FORECLOSING AFTER TAKING A DEED-IN-LIEU

*by Bruce J. Bergman

It seems an incongruous notion: starting or completing a foreclosure action after taking a deed-in-lieu of foreclosure. But it *can* be done and sometimes it may be imperative to do so. The process of in essence foreclosing on one's self, though, appears on the surface to be anomalous and so the ability to foreclose is nonetheless often viewed with incredulity. Consequently, considering at least the underpinnings of the pursuit should be worthy. Both the impediment and the solution are found in the doctrine of merger, later discussed here in context.

FUNCTION OF FORECLOSURE; BASIS OF DEED-IN-LIEU

If it proceeds to a conclusion, a mortgage foreclosure of course ends with a judicial sale of the mortgaged premises. One goal of the action, therefore, is to arrive at that sale so that the value of the property can be unlocked and the foreclosing lender can be paid whatever that value is, up to the sum owed upon the mortgage debt as assessed by the court in the judgment of foreclosure and sale.[1]

Should a third party be the successful bidder at the auction sale, the foreclosing plaintiff will have derived whatever the market was willing to pay. There are many variables attendant to the sale issues, but the main point here is that the lender will either have been paid its upset price, or will have elected itself to be the successful bidder.

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In this latter instance, the lender takes back the property. It becomes the owner, free then to resell the property for *any* price it can derive – even a profit in the felicitous instance of a wise investment.

The deed-in-lieu shortcuts the foreclosure sale process by conveying title to the lender (or its nominee, discussed, *infra*.) without necessity of proceeding through all the tortuous and time consuming plateaus of the mortgage foreclosure action. In a certain sense, the end of the case comes sooner rather than later.[2]

The deed-in-lieu, however, is not a perfect substitute for a foreclosure sale – indeed, as a matter of law, the tender of a deed-in-lieu of foreclosure is not the legal equivalent of a foreclosure[3] and it is this observation which begins to approach the reason why continuing the foreclosure action even though title has already been divested can be necessary.

Because conveyance by the borrower-owner as grantor is not a judicial sale, the title is burdened by all encumbrances which may have attached since the mortgage was delivered. To highlight the apparent, should the borrower have obtained a second mortgage, or suffered money judgments, or mechanics' liens, all attach to the property conveyed by the deed-in-lieu. The foreclosure sale would have extinguished those interests; the deed-in-lieu does not have that effect. Thus, most of the time, but not always, a foreclosing party will not accept a deed-in-lieu unless a continuation of its foreclosure search confirms that there are no subsequent interests encumbering the mortgaged premises.[4]

THE USUAL SITUATION

The typical and obvious case best suited to the deed-in-lieu is one where there is no equity in the property and no liens or encumbrances attach to the mortgaged

premises. The borrower understands that a foreclosure is stressful and he may be exposed to a deficiency liability. He wants to be done with the trauma and move on. He recognizes all this nearer to the outset of the action – helpful because the time saved in prosecuting the foreclosure is much greater if a deed-in-lieu is taken at the outset rather than, for example, on the eve of sale.

If the deed-in-lieu is conveyed via such a scenario, the matter ends, the foreclosing party owns the property (with fee title insurance as counsel will recommend), free to sell the property and recoup all available proceeds. In this perfect case, there is no need to contemplate continuing the foreclosure case. It is not necessary.

CIRCUMSTANCES TO CONTINUE FORECLOSURE

The foreclosure arena being far more imperfect than other worlds, such an amenable fact pattern cannot always be enjoyed. There might be, and often are, occasions when completing the foreclosure is meaningful, even mandatory. Some examples follow.

The lender encounters a dedicated, litigious borrower who also happens to possess the financial wherewithal to defend and delay the foreclosure unto eternity – and takes great pride in doing so. Even though a perfectly drafted mortgage and highly skilled plaintiff's counsel can still be victimized by borrowers' dilatory tactics, the problem can be decidedly exacerbated by any flaws in the documentation and any attorney or court miscues. In short, the path to an eventual end of the foreclosure action can readily become dismayingly protracted.

Enter the deed-in-lieu. If the borrower fears a deficiency, he could find the deed-in-lieu enticing (accompanied by a waiver of such liability), particularly if sweetened by some cash compensation. Should the borrower convey the deed and thus depart the

field of battle, the opposition is gone and the impediment to concluding the foreclosure has likewise disappeared. This, then, is a case where taking a deed-in-lieu intersects quite understandably with concomitant continued prosecution of the foreclosure action.

Another example: a deed-in-lieu is taken under what appear to be the pristine conditions earlier recited as the usual situation. But after the deed-in-lieu is received (and even if the foreclosure had not yet been discontinued) the plaintiff-grantee becomes aware of a missed interest. That is, the property was believed to be free of junior encumbrances but the notion was mistaken. The foreclosure search may not have revealed a judgment or a mortgage. There might have been a tenant in possession without a recorded lease. Such occurrences are quite real and present but a few of the unfortunate possibilities. If the foreclosure cannot proceed (presumably because the lender is now also the owner of the property) then the deed-in-lieu was a serious blunder. This is a foreclosure action that *does* need to proceed.

Then there is the confluence of a property without equity and a guarantor liable for the debt (possessed of the assets to satisfy a judgment obtained against him). For any number of reasons, including the case of the litigious borrower, taking a deed-in-lieu can be seductive. But in order to pursue a deficiency judgment there must have been obtained a foreclosure judgment decreeing the party so liable with a foreclosure sale conducted as an element in establishing the shortfall.[5]

Thus, the foreclosure must reach a conclusion to accomplish the purpose of preserving deficiency liability. In turn, the deed-in-lieu cannot be a bar to that end; rather the action must go forward.

Further danger lurks in the realm of bankruptcy. Although perhaps a remote possibility, a deed-in-lieu of foreclosure could be set aside by a bankruptcy court as a

fraudulent conveyance if the mortgagor-grantor files a petition in bankruptcy within one year after the conveyance.[6]

Possibly of greater application to the deed-in-lieu is Section 548(a)(1)(B) of the Bankruptcy Code which empowers the trustee to avoid a debtor's transfer where the debtor has "received less than a reasonably equivalent value in exchange for such transfer." To be sure, even if the condition is met, it must also be shown that the debtor "was insolvent on the date that such transfer is made... or became insolvent as a result of such transfer.[7]

Defining equivalent value is very much a subject unto itself, not economically explored here. The point remains, however, that imposition of bankruptcy dictates can threaten the viability of a deed-in-lieu and impel a foreclosing party to complete a foreclosure action.

ROLE OF THE DOCTRINE OF MERGER

As real estate practitioners will recognize, the doctrine of merger provides that when legal title to both the property and the mortgage become vested in the same owner, the lesser ownership interest is merged into the greater.[8] Thus, when a mortgage is returned to a mortgagor in apparent satisfaction of a debt, the law then implies of a merger of legal and equitable interests whereby the mortgage lien is extinguished.[9]

While there is, not surprisingly, more to this subject, in short, it is the possibility of a merger resulting from a deed-in-lieu which would make continuing a foreclosure impossible. Soberingly, the doctrine of merger can be and is enforced.[10]

But it can also be avoided, and quite readily so.

Equity disfavors merger.[11] Whether a merger has actually occurred is a question of fact[12] and the intent of the parties will be controlling.[13] Helpfully, the estates will be presumed to remain separate if justice so requires,[14] (provided that the rights of third parties and creditors do not intervene[15]). Even should the two estates come together in one owner – for our purposes the mortgage and the fee – the owner has a reasonable time in which to decide whether a merger is intended[16]; sixty days have been held to be a reasonable duration.[17]

Thus, merger can be readily avoided and where it is so avoided, the mortgage survives as enforceable.[18] It is that maxim which ultimately reveals how it is that a deed-in-lieu which might otherwise be a bar to foreclosure need not be.

While the end result should thus be clear, there is always room for nuance and resultant contention, and one case example serves to underscore the conclusion. There, the deed-in-lieu specified that the mortgage was to survive and the mortgagee elected to sue at law on the note against other obligors who had been defendants in the foreclosure action. Although those obligors were entitled to a credit for the value of the property conveyed, they were still held liable for the shortfall.[19]

As a practical matter, the most efficient way to deflect merger, and sidestep the need to explore intent as a question of fact is either to include non-merger language in the deed, or designate a grantor not the foreclosing party. Both approaches work and attorneys will certainly be familiar with them. *Why* these methodologies need to be considered is now hopefully more evident.

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1 The goal of a foreclosure is somewhat more nuanced than stated. For a further review of the subject, see 1 *Bergman on New York Mortgage Foreclosures*, §2.02, LexisNexis Matthew Bender (rev. 2014). Particularly relevant to this review is the function of a foreclosure sale to convey the title as it was when the mortgage was executed and delivered.

[2] For a complete review of the subject of the deed-in-lieu of foreclosure, see 3 *Bergman on New York Mortgage Foreclosures*, Chap. 25, LexisNexis Matthew Bender (rev. 2014).

[3] *Riley v. South Somers Dev. Corp*., 222 A.D.2d 113, 644 N.Y.S.2d 784 (2d Dept. 1996).

[4] This also becomes a matter of business judgment as well. A minor parking violations bureau judgment should not likely impede conveyance of the deed while a substantial junior mortgage would.

[5] See, RPAPL §1371 and discussion and case law at 4 *Bergman on New York Mortgage Foreclosures*, Chap. 34, LexisNexis Matthew Bender (rev. 2014).

[6] Section 548(a)(1)(A) of the Bankruptcy Code empowers a trustee to avoid a debtor's transfer of an interest in property made within one year of filing the bankruptcy petition if the debtor voluntarily made the transfer and had actual intent to "hinder, delay or defraud any entity to which the debtor was or became, on or after the date that such transfer occurred or such obligation was incurred, indebted..."

[7] Bankruptcy Code §548(a)(1)(B)(ii).

[8] See, *inter alia*, *Cambridge Factors, Inc. v. Thompson*, 215 A.D.2d 427, 626 N.Y.S.2d 259 (2d Dept. 1995); *200 E. 64th St. Corp. v. Manley*, 44 A.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).

[9] See, *2301 Jerome Avenue Realty Corp. v. Dipaolo*, 190 Misc.2d 383, 737 N.Y.S.2d 816 (Sup. Ct. 2002), citing *Krekeler v. Aulbach*, 51 A.D.591 64 N.Y.S.2d 901 (1st Dept. 1900) aff'd., 169 N.Y.372, 62 N.E. 416 (1902); *Egrini v. County of Suffolk*, 157 Misc.2d 988, 599 N.Y.S.2d 457 (Sup. Ct. 1993); *Erhal Holding Corp. v. Nobile*, N.Y.L.J., Jul. 25, 1994, at 30, col. 3 (Sup. Ct., West. Co.).

[10] See discussion and case law at 3 *Bergman on New York Mortgage Foreclosures*, §25.06[2], LexisNexis Matthew Bender (rev. 2014).

[11] See, *inter alia*, *Central Hanover Bank & Trust Co. v. Roslyn Estates*, 266 A.D.244, 42 N.Y.S.2d 130 (2d Dept. 1942), aff'd., 293 N.Y.680, 56 N.E.2d 294 (1944); *Armstrong v. Germain*, 98 N.Y.S.2d 946 (Sup. Ct. 1949).

[12] See, *inter alia*, *2301 Jerome Avenue Realty Corp. v. DiPaolo*, 190 Misc.2d 383, 737 N.Y.S.2d 816 (Sup. Ct. 2002), citing *Krekeler v. Aulbach*, 51 A.D.591 64 N.Y.S.2d 901 (1st Dept. 1900) aff'd., 169 N.Y.372, 62 N.E. 416 (1902).

[13] See, *inter alia*, *Long Island Lighting Company v. Commissioner of Taxation and Finance*, 235 A.D.2d 637, 652 N.Y.S.2d 640 (3d Dept. 1997); *Cambridge Factors v. Thompson*, 215 A.D.2d 427, 626 N.Y.S.2d 259 (2d Dept. 1995).

[14] *Cambridge Factors v. Thompson*, 215 A.D.2d 427, 626 N.Y.S.2d 259 (2d Dept. 1995); *Becker v. Snowden Dev. Corp.*, 66 Misc.2d 1060, 323 N.Y.S.2d 79 (Sup. Ct. 1971).

[15] *Long Island Lighting Company v. Commissioner of Taxation and Finance*, 235 A.D.2d 637, 652 N.Y.S.2d 640 (3d Dept. 1997); In re *Nochomov's Estate*, 206 Misc.290, 132 N.Y.S.2d 720 (Sup. Ct. 1954); See *Dunkum v. Maceck Bldg. Corp*, 256 N.Y.275, 176 N.E.392 (1931); *Wilkinson v. Medbury*, 132 Misc.58, 228 N.Y.S. 666 (Sup. Ct. 1928).

[16] *Becker v. Snowden Dev. Corp.*, 66 Misc.2d 1060, 323 N.Y.S.2d 79 (Sup. Ct. 1971).

[17] *Thornburn v. Wende*, 235 A.D.424, 257 N.Y.S.186 (4th Dept. 1932).

[18] *Central Hanover Bank & Trust Co. v. Roslyn Estates*, *supra.* at note 11, aff'd., 293 N.Y.680, 56 N.E.2d 295 (1944); *Egan v. Engeman*, 125 A.D.743, 110 N.Y.S.366 (1st Dept. 1908); *Alden Hotel Co. v. Kanin*, 88 Misc.2d 546, 387 N.Y.S.2d 948 (Sup. Ct. 1976); *American Sav. & Loan Ass'n v. Eidelberg*, 54 Misc.2d 668, 283 N.Y.S.2d 255 (Sup. Ct. 1967); *Mintz v. Kupferstein*, 177 N.Y.S.2d 652 (Sup. Ct. 1958); In re *Nochomov's Estate*, 206 Misc.290, 132 N.Y.S.2d 720 (Sup. Ct. 1954).

[19] *Central Hanover Bank & Trust Co. v. Roslyn Estates, supra.* at note 11.