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Zombie Loans Raise Hurdles For Deed-in-lieu Transactions

In an earlier article, we examined certain equitable defenses that borrowers may avail themselves of when fighting a lender's enforcement of remedies.¹ These equitable defenses, we posited, were more likely to be made when a lender pursued a foreclosure action in reliance on a non-monetary default as opposed to plainly objective payment defaults. While recognizing that lenders would be better positioned in a litigation if they waited for a payment or maturity default, some lenders, we noted, would be unwilling to sit by, unable to take control of a troubled property while waiting for a monetary default which may take months or years to occur in some cases. This unique aspect of the current crisis and the prevalence of loans that are objectively bad but not yet in payment default has yielded a new, widely used term, "zombie loans." This article will explore the use of deed-in-lieu transactions as a method of dealing with zombie loans as well as the possible hurdles a lender may face when choosing a seemingly logical remedy to take control of a troubled property.

Zombie loans have dominated recent discussions in both real estate finance industry journals and conferences alike. The term refers to mortgage loans that while generally considered performing, since the property cash flow or other reserves cover the cost of operating the property and the payment of debt service, are in fact destined for default at a foreseeable later date when, at maturity, the debt service reserve runs dry or the property owner will be unable to refinance the impending balloon payment due to tightening credit standards and depressed real estate values. In the



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event the property securing the zombie loan is supported by good tenants and is otherwise decent asset quality, one school of thought suggests that the maturity date on such loan should simply be extended until the credit crisis resolves and the loan can be properly refinanced. On the other hand, a loan that is being kept afloat by

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large interest reserves (providing longer-lasting debt service coverage, perhaps, due to historically low interest rates) or is secured by a property that is otherwise troubled may better be dealt with on a more immediate basis, even prior to the occurrence of an actual default.

One suggested resolution for these zombie loans is the deed-in-lieu of foreclosure, a transaction in which the parties to a mortgage loan forego the time and expense of foreclosure litigation by having the mortgagor transfer title directly to the mortgagee or mortgagee's designee

in satisfaction of the mortgage debt. Mortgage borrowers and their principals normally receive additional inducement to complete the so-called "deed-in-lieu" in the form of a release from guaranty obligations. The deed-in-lieu is generally considered a positive resolution to a troubled mortgage transaction and has been looked upon favorably by courts from a public policy perspective as it reduces the use of already scarce judicial resources.

Subsequent equitable attacks on a deed-in-lieu, whereby a borrower asserts some sort of fraud, duress or unfair bargaining power claim, rarely carry much weight in the commercial context where the interested parties enter into a consensual agreement, are represented by counsel, are savvy to the relevant business issues, and normally receive the additional consideration of releases from guaranties and the like. Furthermore, any such defenses may generally be dispensed with by examining the totality of the circumstances and demonstrating that the mortgagee's taking of title was all but inevitable whether by deed-in-lieu or a more lengthy foreclosure effort. Presumably, any mortgagor that reasonably believed there to be any equity remaining in its asset would protect its interest at nearly any cost and would consequently refuse entering into a deed-in-lieu to obtain the lender's release of the borrower, thereby defeating such equitable defense. The more common equitable defense lies in a common law doctrine having its origins in 17th century English common law, the equity of redemption.

The spectre of the equity of redemption in the context of a deed-in-lieu transaction has largely been the dominion of academic scholars. Commentators and courts have examined the timing of a deed-in-lieu as it relates to the original mortgage transaction in order to determine whether the deed was

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essentially given to the lender in escrow at the time of closing (impermissible)² or as part of a subsequent separate transaction after the occurrence of an event of default (acceptable).³ Secondly, questions of independent and adequate consideration must be considered since courts cannot rely alone on an argument that *but for* the mortgagor's agreement to give a deed-in-lieu, the mortgagee could have proceeded to foreclosure at once.

In response to concerns about consideration, lenders must undertake a well documented evaluation of the property's value, including complete property financial reports and appraisals of the property, demonstrating that the amount of debt being forgiven by the lender as a condition of the deed-in-lieu is in excess (often by considerable amounts) of the property's current value. Several commentators have also recommended that mortgagees condition a deed-in-lieu transaction on the mortgagor's delivery of an "anti-clogging affidavit" executed by the mortgagor and affirming such party's understanding that the arrangement will not clog the equity of redemption.⁴ The affidavit should address the sophistication of the parties, that the borrower was adequately represented by counsel, the voluntariness of the transaction and lack of duress, and that the borrower received independent, fair and bargained-for consideration. Title companies requested to insure a deed-in-lieu transaction may request additional certifications as well.

The review of these equitable concerns gets somewhat more complicated in the context of a deed-in-lieu given in connection with a zombie loan that is, by definition, not yet in default. While the financial inquiry detailed above made at the time of the deed-in-lieu transaction may show the loss of all borrower equity in a property, there is no way to properly value the property in the future when the default of the zombie loan in question is ultimately expected to occur. Furthermore, in the bankruptcy context, other creditors may be able to assert that the deed-in-lieu constituted a fraudulent transfer subject to attack under Section 548 of the Bankruptcy Code and any applicable state law. We acknowledge that the advent of special purpose covenants limiting a mortgage borrower's permitted indebtedness should mitigate the ultimate risk of attack in bankruptcy, however, current events suggest that bankruptcy-remote does not translate to bankruptcy-proof and there still exists some concern of other creditors asserting claims in a borrower bankruptcy.

Other than a properly completed foreclosure under applicable state law (whether judicial or non-judicial

foreclosure), the U.S. Supreme Court concluded in the case of *BFP v. Resolution Trust Corporation*⁵ that any conveyance of real property may be reviewed to determine whether a fraudulent transfer has occurred. Bankruptcy courts have held, notably in *In re Main*,⁶ that an evidentiary hearing would be required to determine whether Chapter 11 debtors received reasonably equivalent value at the time they transferred any real property subject to a mortgage or deed of trust in satisfaction of indebtedness due and owing by them to the holder of such mortgage or deed of trust, for the purpose of determining whether the deed-in-lieu transfer was fraudulent. In the case of determining whether a borrower under a zombie loan completed a deed-in-lieu for reasonable equivalent value, however, the question is whether the court should examine the value exchanged at the time

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of the deed-in-lieu transaction or rather at the time of the future default, when foreclosure was all but inevitable. Without strong if any relevant case law regarding the unique issues raised by zombie loans, counsel for lenders planning to take a deed-in-lieu as a resolution for such a loan must guide their clients carefully through the equitable risks.

In reality, not all zombie loans are equally problematic in the context of determining whether reasonably equivalent value was exchanged in connection with a deed-in-lieu. For instance, an argument that the anticipatory determination of value was ultimately prejudicial to other creditors and therefore constitutes a fraudulent transfer will have less strength if the anticipated maturity date is only one or two quarters in the future. However, a creditor may argue that it was prejudiced when a borrower waived its right to extend maturity pursuant to an extension option whether or not the extension required payment of a fee by the borrower. While one may reasonably determine that capital markets and property valuations will not change in the immediate future, longer range predictions are more questionable.

Furthermore, simply because there is no equity remaining in the property at the time a borrower under a zombie

loan offers up a deed-in-lieu may not be sufficient to protect the transaction from attack in bankruptcy. Prior to accepting a deed of lieu in anticipation of a loan default in the future, lenders should look to current financial reporting provided by borrowers to determine whether a key tenant's decision to vacate the property or other property conditions will ultimately support the loss of all borrower equity both at the time of determination and in the future.

We note that while mezzanine loans are distinct from traditional mortgage loans, they do share certain characteristics such as ultimately looking to real property as collateral. Acknowledging the lack of relevant case law on point, lenders should be wary of courts sitting in equity that may deem a mezzanine loan an equitable mortgage or hold that a mezzanine borrower is entitled to the same equitable rights as mortgagor. Cautious lenders negotiating the equivalent of a deed-in-lieu of a mezzanine loan should head the same cautions and follow the same procedures as if the mezzanine loan were a mortgage loan. Thus, if a court draws the parallel between mezzanine loans and mortgage loans, the lender will be able to point to the default to show that there was no clog on the equity of redemption.

Deeds in lieu offer a valuable tool in dealing with troubled mortgage loans. In most contexts, the consensual nature of the transaction coupled with the dire economic realities that push a borrower into such a resolution will normally provide solid protection from later equitable attacks. Still, in light of current conditions and the diversion of market realities from the context in which deeds in lieu were previously examined by courts, lenders should be cautious before accepting a deed-in-lieu on a zombie loan that has not yet been called in default.

1. Jeffrey B. Steiner and Jason R. Goldstein, "Dealing with Equitable Defenses to Foreclosure," NYLJ, March 18, 2009.

2. *Kirby v. Tricker*, 265 AD 149 (N.Y. App. Div. 1942).

3. *Verity v. Metropolis Land Co.*, 248 AD 748 (N.Y. App. Div. 1936).

4. John C. Murray provides an example of an anti-clogging affidavit from in the appendix of his article, "Clogging Revisited," 33 REAL PROP. PROP. & TR. J. 279 (1998-1999).

5. *BFP v. Resolution Trust Co.*, 511 U.S. 331 (1994).

6. *Main v. Brim (In re. Main)*, 75 B.R. 322 (Bankr. D. Az. 1987).