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Deed in Lieu of Foreclosure or Equitable Mortgage? Pitfalls for Lenders to Avoid

When a borrower defaults under a mortgage loan, the lender might consider options such as temporary forbearance, negotiating a workout or commencing a foreclosure action. Upon weighing the various alternatives, the parties might elect to enter into a deed in lieu of foreclosure transaction, whereby the borrower voluntarily delivers a deed conveying the mortgaged property to the lender. Such a transaction could have advantages for both parties. For instance, the lender could gain control over its collateral more quickly and inexpensively than it otherwise might have with a foreclosure proceeding. For the borrower, a proposed deed in lieu of foreclosure presents an opportunity to negotiate releases from liability and to avoid some of the negative impacts associated with having a public foreclosure proceeding on its record.

However, these transactions are not without risk. One of the dangers facing a lender in a deed in lieu of foreclosure transaction is that a court might recharacterize it as an equitable mortgage, instead of a true conveyance of title. To help frame the issue, this article analyzes recent New Jersey jurisprudence in this area and potential mitigants against this risk.

Equitable Mortgages

The equitable mortgage doctrine has been recognized by New Jersey courts of equity for a long time. This doctrine stands for the principle that "a conveyance, whatever its form, if in fact given to secure a debt, is neither an absolute nor conditional sale, but a mortgage, and that the grantor and grantee have merely the rights, and are subject only to the obligations, of the mortgagor and mortgagee." *J.W. Pierson Co. v. Freeman*, 113 N.J. Eq. 268, 271 (E. & A. 1933). The name given to the instrument does not matter in this analysis, for "[i]f a deed or contract, lacking the characteristics of a common law mortgage, is used for the purpose of pledging real property, or some interest therein, as security for a debt or obligation, and with the intention that it shall have effect as a mortgage, equity will give effect to the intention of the parties." *Id.* at 270-71.

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In other words, applying principles of equity, a New Jersey court might look past the form of a purported conveyance and recharacterize the transaction as an equitable mortgage. If such a finding is made, then the transferee would lack indefeasible title to the property, and the transferor would retain its equity of redemption (i.e., the right of a mortgagor to retain title to its property by paying all amounts owing under the mortgage). *Id.* at 270.

Factors Considered by Courts in Determining the Existence of an Equitable Mortgage

New Jersey's Supreme Court recently cited the principle that if an "instrument is in its essence a mortgage, the parties cannot by any stipulations, however express and positive, render it anything but a mortgage, or deprive it of the essential attributes belonging to a mortgage in equity." *Zaman v. Felton*, 219 N.J. 199, 217 (2014) (citation omitted). As a guide to assist trial judges in determining whether a transaction gives rise to an equitable mortgage, the court endorsed the eight-factor framework articulated by the United States Bankruptcy Court for the District of New Jersey in *O'Brien v. Cleveland*, 423 B.R. 477 (Bankr. D.N.J. 2010). *Zaman v. Felton*, 219 N.J. at 218.

The *O'Brien* court identified the following factors that indicate an absolute or conditional deed should instead be seen as an equitable mortgage:

1. Statements by the homeowner or representations by the purchaser indicating an intention that the homeowner continue ownership;

2. A substantial disparity between the value received by the homeowner and the actual value of the property;

3. Existence of an option to repurchase;

4. The homeowner's continued possession of the property;

5. The homeowner's continuing duty to bear ownership responsibilities, such as paying real estate taxes or performing property maintenance;

6. Disparity in bargaining power and sophistication, including the homeowner's lack of representation by counsel;

7. Evidence showing an irregular purchase process, including the fact that the property was not listed for sale or that the parties did not conduct an appraisal or investigate title; and

8. Financial distress of the homeowner, including the imminence of foreclosure and prior unsuccessful attempts to obtain loans.

O'Brien v. Cleveland, 423 B.R. at 491.

In connection with the analysis under *O'Brien*, a court will consider "not only the form of the transaction itself but circumstances that can motivate a party to disguise a mortgage secured by a property as a sale of land and indications that both parties intend the seller to retain the land notwithstanding the purported sale." *Zaman v. Felton*, 219 N.J. at 218.

Practice Tips for Lenders

If a lender plans to accept a deed in lieu of foreclosure in New Jersey, it should be cognizant of the risk that the transaction may be recharacterized as an equitable mortgage, if the transaction is not executed properly. Every deed in lieu of foreclosure transaction will be different and must be tailored to its own, unique set of facts. However, the suggestions below provide a good starting point for a lender structuring a deed in lieu of foreclosure transaction, considering the eight-factor framework that was adopted in *Zaman v. Felton*.

In light of factors 1, 3 and 4 listed above, it should be clear in the documentation for, and execution of, the transaction, that the borrower is making a present and absolute conveyance of all of its right, title and interest in and to the property. For this reason, it is not a good idea to accept a deed "in escrow" to be recorded only at a future date upon the occurrence of a specified event. There should be no indication that the borrower will retain ownership of the property or have an option to repurchase it, and the documentation for the

transaction should indicate that no such rights of ownership or purchase will exist upon closing. The parties' written agreement should make it clear that the borrower will not be entitled to possess the property after closing, and the borrower should, in fact, be so excluded from possession of the property.

Part and parcel with the proposition that the deed in lieu of foreclosure effects a present and absolute conveyance of the property, is that all of the responsibilities of ownership should pass to the lender. As considered in factor 5 above, the lender, and not the borrower, should be responsible for the carrying costs and upkeep of the property from and after closing.

To reduce the risk of issues with factor 6 above, the borrower should be represented by counsel, particularly if the lender is the more sophisticated party.

As a best practice, the lender's treatment of a deed in lieu of foreclosure transaction should be similar to that afforded to a third party, arm's length acquisition. While the lender should be doing this anyway, such conduct could also help to bolster the lender's case with respect to factor 7. The lender should conduct such due diligence review as it deems necessary, which review should include, among other things, ordering both a title report and an appraisal of the property.

The appraisal that the lender obtains in connection with its due diligence can also provide support for the lender's position with regard to factor 2. The lender should be able to assert that there is no disparity in the value received by the borrower in exchange for its deed in lieu of foreclosure. The borrower and lender should agree in writing as to the amount of the outstanding obligations under the mortgage, which should be equivalent to, or preferably greater than, the value of the property. The agreements negotiated and documented between the parties in connection with a deed in lieu of foreclosure should be fair and provide sufficient benefit to the borrower. An appraisal will be key to demonstrating that no disparity in the consideration exists.

A lender should not consider accepting a deed in lieu of foreclosure before there is a default under the mortgage. (After all, how can a deed be *in lieu of* foreclosure before the lender has the right to foreclose?) Therefore, almost by definition, some degree of financial distress and the imminent threat of foreclosure will exist in a deed in lieu of foreclosure transaction. In consideration of factor 8 above, the lender should be prepared to demonstrate that the transaction is not designed to take advantage of borrower's financial difficulty and that it is voluntary and free of coercion. The borrower's representations in the transaction documents should contain a certification to that effect as well. In an ideal scenario, the proposal to deliver a deed in lieu of foreclosure would have originated with the borrower, and the lender would have documentation to demonstrate same.

Conclusion

A deed in lieu of foreclosure transaction will contain many complexities for the lender. Among them will be the need for preparedness to defend the conveyance from an attack asserting that, rather than effecting a true transfer of title, the parties created an equitable mortgage. Lenders in New Jersey must remain mindful of the *O'Brien* factors when negotiating and executing a deed in lieu of foreclosure transaction.