DEED IN LIEU OF FORECLOSURE –
SAFE TO GO IN THE WATER?

By: Bruce J. Bergman*

Pardoning the mixed metaphor of the title, readers may be aware that the Home Equity Theft Prevention Act[1] (the "Act") created serious questions about the viability of a deed in lieu as a settlement methodology in mortgage foreclosure cases. But then comes a May 10, 2011 advise of the State of New York Banking Department which opines that the act does not apply to the deed in lieu – but, it must be given to the holder of a defaulted mortgage who would otherwise have been entitled to foreclose and the value of the property must be less than the mortgage.

While this may appear on the surface to dispose of the disquietude about the Act encompassing the deed in lieu, concern still lurks.

If the Act really creates no issues for the deed in lieu, then the Banking Department could have stated in clear, unconditional, unequivocal terms that the Home Equity Theft Prevention Act was not intended to and does not apply to a deed in lieu of foreclosure. But it does not say that. Rather, it *qualifies* the exemption -- in two ways. It is akin to the old saw about being a little bit pregnant. Either you are or you are not. Here they say the Act does not apply to

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* Bruce J. Bergman, a partner with Berkman, Henoch, Peterson, Peddy & Fenchel, P.C. of Garden City, is the author of "Bergman on New York Mortgage Foreclosures" (three vols., LexisNexis Matthew Bender, rev. 2011).

a deed in lieu – but it might in some situations. How then can it be concluded that the Act does not apply to the deed in lieu? The lamentable fact is that it cannot.

That noted, while as a matter of law the view here is that the dilemma is not resolved, as a practical matter it may be.

The Problem of the Act

The Act was patently addressed to protecting distressed borrowers from scam artists who would take their property through schemes. This should not be seen as applicable to a lender holding the mortgage in default, but such is not determinable from reading the words of the statute. Among other things, the Act imposes extensive contractual requirements via RPL §265-a upon the sale of a one-to-four family, owner-occupied residence from a person either in default upon his mortgage or in foreclosure.[2] The immediate problem is that a deed in lieu is *precisely* a conveyance from such a person. The breadth of the contractual mandates and prohibitions is substantial and includes a five-day right of cancellation.

Of equal or perhaps greater significance, RPL §265-a(8)(a) and (b) provide that where there is a material violation of subdivisions three, four, six, seven and eleven of section 265-1, the transaction is voidable and may be rescinded by the seller within two years of recording the conveyance.

As a practical matter, deeds in lieu of foreclosure – certainly in the usual residential situation -- are seldom the subject of a formal contract. Unlike a commercial case which would often elicit a contract, discussions and letters usually suffice. Therefore, the very need for a contract is an atypical event arising from the Act.

The impetus for the Act[3] could lead to the thought that it was not intended to apply to a deed in lieu of foreclosure, directed instead to the goal of avoiding third party scam artists from fleecing unwary homeowners out of the equity in their homes. But among the exceptions delineated in the Act, none recites the mortgagee as a purchaser.[4] While a deed from a referee in the foreclosure action is specifically mentioned, as is a sale by court order, there is no reference to the deed in lieu of foreclosure. Even the notable exception for a bona fide purchaser for value may offer no comfort because of certain language specific to the unusual circumstances the Act seeks to bar. [5]

But then there is RPL§265-a(14) which may hint of deed in lieu exemption from the Act. It provides that:

> This section shall not apply to a prior lien holder where the lien was properly recorded prior to the execution of any covered contract by both the equity seller and the equity purchaser nor shall any

> provision of this section be deemed to impair any equity or other available rights of any such prior lien holder.

The language is tantalizing, albeit oddly ambiguous. If it meant to address a mortgagee, why not say so, clearly? Then too, this subsection still refers to execution of the covered contract, antithetical to the notion that a deed-in-lieu need not comply. It might therefore seem bold for a title company to insure a residential deed in lieu in reliance upon this dubious statutory recitation – and without title insurance, a deed in lieu is not recommended.

It is self-evident that the branches of the Act – primarily for RPL§265-a – create in the residential case both burdens and perils. Counsel would be unable to definitely opine that the act does not apply to a deed in lieu of foreclosure. Given that uncertainty, whether a mortgage holder would or should exchange the relative assurance of a foreclosure sale at the conclusion of a foreclosure action for the now arduous and possibly dangerous deed in lieu of foreclosure is pointedly problematic. All could then hope for rescue by the Banking Department opinion.

<u>The Banking Department Opinion</u>

The opinion finds interpretations of the Act expressing concerns about inclusion of the deed in lieu to be "misguided". Such a view would actually be

welcome because imposing the Act's mandates upon a deed in lieu helps neither lenders nor borrowers. But the opinion presents its own problems.

-- INTENT

First, it emphasizes legislative intent for the proposition that the Act was not directed to the deed in lieu. Given the goal of thwarting scammers who prey upon borrowers in distress, it would indeed seem that the Act did not mean to impose its mandates upon a deed in lieu. However, as earlier mentioned, while the drafters delineated specific exclusions from the Act, a deed in lieu was not among them. This then is strongly suggestive that the legislature *did* intend to include the deed in lieu with the dictates of the Act. The only other alternative to contemplate is careless draftsmanship by the solons which, while possible, does not support the argument that legislative intent was to exempt the deed in lieu.

-- ISSUE OF PROPERTY VALUE

Then there is the qualification in the opinion to exclude the deed in lieu "…so long as… the current market value of the home is less than the amount owning under the mortgage." If the Act should not be interpreted to apply to a deed in lieu of foreclosure, the Banking Department has just *in*cluded it in the event the property is worth more than the sum due on the mortgage. And would that apply even if the equity above the mortgage was small, or *de minimus*? The question could be asked, how should a lender (and its title insurer) find assurance in the putative non-relationship of the Act to the deed in lieu if the

State opines that it *does* apply when the mortgage is less than the property value?

-- ISSUE OF MERGER AVOIDANCE

Finally, the opinion declares that the Act “does not apply to deed in lieu given to the holder of a defaulted mortgage who otherwise would be entitled to the remedy of a foreclosure.”[6] The exigent point in this regard is that the foreclosing party only very seldom would take a deed in lieu in its own name. The reason is to avoid merger of the mortgage into the fee.

The doctrine of merger provides that where legal title to both the property and the mortgage become vested in the same owner, the lesser ownership interest is merged into the greater.[7] Therefore if a foreclosing lender is the grantee of the mortgaged property – the result of accepting a deed in lieu of foreclosure – the mortgage is extinguished.

In turn, there are compelling reasons to avoid mortgage extinguishment elicited by merger. For example, there may be a need to pursue guarantors for the deficiency, available only if the action proceeds to sale. Then too, notwithstanding what a foreclosure or title search might present, there could be interests in the mortgaged property which were missed. Disposing of those would necessitate a viable foreclosure action which would of course evaporate if the mortgage merges into the fee.

While one method to avoid merger is to insert appropriate language in the deed itself,[8] a more common (and likely comfortable) approach is to take title in the name of a nominee, typically a limited liability company or corporation created for that purpose.

In sum on this point, if foreclosing lenders most often take a deed in lieu in the name of some other entity, whether the Banking Department opinion assures exclusion of the deed in lieu is not certain.

Real World Concerns

Another message of the opinion presented in support of its posture is the absence of case law construing deeds in lieu as encompassed by the Act. While this is true – borrowers would most often have no reason to undo a deed in lieu conveyance – the observation is not dispositive of the legal question. And lest it be assumed that a deed in lieu is otherwise exempt from successful assault, case law demonstrates to the contrary.[9]

Where a borrower might seek the prosecution of the Act to set aside a deed in lieu, it can be noted that recent legislation dedicated to protecting borrowers has been very strictly construed in the favor of borrowers. Courts have taken this mission quite seriously. So, if the choice is to include the deed in lieu under the borrower friendly protections of the Act where its exclusion is

hardly certain, it would seem prudent to predict inclusion. And welcome though the Banking Department opinion purporting to state the contrary may be, it is not law.

The Practical Conclusion

Given the actual language of the Act it is at least difficult for any counsel to opine that it cannot control a deed in lieu. Mindful too of the qualifications that diminish the force of the Banking Department opinion, it is likewise difficult to conclude that the quandary is disposed of.

As a matter of law, therefore, this remains an open issue. But is that meaningful? Probably not so often. Attorneys for foreclosing lenders will counsel the purchase of title insurance for any deed in lieu of foreclosure. Insofar as title insurers will insure a deed in lieu based upon ameliorative affidavits addressed to the strictures of the Act, then the grantee has substantial protection from danger. The possible peril itself exists, but where the insulation of title insurance prevails, the issue may become more of an intellectual exercise than a practical concern.

1. Effective February, 2007

2. Pursuant to RPL §265-a(2)(d), a default is said to exist if a person (an equity seller) is two months or more behind in his mortgage payments. As defined in RPL §265-a(2)(g), “foreclosure” is an active lis pendens filed “in court” pursuant to RPAPL Article 13 (although the notice of pendency is more a creature of CPLR Article 65) against the subject property – or the property is on an active tax lien sale list.

3. See RPAPL §265-a(1)(a), (b), (c) and (d).

4. Excluded by RPAPL §265-a(2)(e)(i) through (viii) from the definition of an equity purchaser “is a person who acquires title:

(i) to use, and who uses, such property as his or her primary residence;

(ii) by a deed from a referee in a foreclosure sale conducted pursuant to article thirteen of the real property actions and proceedings law;

(iii) at any sale of property authorized by statute;

(iv) by order or judgment of any court;

(v) from a spouse, or from a parent, grandparent, child, grandchild or sibling of such person or such person’s spouse;

(vi) as a not-for-profit housing organization or as a public housing agency; or

(vii) a bona fide purchaser or encumbrancer for value."

5. RPL §265-a(2)(a): "Bona fide purchaser or encumbrancer for value" means anyone acting in good faith who purchases the residential real property from the equity purchaser for valuable consideration or provides the equity purchaser with a mortgage or provides a subsequent bona fide purchaser with a mortgage, provided that he or she had no notice of the equity seller's continuing right to, or equity in, the property prior to the acquisition of title or encumbrance, or of any violation of this section by the equity purchaser as related to the subject property.

6. Earlier in the opinion the citation of the mortgage holder is expanded to include "any agent of such person". That is helpful, but does not confirm that a nominee or subsidiary corporation (the usual grantees of deeds in lieu of foreclosure) are to be defined as agents.

7. *Cambridge Factors, Inc. v. Thompson*, 215 A.D.2d 427, 626 N.Y.S.2d 2359 (2d Dept. 1995), *Erhal Holding Corp. v. Nobile,* N.Y.L.J., July 25, 1994, at 30 col. 3 (Sup. Ct. Westchester Co.,

Lefkowitz, J.); *200 E. 64th St. Corp. v. Manley* 44A.D.2d 11, 352 N.Y.S.2d 694 (3d Dept. 1974), *aff'd*, 37 N.Y.2d 744, 374 N.Y.S.2d 621 (1975); *Whitestone Sav. & Loan Ass'n v. Allstate Ins. Co.,* 28 N.Y.2d 332, 321 N.Y.S.2d 862, 270 N.E.2d 694 (1971). For an extensive discussion with citation see 2 *Bergman on New York Mortgage Foreclosures* §25.06, LexisNexis Matthew Bender (rev. 2011).

8. See discussion at 2 *Bergman on New York Mortgage Foreclosures* §25.06[3], LexisNexis Matthew Bender (rev. 2011).

9. See in particular *Garan v. People*, 259 A.D.2d 313, 686 N.Y.S.2d 419 (1st Dept. 19990. See also discussion and cases at 2 *Bergman on New York Mortgage Foreclosures* §26.02[2] and [3][a], LexisNexis Matthew Bender (rev. 2011).

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