

To Deed, Or Not To Deed (That is the Question): The Pros and Cons of a Deed in Lieu

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Amidst soaring interest rates and the recent swell in commercial real estate loan workouts, borrowers and lenders alike are increasingly considering an alternative to the traditional and sometimes long and cumbersome foreclosure process: a deed in lieu of foreclosure (often referred to as just a deed in lieu). A deed in lieu is a voluntary conveyance by the borrower to the lender, often in exchange for releasing the borrower and guarantor from all or some of their liability under the loan. Before engaging in a deed-in-lieu transaction, borrowers and lenders should consider the costs and benefits relative to a traditional foreclosure.

Borrower Advantages:

Time, Expenses, and Publicity Avoided: A deed in lieu may be appealing in circumstances in which the borrower no longer possesses equity in the property, does not anticipate a recovery within a reasonable amount of time, and/or is not interested in investing more equity in the property in consideration for a loan modification and extension. A speedier transfer of title may further benefit the borrower by relieving it of its obligation to continue funding the property's cash shortfalls to avoid triggering recourse liability (e.g., for waste or nonpayment of taxes and insurance). A deed in lieu can also be advantageous because the borrower can avoid incurring legal expenses and the negative publicity of a public foreclosure sale. A deed in lieu is relatively private (until the deed is recorded) and may appear to the public to be more like a voluntary conveyance of the property. A consensual resolution may also allow the borrower or its principal to preserve its relationship with the lender and its ability to raise capital in the future.

Release of Obligations: Typically, in consideration for facilitating a change in ownership, the borrower and guarantors are released in whole or in part from further payment and performance obligations arising after the conveyance. However, in the case of a carry guaranty, the borrower may have to satisfy a number of conditions for a deed in lieu, including paying transfer taxes and obtaining a clean environmental report, and the guarantors may have continuing obligations, including the responsibility for funding cash shortfalls to pay real estate taxes, maintenance, and other operating costs for an agreed period of time post transfer (referred to as a "tail"). Releases will often exclude environmental indemnities, which in many cases remain subject to their existing terms.

Borrower Disadvantages:

Loss in Ownership, Title, and Equity: The most obvious drawback of a deed in lieu is the loss of ownership, title, and equity in the property. A borrower will also lose any improvements that were done on the property, rental income, and other profits related to the property. However, these same consequences will inevitably occur if the lender were to foreclose on the property, but without any releases or other consideration obtained in the context of a deed in lieu.

Lender Dependent: Although a borrower may conclude that a deed in lieu is preferable to a traditional foreclosure, the availability of this option ultimately depends on the willingness of the lender. Voluntary consent of both parties is required. A lender may be reluctant to accept a deed in lieu if the property is not marketable in its present condition and may prefer foreclosure remedies instead in order to slow down the transfer of title. An alternative to taking title could be for a lender to seek the appointment of a receiver to operate the troubled property pending a possible sale to a third party. Furthermore, lenders may reject a deed in lieu and advocate for a “short sale” to a third party if they are not in the business of operating property or lack the requisite expertise to derive sufficient economic value, especially if the condition of the distressed property has deteriorated.

On the flip side, a lender may reject a deed in lieu if it can continue to receive a cash flow without assuming ownership of the property. If there are lock boxes or cash management agreements in place, a borrower will not be able to cutoff cash flow without triggering recourse liability. Therefore, the lender will continue to receive cash flow without having to assume the risks of fee title ownership.

Lenders may be more or less incentivized to agree to a deed in lieu depending on the loan type. For instance, lenders may be hesitant to take a deed in lieu and give up other remedies if the loan is a recourse loan, which would allow lenders to pursue both the loan collateral and the borrower’s other assets.

Tax Considerations:

Payment of Taxes: The transfer of a property by deed in lieu may be considered a taxable event resulting in a payment of transfer taxes. Laws governing transfer taxes and taxable events vary from state to state. Some states exempt transfers by a deed in lieu while others do not. In general, a borrower typically ends up paying any applicable transfer tax if not exempted or waived. Lenders can also condition the transaction on the borrower paying the transfer tax as the transferee.

In addition to transfer tax, a deed in lieu transaction can result in cancellation of debt (“COD”) income if a recourse loan is involved. When recourse debt is involved, the transaction will generally result in COD income and the transfer of property will be deemed a sale resulting in proceeds that are equal to the property’s FMV. If the debt exceeds the property’s FMV, the excess is considered COD income taxable as ordinary income unless an exclusion applies. In the case of non-recourse debt, there is typically no COD income since the “proceeds” of the deemed sale are equal to the outstanding debt balance rather than the property’s FMV. Instead, borrowers may recognize either a capital gain or loss depending on whether the outstanding debt balance exceeds the adjusted basis of the property.

Lender Advantages:

Ownership and Control of the Property and Rental Profits: One obvious advantage for a lender of a deed in lieu is that it is a quick and less disruptive way for the lender to obtain ownership and control of the property. By obtaining ownership and control more quickly, the lender may be able to maximize the property's economic value, use, and obtain all its income and avoid waste. If the property is leased to tenants, such as a shopping center or office building, the lender may be able to preserve any valuable leases and contracts with a more seamless transfer of ownership. Additionally, the lender will benefit from a recovery in the value of the property over time as opposed to an immediate sale at a more depressed value.

Time and Expenses Avoided: As with borrowers, a primary advantage of a deed in lieu for lenders is speed and efficiency. It allows a lender to take control of the collateral more quickly, without the significant time and legal expenses required to enforce its rights, especially in judicial foreclosure states or if a receiver needs to be appointed (at the lender's expense if cash flow is not sufficient). For instance, contested foreclosure proceedings in New York may take 18 months to 3 years (or longer), while a deed in lieu transaction can be completed in a fraction of this time and at a fraction of the cost. Time may be particularly important to the lender in a scenario in which property values are decreasing. The lender may prefer to obtain ownership quickly and focus on selling the property in a timely manner, rather than risk increased losses in the future during a prolonged foreclosure process.

Lender Disadvantages:

Subordinate Liens, Encumbrances, and Judgments: Unlike in a foreclosure action, subordinate liens are not extinguished when a lender acquires title by deed in lieu. Often, borrowers are not in a position due to their financial circumstances to remove items such as subordinate mechanic's liens and creditor judgments. In a deed in lieu, the lender will take title subject to such encumbrances.

Liabilities, Obligations, and Expenses: When the lender receives title to the property, the lender also assumes and becomes responsible for the property's liabilities, obligations, and expenses. Depending on state law, and the financial limitations of the borrower, the lender may also be responsible for paying transfer taxes.

Fear of Future Litigation: Another risk to the lender is that, in a bankruptcy action (or other litigation) filed subsequent to the deed in lieu, the borrower or its creditors may seek to set aside the transaction as a fraudulent or avoidable transfer by arguing, for example, that the lender received the deed for inadequate consideration at a time when the borrower was insolvent. The lender may be able to reduce the risk of the transaction being unwound by, among other things, encouraging the borrower to market the property for sale prior to closing on the deed in lieu transaction or obtaining an appraisal to establish that the mortgage debt exceeds the property's value and/or providing releases or other valuable consideration to the borrower, with a carveout for full recourse in the event of a future voluntary or collusive bankruptcy filing (to further reduce the risk of a future bankruptcy and avoidable transfer inquiry).

For these reasons, lenders and borrowers should consider a deed in lieu as an alternative to foreclosure or an immediate short sale that could benefit both parties and preserve value depending on the circumstances of a particular troubled property.

