

Averting foreclosure with a deed-in-lieu

by John Kelly

Given the present economic climate, it's no surprise many real estate developers are having difficulty paying back their lenders. The lender may agree to waive the existing defaults and restructure the loan by modifying the terms of the loan or adding additional collateral or the lender may instead proceed immediately to foreclosure. After conducting its distressed loan due diligence, however, the lender may determine that neither extreme is the right choice.

Restructuring the loan may be impractical given that economic circumstances make foreclosure inevitable, but the lender may want to avoid the expense and time needed to foreclose. This article discusses the compromise position where the borrower typically avoids foreclosure in exchange for the cancellation of the indebtedness. The key aspects of a deed-in-lieu transaction will be reviewed, with brief mention of related tax and bankruptcy issues.

The main advantage offered to both borrowers and lenders is that a deed-in-lieu avoids the cost, time and negative stigma of a drawn-out and contested foreclosure action. For lenders, they can quickly and efficiently take over the operation of the project and preserve existing leases and contracts. For borrowers, they can obtain a release of their personal liability.

This article discusses the compromise position where the borrower typically avoids foreclosure in exchange for the cancellation of the indebtedness.

To preserve the validity of the transfer of the property to lenders, it's very important that the conveyance was made voluntarily and for adequate consideration. Lenders will want to protect themselves from the borrower later arguing that they were subject to duress, undue pressure or fraud in an effort to overturn the transaction.

With regard to adequate consideration, the lender typically won't accept the conveyance unless the fair market value of the property is close to the amount of the indebtedness and the property can be obtained for less than the total cost of a foreclosure. To make clear the transfer was voluntary, the borrower should first submit a written offer to the lender offering to convey the property to the lender by outlining the terms and conditions of the offer.

The lender should in turn reply to the borrower's offer in writing, providing a list of conditions under which it will accept a deed-in-lieu. With respect to the adequacy of the consideration, the lender and borrower should self-servingly provide in an agreement that the current value of the property is equal to or less than the outstanding indebtedness. Lastly, as part of its due diligence, the lender should order an appraisal of the property, along with a title search and environmental study.

Usually, the agreement also would preserve the lender's first lien on the property. This gives the lender the right to later proceed with a regular foreclosure in order to wipe out any junior lien



KELLY

holders and clear title as needed. To preserve this right, the agreement should make clear the intent of the parties for the lien to remain separate even though the lender would then be the owner of the property as well as the holder of the mortgage lien. Another method of dealing with these anti-merger concerns is to have the lender take title to the property in a related entity.

Tax issues

A borrower considering the possibility of foreclosure or a deed-in-lieu of foreclosure should be aware these events can lead to income taxation of capital gain or cancellation of indebtedness income. The tax results depend in large part on whether the loan is a "recourse" loan or a "nonrecourse" loan. A nonrecourse loan is one where the lender's sole option for recovering on the loan is to take back the property. If the lender can pursue the borrower personally for any shortfall by obtaining a deficiency judgment, then it is a recourse loan.

In the case of a nonrecourse loan, the conveyance is taxed as if it were sold for the greater of the outstanding debt or the sales price. The nature of the gain and the deductibility of any loss depend on the holding period and the nature of the property.

In the case of a recourse loan, in addition to the potential income and gain resulting from the sale for value, there also may be cancellation of indebtedness income if the debt exceeds the value of the property. Cancellation of indebtedness income is taxed at ordinary income rates, but there are several temporary exceptions.

For example, you can exclude cancellation of indebtedness income if the debt is discharged in bankruptcy, to the extent the borrower is insolvent or in certain situations related to qualified real property business indebtedness. Note that the exception for real property business indebtedness is generally available for rental real estate and other income-producing property, but typically is not available for property held for sale such as a residential development.

Lastly, note for noncommercial properties, the Mortgage Debt Relief Act of 2007 generally allows taxpayers to exclude income from the discharge of debt on their principal residence.

Bankruptcy issues

If afterward the borrower files for bankruptcy, then in certain circumstances the conveyance of the property back to the lender could be disallowed. The two main issues to be concerned about with respect to bankruptcy after a deed-in-lieu are preferential transfers and fraudulent conveyances.

Section 548 of the Bankruptcy Code provides fraudulent conveyances may be set aside if made within the statutorily proscribed timeframes. To be deemed fraudulent, a transfer must be made for less than the reasonable equivalent value and if the borrower meets certain tests of insolvency.

Under Section 547 of the Bankruptcy Code, preferential transfers

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within 90 days of the date of bankruptcy filing may be set aside. Further, preferential transfers from insiders who had reasonable cause to believe the debtor was insolvent may be set aside if it is made between 90 days and one year prior to the date of filing of the bankruptcy petition.

A preferential transfer is a transfer from an insolvent debtor that's made for the benefit of a creditor, providing the creditor to receive more than it would have received in a Chapter 7 liquidation if the transfer hadn't been made. To prevent the transfer from being voided by the bankruptcy trustee, the lender must show the lender didn't receive more than it would have been entitled to under a Chapter 7 liquidation because the fair market value of the property conveyed is less than the outstanding indebtedness owed to the lender.

For a detailed analysis of your situation, do not hesitate to contact the author.

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