Deed in a Box: An Advantageous Loan Workout Method in the Time of the COVID-19 Pandemic

Introduction

Most real estate attorneys would typically be dismissive of a transaction that places a deed in escrow as collateral for a loan. This is because it is universally known that any loan term that interferes with a borrower's equity of redemption will be considered unenforceable. However, despite a centuries old common law rule that borrowers cannot bargain away their right of redemption, the deed-in-a-box transaction can be a mutually beneficial and effective loan workout method, especially in the age of COVID-19.

Brief History of the Equity of Redemption

The concept of an equitable right of redemption originated in the English Courts of Equity. It is the basic principle that a borrower shall have the right to redeem its mortgaged property after a default, at any time up until foreclosure, and in some cases even after a foreclosure has occurred, for the amount of the indebtedness. Any provision in loan documentation that is deemed to "clog" a borrower's right of redemption may be considered to be unenforceable. A clog can take the form of any remedy that gives a lender a collateral advantage, such as an option to purchase, a deed, or a grant of equity that prevents the borrower from being able to reclaim the property prior to a foreclosure proceeding.

Courts have traditionally held that the lender's ability to record a deed delivered in escrow impedes a borrower's equitable right of redemption thereby making such a deed unenforceable.

How, then, have deeds in escrow become a valid and enforceable (in some instances) workout method for distressed loans?

Some courts have held that a deed delivered in escrow in connection with a workout of a distressed loan is enforceable. However, there are several factors that a court would consider before affirming the enforceability of such a "deed-in-a-box" transaction.

What is a Deed-In-a-Box Transaction?

When a borrower defaults on its loan payments the lender is faced with the decision of whether to, among other options, institute a foreclosure proceeding or engage with the borrower in a loan workout. During an economic crisis, such as the current crisis precipitated by COVID-19, the market value of real estate collateral may not be sufficient to cover the entire outstanding balance of the loan. Therefore lenders, particularly non-recourse lenders, may be incentivized to forbear from the exercise of their foreclosure remedy.

If a lender chooses to enter into a workout negotiation with its defaulting borrower, then the lender has a variety of structuring options, and among those options is the deed-in-a-box transaction. In a typical deed-in-a-box transaction a borrower voluntarily places a deed to the mortgaged property in escrow (i.e., in a box) and the lender's consideration for such deed in escrow is its agreement to forbear from exercising its remedies under the loan documents for a certain period of time subject to borrower's compliance with certain terms and conditions set forth in a forbearance agreement. Upon a default by the borrower during the agreed upon forbearance period, the lender has the right to record the deed and take title to the mortgaged property.

While this method might sound like an unenforceable clog on the borrower's right of redemption, there are several important factors that distinguish a deed-in-a-box utilized in a loan workout from the unenforceable deed placed in escrow at loan origination.

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What Factors Are Important?

Both statute and public policy dictate that a borrower may not be compelled to deliver a deed in escrow as collateral for the origination of a loan. This is meant to prevent a lender from denying a borrower its right to reclaim its mortgaged property following a default if the borrower is able to do so prior to lender's exercise of its remedies (or, in some cases following a lender's exercise of its remedies). However certain circumstances in a loan workout situation mitigate the foregoing policy concerns that otherwise prevent delivering a deed-in-a-box.

While a deed cannot be delivered in escrow at the origination of a loan, a lender may require a borrower to deliver a deed in escrow in exchange for additional consideration from the lender. A deed-in-a-box transaction is likely unenforceable if additional loan funds is the sole additional consideration offered for borrower's delivery of such deed-in-a-box. Rather, new consideration that would render such a transaction enforceable typically takes the form of lender's agreement to forbear from the exercise of its remedies after a default or other forms of lender leniency.

For a deed-in-a-box transaction to be enforceable, courts will consider a number of factors that protect the borrower and such factors must be clearly delineated in any workout agreement. The borrower must have no equity in the project (i.e., the loan amount exceeds the value of the property) because otherwise the transfer will likely be subject to an attack as a fraudulent conveyance. The workout documents must make it clear that the outstanding loan balance is greater than the fair market value of the property. The borrower must also acknowledge that it was not able to pay back the balance of the loan and has not made an attempt to do so. Additional factors that courts will consider typically include sophistication of the borrower, reasonableness of the lender, whether the collateral is a commercial property rather than residential property, and that both parties are represented by counsel. The circumstances of the agreement between the borrower and lender must make it clear to a court that the lender has not taken unfair advantage of the borrower.

The public policy concerns preventing a borrower from delivering deed in escrow at loan origination do not exist when a deed is delivered in escrow for a loan workout. On the contrary, there are several compelling public policy benefits, which make these transactions advantageous for all parties. Deed-in-a-box agreements keep time-consuming and administratively burdensome foreclosure proceedings out of the courts. In times of wide-spread economic tumult, deed-in-a-box transactions keep properties in the hands of borrowers in circumstances that might otherwise result in a foreclosure and allow borrowers to make attempts to improve their financial standing.

Other Considerations and Risks

Lenders considering a deed-in-a-box workout method must ensure that the terms of the loan workout do not constitute a new loan. Lenders should be aware that offering additional funds to borrower in a loan workout could potentially be viewed as a new loan origination rendering unenforceable an otherwise enforceable deed-in-a-box transaction. Further, it is important that lenders engage in fair and balanced negotiations with respect to any loan workout.

Lenders must also be conscious of subordinate lenders and give notice as required by any subordinate loan documentation. Lenders should also be prepared to take on the risks involved with a potential bankruptcy proceeding. Some bankruptcy courts have held that the deed-in-a-box is part of a debtor's bankruptcy estate, prior to the transfer to the secured party, leaving the lender without the benefit of the loan workout and instead will be subject to a restructuring of the loan in a bankruptcy proceeding.

Conclusion

A deed-in-a-box transaction is particularly well-suited for the COVID-era economic instability. The expectantly temporary nature of the downturn in the industries that have been hit hard, (i.e., hospitality, restaurants, and tourism) may give lenders some assurance that a workout will be successful and enforceable. Recent income deficiencies are caused by factors that will, eventually, give way and allow a number of distressed property owners' equity to regain value and eventually enable borrowers to meet their loan obligations.

During the course of the current recession, Cozen O'Connor has assisted multiple lenders and borrowers in negotiating forbearance agreements that incorporate a deed-in-a-box component. The enforceability of a deed-in-a-box transaction is determined on a state-by-state basis. Cozen O'Connor's real estate finance group has assisted clients with such transactions across the country, in multiple jurisdictions. While risks are apparent in negotiating these transactions, a deed-in-a-box is a loan workout option that should be considered, especially during the existing economic crisis.

If you have any questions about deed-in-the-box transactions or how to structure such deals, contact William F. Davis or Peter E. Swain from Cozen O'Connor's Real Estate Practice.