"DEED IN LIEU": DEED THAT IS NOT REALLY IN LIEU OF FORECLOSURE WILL LIKELY NOT BE TREATED AS A DEED

In re Primes, 518 B.R. 466 (Bankr. N.D. Ill. 2014) –

A mortgagee moved for relief from the automatic stay, arguing that it acquired title to property prior to the bankruptcy under a quit claim deed given to it by the debtor. However, the bankruptcy court agreed with the debtor that the deed, which was given in connection with a forbearance agreement, should be treated as an equitable mortgage.

After a prior bankruptcy, the bank and the debtor entered into a forbearance agreement (as contemplated by the chapter 13 plan). In addition to modifying the terms of the promissory note, the forbearance agreement provided:

Borrower has agreed to execute a Quit Claim Deed from Borrower to Bank for the Property…*Said Deed shall remain in escrow and not be recorded or delivered to Bank until the earlier of the following events:*

a. If a default occurs under the terms of this Agreement (or any documents associated therewith), Bank shall give written notice to Borrower of said default and give Borrower thirty (30) days to cure said default. If said default is not cured within thirty (30) days, - _____ [sic] is directed to release the Deed to the Bank and the Bank is entitled to record said Deed and take possession of the Property. *By recording of said Deed, Bank is not releasing Borrower from any indebtedness due Bank.* Upon the sale of the Property, Bank shall provide a credit to Borrower against the indebtedness which is due at that time. Any deficiency which remains after the sale of the Property shall be due and payable in full to Bank from Borrower…
b. If Bank is not paid in full by August 1, 2015, _____ [sic] is directed to release the Deed to the Bank and the Bank shall be allowed to record the same. *The recording of the Deed will not extinguish the debt of Borrower to Bank."*

The deed stated that it was a deed in lieu of foreclosure pursuant to a state statute.

The borrower testified that she did not understand what a quit claim deed was or what forbearance meant. She stayed current under the modified loan

terms until she broke her wrist and was unable to work for several months, so was unable to make payments. After returning to work, she resumed the loan payments.

The bank continued to carry the transaction on its books as a loan after the debtor signed the deed. A bank officer testified that at the time the deed was delivered the bank's understanding was that the deed was "just security for the loan." The bank did not record the deed until two years later.

The threshold issue was whether the bank was correct that the deed transferred ownership of the property to the bank prior to the bankruptcy so that the debtor had no interest in the property.

Under applicable state law, a mortgagee is generally required to terminate a mortgagor's interest in real estate through a judicial foreclosure. Turning to the state foreclosure statute, the court noted a provision stating that real property cannot be sold by a power of sale in a mortgage, but may only be foreclosed. The purpose of this section was to prevent sales of the equity of redemption and avoid circumvention of the protections of the foreclosure act.

This restriction on a power of sale also invalidated agreements to convey a deed upon future defaults or to waive the right of redemption in connection with the original mortgage. These protections of the right of redemption were not limited to the original mortgage transaction, but included refinancing, forbearance or other workout situations.

Also, typically a voluntary transfer by a mortgagor of the mortgaged property is void and will be recharacterized, particularly when the transfer was to a lender and contingent on a future default under the loan. In considering how a deed should be characterized, if it is intended to provide security for a loan, it will be treated as a mortgage. If the consideration for a deed is prior indebtedness which was not satisfied by the conveyance, it is presumed that a mortgage is intended. Consistent with this analysis, old case law specifically held that a conditional quit claim deed given in connection with a forbearance agreement is a mortgage.

The bottom line for the bankruptcy court was that "nothing is more firmly established under state law than that it is not competent for the parties, even by express stipulation, to cut off the right of redemption, and to permit them to make such an instrument an absolute deed upon some future contingency,

would simply be cutting off the right of redemption, which we have just seen cannot be done."

A state statute did specifically recognize the validity of a deed in lieu of foreclosure. However, the key difference was that a deed in lieu results in termination of the mortgagor's interests after a default, but is *not* conditioned on occurrence of a future contingency. Rather, it is an immediate transfer of the property, often in full or partial satisfaction of the secured debt.

Since it was clear that recording the deed did not serve to extinguish or satisfy the debt owed by the debtor to the bank, and the debt was not reduced until after a sale of the property (when the net proceeds would be credited against the debt), the court held that it was clear that the deed was intended as security rather than as an absolute conveyance.

The status of a deed in lieu of foreclosure under state law can be uncertain. Given facts such as those in this case, it seems likely that most courts would find that the deed should be recharacterized as an equitable mortgage. However, a deed given as a current conveyance of the mortgagor's title in exchange for whole or partial release from the loan secured by the property presents a much closer question.