ill. Ann. Stat. ch. 120, para. 9-902 (Smith-Hurd 1990).

[215] *Id*. at para. 9-902(d).

[216] *Id*.

[217] *Id*.

[218] *Id*.

[219] *Id*.

the seller's or transferor's account.[220] If the Department fails to notify the purchaser or transferee of any claims against the seller or transferor on or before the closing date, the purchaser or transferee is relieved of any duty to continue withholding a portion of the purchase price.[221] The Department's failure also relieves the purchaser or transferee from any liability for any amount due from the seller or transferor.[222] The purchaser or transferee is required to pay any delinquent tax, penalty, or interest owed by the seller or transferor if: (1) the seller or transferor fails to pay the tax if a report of the transfer was properly filed, and (2) the Department issues a timely stop order.[223] If these conditions exist, the purchaser or transferee must pay the Department up to the amount withheld from the purchase price.[224]

VIII. COOPERATION WITH TITLE INSURER

A. Need for Owner's Policy

Under Section 2, Item (a) (Continuation of Insurance) of the Conditions and Stipulations of the ALTA Loan Policy, adopted September 1986, and effective June 1987, the coverage of the mortgage policy continues in effect after the mortgage lender acquires title to the property through a deed in lieu of foreclosure.[225] The coverage amount equals the lesser of: (1) the amount of insurance stated in the original mortgage policy, (2) the difference of amount of principal, interest, costs, expenses, and advances paid by the lender to protect the security and the amount of all payments made, or (3) the amount paid by any governmental agency, if it is the insured claimant, to acquire the property in satisfaction of its insurance contract or guaranty.

Notwithstanding the continuation of coverage provided to the lender under its mortgage loan title policy, if the lender acquires title through a deed in lieu of foreclosure, the lender should obtain an owner's title policy effective on the date of the conveyance. Obtaining an owner'' title policy is important because Section 2, Item (a) of the Conditions and Stipulations states that the loan policy provides coverage only as of the date of issuance of the policy, and it further stipulates that the lender must discharge the lien of the insured mortgage in connection with the acquisition of title by the lender.[226]

A foreclosure or deed in lieu of foreclosure loan policy does not convert into an owner's policy. Rather, the policy continues to provide the same coverage as it did initially, subject to all policy conditions and stipulations. The insurer's liability is,

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[220] *Id.*
[221] *Id.*
[222] *Id.*
[223] *Id.*
[224] *See* Jackson E. Donley & Joseph E. McMenamin, *Bulk Transferee Liability Under Illinois Income Tax and Sales Tax Laws*, *in* Tax Trends (State Taxation Section Newsletter, Illinois State Bar Association, April 1987).
[225] D. Barlow Burke, Jr. Law of Title Insurance 365, 383 (Supp. 1991).
[226] William B. Dunn, *A Lender's Counsel's Perspective About Title Insurance in a Commercial Loan Transaction*, *in* Commercial Real Estate Financing: Living with Today's Economy and Tax Reform 701 (ALI-ABA 1987).

therefore, limited to the amount of the mortgage indebtedness insured under the original loan policy. The lender will take title subject to all liens, encumbrances, and other title exceptions occurring subsequent to the date of the original loan policy. Any claim for loss must be measured against the extent to which that amount is impaired by the defect in title. The loss is not measured by its effect on the full value of the property, as is the case with an owner's policy.[227] Therefore, the lender should obtain an owner's policy providing coverage as of the date of the transfer. By obtaining owner's, rather than lender's coverage, the lender can make a claim even if a defect does not impair the lender's security position.

B. Policy Coverage and Requirements

The lender should obtain a title search and a commitment for an owner's policy at the outset of the transaction. The title insurance policy issued pursuant to the commitment should equal the amount of the principal indebtedness, plus interest, advances, and foreclosure expenses. The lender should cover the following points in procuring an adequate commitment:

1. Make certain the original borrower still has fee simple title. If interim conveyances have occurred, ascertain all current title holders and require them to execute all applicable documents.

2. Check for other liens, mortgages, judgments, or other encumbrances against the property, including federal tax liens and bankruptcy filings.

3. Obtain and examine closely copies of all easements, existing leasehold interests, and other matters affecting title to the property.

4. Ensure that the legal description is correct, keeping in mind that it may be different from the original mortgage description because of partial releases, modification agreements, and the like.

5. Consider requiring a full or partial survey of the property to obtain an accurate legal description of the property, to assure the use of easements on adjacent property that benefit the subject property, to resolve boundary line disputes, and to establish the location of property improvements.

6. If necessary, obtain extended or affirmative coverage or special endorsements regarding mineral rights, easements, and mergers.

7. Obtain current Uniform Commercial Code searches.

Title Companies require the following actions or documents before writing an insurance policy for a title obtained by deed in lieu of foreclosure:

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[227] *See* CMEI, Inc. v. American Title Ins. Co., 447 So. 2d 427 (Fla. Dist. Ct. App. 1984); Harold A. Drees, *Misconceptions on Title Insurance Loan Policy Coverage*, Fla. Bar. J., Feb. 1990, at 64,65.

1. Original or certified copies of all documents evidencing the current legal authority and ability of the conveying entity (and its appropriate officer(s), partner(s), or trustee(s)) to enter into the transaction and to execute the conveyance documents;

2. Prior approval by the title company of a written Settlement Agreement setting forth the terms of the transaction;

3. Proof of cancellation of the note and a recorded release of the mortgage in those states that will not allow the lender to retain its mortgage lien upon a conveyance of the property from the borrower to the lender;

4. Surrender by the borrower of possession and control of the property on the closing date, unless the borrower retains an interest as, for example, a tenant and the title insurer agrees that the interest does not constitute an equitable mortgage;

5. Dismissal by the lender of any pending foreclosure proceedings affecting the property;

6. Execution of an estoppel affidavit by the borrower, which will usually by contained in the Settlement Agreement;

7. An independent appraisal or other evidence showing that there is no equity in the property which enables title insurance companies to insure against exceptions for state and federal preferential transfer and fraudulent conveyance statutes.[228]

If a transaction is contemplated in which the note and mortgage are not to be canceled and the mortgage is not to be released, for example, to preserve the lender's position with respect to other liens, the title company will usually require specific language in the Settlement Agreement and in the deed preventing merger of the lender's and borrower's interests. If the loan is nonrecourse, the title company may also require a release of personal liability under the note or a covenant not to sue (but not a cancellation or extinguishment of the indebtedness), or some other recital of consideration.

C. Closing Requirements and Transfers Taxes

The lender should send detailed escrow or closing instructions, or both, to the title company when the transaction is ready to close. It is also important for the lender to check state statutes pertaining to a transfer tax on the conveyance of real estate by a deed in lieu of foreclosure. Often, the statute will exempt a deed given pursuant to a voluntary

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[228] See Edmund T. Urban, *Future Advances and Title Insurance Coverage*, 15 Wake Forest L. Rev. 329, 346-51 (1979), for a discussion of title exceptions in connection with deeds in lieu of foreclosure.

conveyance from transfer taxes. The deed should specifically refer to the applicable statutory exemption.[229]

D. Compliance with State Statutes

In states that have enacted statutory provisions pertaining to deeds in lieu of foreclosure, title insurance coverage will depend, in part, on a showing of statutory compliance. For example, the Illinois Mortgage Foreclosure Act contains a provision covering deeds in lieu of foreclosure.[230] Under this provision, the borrower and the lender may agree to the termination of the borrower's interest in the mortgaged real estate after the borrower defaults. The lender's acceptance of the deed, which is subject to any other claims or liens affecting the real estate, relieves all persons liable for the debt, including guarantors, from personal liability.[231] However, the relief will not apply to the extent a person agrees not to be relieved in a contemporaneously executed instrument.[232] Consistent with existing Illinois case law, the statute provides that the acceptance by the lender of a deed in lieu of foreclosure will not merge the lender's interest as mortgagee and its interest in the fee title.[233] The statute also provides that merely tendering an executed deed by the mortgagor or recording a deed by the mortgagor to the mortgagee shall not constitute acceptance by the mortgagee of a deed in lieu of foreclosure.[234]

Iowa has a statutory provision expressly relating to deeds in lieu of foreclosure of agriculture land.[235] Under this provision, if the subject property is agricultural land used for farming, the lender and borrower may enter into an agreement in which the borrower agrees to transfer the agricultural land to the lender in satisfaction of all or part of the mortgage obligation. The agreement may grant the borrower a right to purchase the agricultural land for a period not to exceed five years, and may entitle the borrower to

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[229] In Illinois, the Real Estate Transfer Tax Act, Ill. Ann. Stat. ch. 120, para. 1004 (Smith-Hurd 1991), provides that, effective January 1, 1986, deeds issued by a sheriff pursuant to a mortgage foreclosure sale or deeds taken by the holder of the mortgage in lieu of foreclosure, are exempt from transfer taxes. This exemption should also apply to all county ordinances in Illinois levying transfer taxes because of the provision in the Counties Act, which states: "All deeds. . . exempted in Section 4 . . . shall also be exempt from any tax imposed [by a county] pursuant to this section." Ill. Ann. Stat. ch. 34, para. 5-1031 (Smith-Hurd 1992). *See also* Cal. Rev. & Tax Code § 11926 (West Supp. 1991); Iowa Code Ann. § 428A(18) (West 1990); Neb. Rev. Stat. § 76-902(7) (1990); Ohio Rev. Code Ann. § 319.54(F)(3)(m) (Anderson 1990); Pa. Stat. Ann. tit. 72, § 8102-C.3(10) (1990); Ohio Att'y Gen. 85-083 (1985). In the event of a conveyance of real property from the debtor to a creditor in accordance with an approved bankruptcy plan, § 1146(c) of the Bankruptcy Code provides that such a transfer may not be taxed under any law imposing a stamp tax or similar tax.

[230] Ill. Ann. Stat. ch. 110, para. 15-1401 (Smith-Hurd Supp. 1991).

[231] *Id.*

[232] *Id.*

[233] *See* cases cited *supra* note 195.

[234] Ill Ann. Stat. ch. 110, para. 15-1401 (Smith-Hurd Supp. 1991); *see also* Olney Trust Bank v. Pitts, 558 N.E.2d 398 (Ill. App. Ct. 1990) (mortgagee brought foreclosure action against wife's undivided one-half interest in property to which husband had granted mortgagee deed in lieu of foreclosure; court held that because § 15-1401 of Illinois Mortgage Foreclosure Law expressly provided for nonmerger, the mortgage debt was not satisfied or extinguished; mortgagee could properly foreclose on wife's one-half interest in the property, but he could not obtain a deficiency judgment against wife because she did not agree to be held personally liable).

[235] Iowa Code Ann. § 654.19 (West Supp. 1991).

lease the agricultural land.[236] The parties must record the agreement along with the deed transferring title to the lender.[237] This statutory provision specifically states that a transfer of title and the execution of an agreement pursuant to the statutory provision do not constitute an equitable mortgage.[238]

The Nebraska Constitution provides that a corporation or syndicate that acquires agricultural lands by process of law in the collection of debt or by any procedures for the enforcement of a lien or encumbrance must dispose of the property within five years after the acquisition date.[239] It is not clear whether the provision covers the acquisition of property by a corporation or syndicate through a deed in lieu of foreclosure. If the constitutional provision does not cover a deed in lieu acquisition, the Nebraska Attorney General may within two years bring an action to force divestiture of the land held by the corporation.[240] During the five-year period, the corporation may not use the property for farming or ranching purposes.[241] The corporation may only lease the property to a family farm or ranch corporation[242] or a nonsyndicate, noncorporate farm or ranch.[243]

IX. CLOSING THE TRANSACTION

To close a voluntary conveyance transaction, the lender should obtain or arrange for the following:

1. original executed copies of all leases and contracts affecting the property;
2. all prepaid rent and security deposits;
3. cancellation of all unwanted leases and contracts, if possible;
4. a written assignment from the borrower of all leases and contracts that the lender wishes to assume;
5. notification, immediately after closing, to all tenants of the change in ownership and their obligation to send all future rents, royalties, and the like, to the lender;
6. evidence that the borrower has paid for all utilities, taxes, rents, maintenance, and operating expenses through the date of delivery of the deed;

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[236] *Id*.
[237] *Id*.
[238] *Id*.
[239] Neb. Const. art. XII, § 8(1)(K) (1989).
[240] *Id*. at art. XII, § 8(1)(N).
[241] *Id*. at art. XII, § 8(1)(K).
[242] *Id*.
[243] *Id*.

7. a warranty bill of sale from the borrower covering all personal property and a warranty, special warranty, or quit claim deed from the borrower conveying title to the real property and all improvements;

8. a closing statement summarizing the transaction and the application of any proceeds and containing all information necessary to comply with § 6050J of the I.R.C.;

9. an IRS-approved affidavit indicating that each borrower is not a foreign person or entity, which exempts the borrower from the tax withholding requirements of § 1445;

10. evidence of the borrower's compliance with all reporting requirements under bulk sale transfer laws;

11. an affidavit from the borrower or language in the Settlement Agreement covering the following items: (1) any known defects in structures on the property, (2) governmental and regulatory approvals, including compliance with environmental requirements, disclosure of underground storage tanks, and the like, (3) all guaranties and warranties associated with the building(s) and personal property, and (4) disclosure of all persons having keys to the property conveyed;

12. an opinion letter from the borrower's attorney regarding execution and authorization of the closing documents and the validity and enforceability of the closing documents; and

13. a check of relevant state statutes for possible insertion of specialized clauses or statutory references in the Settlement Agreement, deed, or other documents regarding, for example, waivers of statutory rights of redemption, waivers of statutory rights of mediation or rights of first refusal to lease or purchase the property after conveyance, waivers of the right to contest foreclosure, and agreements to pay attorney's fees.[244]

X. CONCLUSION

A real estate mortgage lender should not accept an offer of a voluntary conveyance of mortgaged property from a borrower unless the lender is satisfied that:

1. any potential deficiency judgment would not likely have any current value or that its value would be less than taking a deed in lieu of foreclosure;

[244] For excellent discussions of deeds in lieu of foreclosure, as well as sample checklists and form documents, see Paul E. Roberts, *Deeds in Lieu of Foreclosure*, *in* 2 Modern Real Estate Transactions 1251 (ALI-ABA, 4th ed. 1983), and John D. Hastie, *Conveyances in Lieu of Foreclosure*, *in* Real Estate Defaults, Workouts, and Reorganizations 263 (ALI-ABA 1990).

2. no junior liens or encumbrances exist, unless the lender is willing to take title subject to any liens or encumbrances;

3. no unacceptable conditions exist in the offer, such as a reservation of possessory rights or a first right of refusal to repurchase, unless sufficiently limited to avoid the possibility that a court would construe the deed as a continuing security device or equitable mortgage;

4. the total expense of accepting the voluntary conveyance, not including cost of title insurance, would be less to the lender than the expense of foreclosing;

5. a substantial advantage will be gained by acquiring title with immediate possession, which saves time and expense that would be consumed during a normal foreclosure period;

6. the borrower has no equity in the property as determined by the lender's appraisal or, if necessary, an independent appraisal; and

7. a title insurance company will provide an owner's policy without exceptions for preferential transfer or fraudulent conveyance claims and without the "creditor's rights" exclusion or exceptions for equitable mortgage claims.

A deed in lieu of foreclosure is a complex legal transaction. Attorneys for both the lender and the borrower should carefully consider the practical, legal, and tax aspects of a deed in lieu of foreclosure. A voluntary conveyance may benefit either or both parties. Both sides of the transaction should carefully draft and document all phases of the conveyance to avoid unintended and undesirable legal and economic consequences.