Fall 2009

Bad Timing For Deeds In Lieu

Roger Bernhardt
Golden Gate University School of Law, rbernhardt@ggu.edu

Bad Timing For Deeds In Lieu

by Professor Roger Bernhardt*

A recent decision made me think that it was time to write about what I think are some misapprehensions about the effectiveness of deeds in lieu of foreclosure. In *Hendrickson v JGR Properties Inc.* 2008 WL 5053440, Ohio Court of Appeals, December 2008), JRG acquired property on March 30, and on April 3, it gave Hendrickson a note, a mortgage (probably a junior), and a warranty deed to that property, which Hendrickson recorded on February 23, 2007, when JGR defaulted on Hendrickson's loan.

In subsequent litigation, JRG sought to set aside the warranty deed and Hendrickson sought to foreclose the mortgage. The trial court held the warranty deed invalid as prejudicing JGR's right of redemption, but left the mortgage intact, a decision which the Court of Appeal affirmed.

That much of the decision is perfectly logical and should be widely accepted. A deed covering the same property that was made security for a mortgage, and given at the same time that the loan is made and the mortgage was taken is always invalid. The contemporaneous deed in lieu never works. (Although this lender apparently did not know about that rule, since it went ahead and labeled the document "Agreement Deed Held By Lender For Security," more or less inviting any observer to recognize the deed as being something other than a real deed.)

It is elementary law that when a lender holds a mortgage as security for its loan, on default it has to foreclose on that mortgage if it wants to realize on the security. The equity of redemption, i.e., the right of a debtor to pay late, can be cut off only by going through a proper ("foreclosure") procedure, a requirement that the system has had for some 500 years. Even though the transaction may have been drafted as some kind of conditional fee, a mortgagee cannot just take the debtor's property on the instant that a default has occurred.

It did not take the chancellors, who first created this right, long to realize that creditors disliked that mandatory delay requirement and would require their necessitous borrowers to waive it as a condition to getting a loan. It is therefore hardly surprising that the chancellors quickly came up with a companion rule prohibiting lenders from drafting around the foreclosure requirement—the rule against clogging—making it a necessary counterpart to the equity of redemption.

A deed absolute given by the mortgagor at the same time and as a companion to a mortgage is always invalid as a clog on redemption. If it were allowed to operate as stated, it would allow the lender to record the deed on default and immediately claim the property, without the inconvenience of a redemption period or foreclosure or sale beforehand. That is why the courts will always declare the contemporaneous deed in lieu unenforceable.

But the situation is not always that simple. In Hendrickson case the creditor argued that the court should follow another decision it had earlier rendered ("Gormas") which had upheld a deed in lieu of foreclosure that had been given by a mortgagor *after* the mortgage had been given. (In *Hendrickson*, the deed had been delivered a week after the mortgagor grantor had acquired the title, but on the same day that it borrowed the money and signed the mortgage.) The timing, argued the creditor, changed the analysis.

It is true that the rule for contemporaneously executed deeds in lieu of foreclosure is not automatically applied to deeds in lieu that are executed subsequently to the execution of the mortgage. Two reasons are often given for making this distinction.

One explanation is that the presumption that the borrower is necessitous applies only at the time of inception of the loan—when the borrower is too desperate as to sign anything, and not thereafter. This reasoning is not in fact very persuasive, since borrowers who cannot keep up their already existing loans are probably far more threatened and prepared to cooperate concede to demands, as the recent foreclosure rescue scammers well know.

The other reason is better. A deed absolute executed by a mortgagor subsequent to the original execution of the mortgage might merely be the mechanism for completing a true conveyance of the property; a step that an owner of property is entitled to take even though his or her title is subject to a mortgage. If the mortgagor is free to sell mortgaged property to a third person, there is no special reason why she should not be equally free to sell it to the mortgagee. Sale of the equity by the mortgagor to the mortgagee should be no more invalid than a sale to a stranger; that the purchaser is the lender might make a court watchful of the transaction but would not lead to automatic invalidation, as is the case for the contemporaneous deed in lieu (which would never be intended to function as a true sale). So a deed in lieu that is given after the mortgage has already been executed may be enforceable notwithstanding that one given at the same time as the mortgage is not.

The Court of Appeal in Hendrickson was unwilling to rely on its earlier Gormas decision that had validated a subsequent deed in lieu, because it was clear there whether or not that subsequent deed had been given to a new third-party lender who was coming into the picture to bail the mortgagor out on an existing defaulted loan or given to the original lender who was just engaging in some workout refinancing.

That thinking is dangerous, although more common than it should be in many cases. A subsequent deed in lieu is not always valid just because it was not contemporaneous (and its validity should certainly not depend on whether the grantee was the original mortgagee or a different third party).

It is true that there is distinction between a contemporaneous and a subsequent deed in lieu of foreclosure and that the former (contemporaneous) is always bad. But it should not be true that, conversely, the deed in lieu given subsequent to the execution of the initial mortgage is therefore always good. There are two different kinds of subsequent deed in lieu transactions and they must be treated differently.

When a borrower who is hopelessly underwater executes a deed to the property to its lender in order to avoid foreclosure, and both sides appreciate that the deal is over, the loan is gone, and that they are walking away from each other, then that deed ought to be as valid as any other deed executed by an owner, even though it has been delivered to the former mortgagee of the property. That is a true sale. Some court intimate that the transaction has to be extra fair to be upheld, but that is not really good conveyancing law; a lender purchasing the property of its former borrower ought to be as free as anyone else to bargain for a good price or good terms, and the transaction should be set aside only on the same sort of grounds as would upset a purchase by an outside.

What needs be scrutinized closely where the grantee is the former lender is not the terms of the purchase but whether it really is a *purchase* that is occurring, rather than merely a refinancing and/or extending of the old loan relationship. A true sale of the property—whether to the lender or to a third party—means that the property is not the owner's anymore (and the previous mortgage relationship is by definition, over). A refinancing of the old loan means that the property does still belong to the same old owner.

In its earlier Gormas decision, the Ohio court had noted that the new money that was given to the owners was paid not to acquire their title but to give them more time to pay off their debts. That transaction was not a sale of their property, such as described in the previous paragraph; the former owners remained as current owners of the property. They did not say to themselves "now we no longer own that property," rather they said "we can still keep that property if we can later on pay off this new debt." That describes a mortgage rather than a sale. That deed the owners gave in return for that money was not intended to transfer their title away but merely to secure another obligation imposed against their continued title. Whether the money came from the old lender or from a new one made no difference; the subsequent deed was not a deed but a mortgage device, regardless of who it named as grantee.

While a contemporaneous deed in lieu can be said to always be automatically invalid, the question to be asked of a subsequent deed in lieu is not so much whether it is valid or invalid, but rather, if valid then valid as what? A subsequent deed in lieu truly given to transfer title to the lender and end the mortgage relationship should be valid as a deed (even if the terms are harsh, so long as there is no fraud). But if the instrument is given instead as a vehicle to allow the mortgagor hold on the land a little longer, in return the mortgagee having an easier time in taking it away from her later on, then its validity—if any—is as a mortgage, not a deed.

An executory or conditionally effective deed in lieu of foreclosure—one that is to be recorded or otherwise take effect only at a later time if the mortgagor fails to properly perform some obligation - is just another form of mortgage, a mortgage on the equity of redemption, whose terms would permit the mortgagee to take the property without having to go through a foreclosure and sale.

continued on page 15

Bad Timing For Deeds In Lieu

continued from page 5

The distinction between a deed in lieu intended to function as a deed and one intended to function as a mortgage is often slippery. It was easy enough to recognize in a situation like Hendrickson, where the agreement explicitly provided that the deed be recorded only if there was a later default. But was it the "later" or the "default" feature that mattered most? When a deed is delivered into escrow with instructions to be recorded in 30 days, with no further explanation, was it intended to give the owner 30 days to pack his belongings to get out (a true conveyance), or was it intended to give him 30 more days to solve his problems (like a mortgage extension)? Will the outcome depend on what each party recollects saying to the other about those matters? If there is no conditional language in the original escrow instructions but the grantor has some kind of option to stay in possession or to repurchase, what is it?

And when a court decides that the document really is a mortgage rather than a conveyance, what is the consequence of that determination? Is the instrument now invalid, even if it was executed under superfair conditions? But if it is valid, can it operate as a mortgage that does not have to be foreclosed? And if, as a mortgage, it has to be foreclosed, it contains no power of sale clause (it would not dare to include one), so any foreclosure would have to be judicial. Or can the mortgagee ignore this "junior" mortgage instrument and exercise its remedies against its original mortgage or deed of trust, exercising the power of sale clause it contains? (Hendrickson seems to have been trying to do something like that.) Or has the deed in lieu somehow displaced or replaced the original? And if the best result of having this deed in lieu comes from ignoring it, what was gained by demanding it in the first place?

A deed in lieu perhaps works if the borrower quietly disappears after defaulting. But if he or she stays to make trouble, the lender holding that deed may regret that it ever got what it asked for. ◆

**Roger Bernhardt is a Professor of Law at Golden Gate University in San Francisco and Editor of CEB's California Real Property Law Reporter.*