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Deeds in Escrow

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Deeds in escrow, or "pocket deeds," have increased in popularity in recent years. But are they the right option in connection with a workout of your distressed loan?

A deed in escrow is a deed to real estate placed in escrow (sometimes with a third party) for future recording if and when specific conditions are met. Such a deed can be a useful tool for a lender in a workout situation – allowing a borrower to retain possession and ownership of its property pursuant to certain agreed terms, and, upon default of those agreed terms, allowing a lender to record a deed transferring ownership of the property to the lender without incurring the cost of foreclosure. However, such deeds can be subject to legal challenge. They may also meet with resistance from title companies reluctant to insure the title received by the lender via the pocket deed. Thus, before accepting one, the lender should (a) assess its enforceability, (b) work with a title company to ensure its insurability, and (c) structure it carefully to ensure that the lender can still foreclose, if necessary, any interests junior to the lender's lien on the property.

The Enforceability of a Pocket Deed

Before mortgage laws were developed fully in the United States, some lenders would lend money to a borrower and, instead of receiving a traditional mortgage or deed of trust to secure the debt, simply receive and hold a deed to the property for recording in the event of a default. As a result, if the borrower was late with a payment or in violation of any other non-monetary terms of the loan, the borrower was at risk of immediately losing title to its property. This "contract for deed" arrangement, entered at the time of the original lending transaction, came to be viewed in most jurisdictions as unduly harsh – in some instances it eliminated a borrower's right to cure or "redeem" its past-due debt. As a result, this practice fell into an historical legal disfavor in most jurisdictions.

Fast forward to today. Deeds in escrow in a workout situation – executed after a borrower's default and recordable only after a subsequent default by borrower – sometimes suffer the same fate. Although some jurisdictions deem them valid and enforceable as being akin to a "deed in lieu of foreclosure," a commonly accepted foreclosure alternative, other jurisdictions have deemed them unenforceable as the rough equivalent of the historically disfavored contract for deed. The rationale for such a position is that the deed is recordable only in the future, after some future non-performance by the borrower; therefore, it is viewed as a security device that should be in the form of a mortgage or deed of trust to be enforceable.

Securing the Right Counsel Before Signing on the Dotted Line

Given the variance in enforceability across jurisdictions, lenders should obtain advice of counsel before entering into an agreement for a deed in escrow. Lawyers can assist in determining enforceability of such a deed in a given jurisdiction. Further, a title company can advise the lender from the outset whether it will insure title if and when a deed in escrow is recorded. Additionally, the title company may be able to confirm that the proposed deed is in insurable and recordable form prior to its execution and provide any additional documents that a typical transferor would need to sign, such as seller affidavits and corporate resolutions. It may be preferable to obtain these additional documents at the time the deed in escrow is executed. A borrower may be agreeable to signing these types of transfer documents upon execution – to obtain the benefits of the forbearance agreement; however, if the necessary forms are not executed at the closing of the forbearance agreement and are needed later upon the borrower's default, many times a borrower will be less cooperative when the time has come for recording the deed.

A deed from borrower to lender typically does not have the advantage of a properly conducted foreclosure sale, i.e., the deed does not extinguish junior liens or other encumbrances on the property. For this reason, the lender should consider inclusion in its forbearance agreement provisions that: (a) state that the lender is retaining its lien on the property, notwithstanding acceptance of the deed, (i.e., the lender's lien is not "merging" into title); and (b) provide that the debt owed to the lender is not satisfied and remains in full force and effect. (The lender may consider providing the borrower with a covenant not to sue, rather than a release of the debt, if the intent of the parties is that the borrower will not have further liability following transfer of the property to the lender). By doing this, the lender may retain its right to foreclose the mortgage through the standard process, and to credit bid its debt at such foreclosure, in order to extinguish junior liens.

Payoff Statements

During the recent financial crisis, foreclosures increased dramatically. This fact, coupled with borrowers' exploitations of defects, often technical in nature, in a lender's process or documentation, caused significant delays to foreclosures in a number of instances. To avoid such problems, compliance with state and federal requirements is vital. Lenders and servicers who fail to comply with applicable federal and state specific regulations expose themselves to unforeseen litigation and statutory penalties, in addition to wasting time and resources.

The divergence of state regulation is no more apparent than in the statutes governing payoff statement requirements. There are various pitfalls that can burden unwitting lenders and servicers. And, unfortunately, payoff letters are not one-size-fits-all.

General Requirements

The Consumer Financial Protection Bureau has enacted federal requirements under the Truth in Lending Act governing payoff statement requirements. Regulation Z, amended in January of 2014, applies to loans for personal, family or household use that are secured by real property or a dwelling. Regulation Z requires that a payoff statement be provided within 7 business days following a request by a borrower. Penalties for violation of the requirements under

Regulation Z can include actual damages, statutory damages, and reasonable attorneys' fees stemming from the violation.

Ensuring compliance with the federal requirements is important, but, alone, it sometimes is not sufficient. While some state statutes track Regulation Z fairly closely, a number of states have separate or additional requirements related to payoff letters. For instance, while some state statutes – like the federal regulations – exempt commercial loans from their application, many states extend the payoff letter rules to commercial loans as well.

Form Requirements

Issues may also arise with regard to the form of the payoff letter. While Regulation Z contains very general requirements as to form, requiring only an accurate statement of the total outstanding balance required to pay the debt in full as of a specified date, several states have instituted more stringent requirements. Some states require per diem amounts that allow a borrower to calculate the payment amount for some period of time following the date specified in the payoff letter. Some states have very specific requirements for a formal payoff statement and may require that a payoff statement include: the unpaid balance; rate of interest on the unpaid balance; the amount of unpaid interest; the amount of periodic payments required under the note; the date the payment of the debt is due; information on the payment of real estate taxes and insurance premiums; any additional charges, costs or expenses incurred to the beneficiary; and information on the transferability of the debt. Lenders and servicers should be familiar with the information that each state statute requires.

Timing Requirements

Moreover, although federal law might provide a lender with a specific amount of time to produce a payoff letter, several states provide for periods greater than federal law. Thus, lenders should not rely on a state statute's longer periodand should determine if other time periods (mandated by federal statute or otherwise) apply as well. Conversely, in some jurisdictions, lenders may have to deal with time periods set forth in state statutes that are shorter than the period provided under Regulation Z. Lenders operating in these jurisdictions might be in compliance with the federal requirements while still running afoul of the state specific statute.

Complicating the matter further is the fact that issues related to payoff letters tend to arise when the borrower is in default and facing foreclosure. Regulation Z provides that if a loan is in foreclosure, the 7 day requirement does not apply and a lender is only required to provide a payoff statement "within a reasonable time." This has a potentially significant impact in states where non-judicial foreclosure is common – a "reasonable time" might postdate the foreclosure sale. Further, some state statutes may not vary the rules premised on whether or not the property is in the foreclosure process. Lenders should be cognizant that, even if federal regulations extend the time in which to produce a payoff statement when the property is in foreclosure, state requirements may not provide the same leeway.

Penalties for Failing to Comply with Requirements

All of the foregoing issues can cause headaches and potential liability for unwary lenders. Statutes imposing penalties generally allow for the award of any actual damages suffered by a borrower as a result of a lender's failure to provide a payoff statement. Some states also provide for statutory damages regardless of whether a borrower suffered actual damages. A number of states provide for attorneys' fees and costs for borrowers. These penalties may seem trivial, but where a borrower can prove up actual damages, a lender's liability could be significant.

The adage that an "ounce of prevention is worth a pound of cure," is appropriate when it comes to compliance with payoff letter requirements. Lenders and servicers should ensure that their procedures for producing payoff letters are compliant with the federal requirements and the state specific requirements in each jurisdiction in which they hold or service loans to avoid unforeseen problems later on.

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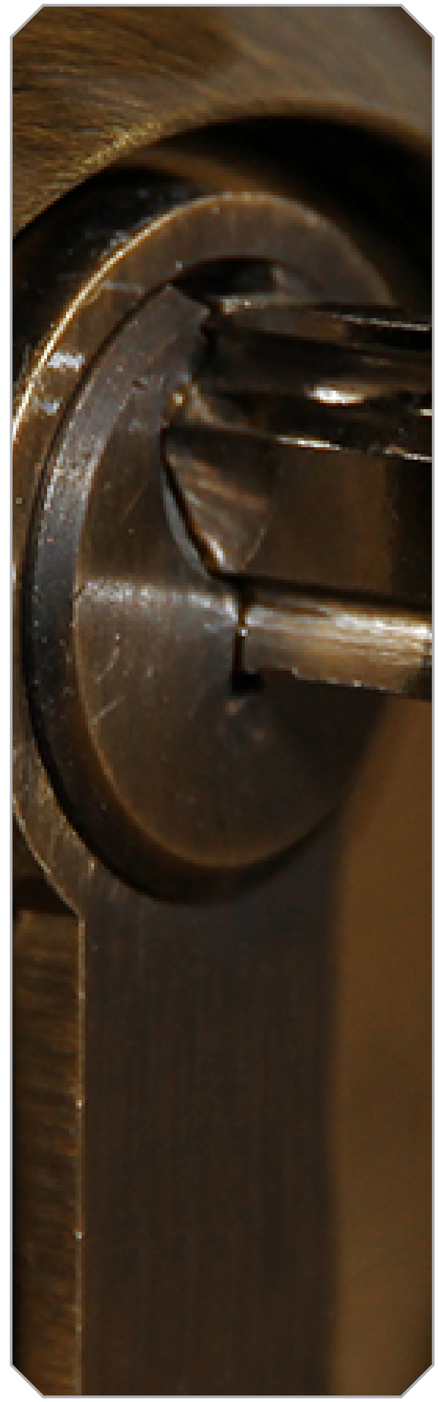

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