Deed in Lieu of Foreclosure: An Overview in Process and Logic for Borrowers to Consider

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This article is the first installment in a multi-part series on borrower considerations in deed-in-lieu transactions. Here, we lay the groundwork by explaining what a deed in lieu is, how the process works, and why both borrowers and lenders may prefer (or not prefer) it to a formal foreclosure. Additionally, we provide a framework of key considerations that borrowers should keep in mind as they negotiate a deed in lieu of foreclosure, each of which will be discussed in greater detail in future articles.

What Is a Deed in Lieu of Foreclosure?

A deed in lieu of foreclosure is a transaction in which a borrower voluntarily conveys (transfers) its property to the lender as an alternative to the lender going through a formal foreclosure. In exchange, the lender typically agrees to release or reduce the borrower's remaining obligations under the loan. The name comes from the fact that the borrower delivers a deed to the lender "in lieu of" (meaning "instead of") the lender having to foreclose on the property.

Unlike a foreclosure, which in judicial foreclosure states is conducted through the courts and can be a lengthy, costly, and public process, a deed in lieu is a private, negotiated transaction between the borrower and the lender. It is most common when the property is not generating enough income to service the debt and the borrower has little or no equity left in the property. In those situations, both sides may conclude that a voluntary transfer is faster, cheaper, and less damaging than a contested court proceeding.

Basic Process

The process typically begins with the borrower sending a written offer to the lender to surrender the property. This offer letter is an

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important document because it establishes several key facts: that the offer is voluntary, that the borrower is not acting under duress, and that the consideration (the property transfer in exchange for release of debt) is fair and adequate. The offer letter helps establish the legitimacy of the transaction if it is ever challenged later, whether in court or in a bankruptcy proceeding.

If the lender is interested in pursuing the transaction, it will respond with a conditional acceptance, and the parties will typically execute a pre-negotiation letter. This letter sets the ground rules for discussions, including mutual confidentiality obligations and a firm timeline for reaching a binding agreement. During this phase, the lender will also begin its due diligence, such as ordering a title search and UCC and judgment searches, reviewing the borrower's organizational documents, confirming the borrower's authority to enter the transaction, obtaining an appraisal to confirm the property's fair market value relative to the outstanding debt, and assessing the financial condition and solvency of the borrower and any guarantors.

Once the parties agree on terms, the lender's counsel will typically draft the deed-in-lieu agreement. This is the central transaction document and it covers a lot of ground. It includes the borrower's acknowledgment of default, the scope of the release (specifying which obligations are discharged and which survive the closing), representations and warranties about the property's condition, closing conditions (what the borrower must deliver and pay at closing), and the non-merger provisions that keep the mortgage alive as a separate estate (discussed further in later articles). The agreement also typically includes the borrower's waiver of its equitable right of redemption, which is the borrower's right under law to reclaim the property after default by paying off the debt.

The closing itself resembles an "as is" property sale. The borrower delivers a recordable deed, a bill of sale for personal property, assignments of leases and contracts, tenant notice letters, a title affidavit, and other standard conveyancing documents. The lender (or its nominee entity, often a newly formed special purpose entity) takes title, and the borrower walks away with whatever releases were negotiated.

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Why Choose a Deed in Lieu?

From the borrower's perspective, the appeal of a deed in lieu comes down to several practical advantages. It avoids the substantial legal fees, the extended timeline, and the negative publicity that come with a foreclosure action. It relieves the borrower of the continuing obligation to fund the property's operating deficits — obligations that, if left unaddressed, could trigger recourse liability for waste or nonpayment of taxes and insurance. Perhaps most important, the borrower can negotiate a release (in whole or in part) of its payment and performance obligations under the loan, including releases for guarantors and indemnitors. A deed in lieu also preserves the borrower's reputation and its relationships with lenders, keeping the door open for future transactions and access to capital. Unlike a foreclosure, a deed in lieu may appear to the public more like a voluntary sale than a forced liquidation.

Lenders have their own reasons for preferring the deed-in-lieu route. The overriding priority for a lender after a borrower defaults is getting its hands on the collateral as quickly and cleanly as possible. A deed in lieu accomplishes this efficiently, allowing the lender to take ownership, stabilize the asset, and minimize ongoing losses. This is particularly valuable when property values are declining, as the lender can focus on repositioning or selling the property rather than watching its collateral deteriorate during a prolonged court proceeding. The cooperative nature of the transaction also reduces disruption to tenants and preserves valuable leases and contracts that might otherwise be jeopardized.

That said, a lender will not always agree to a deed in lieu. If the property is not marketable in its current condition, or the lender lacks the expertise to operate it, the lender may prefer a different approach. If the lender is already receiving adequate cash flow through , it may see no urgency in taking fee ownership. If the loan is recourse, the lender may prefer to retain its deficiency judgment rights. In some cases, the lender may push for a short sale to a third party, and in certain states where foreclosure is already fast and inexpensive, the incremental benefit of a deed in lieu may not justify the complexity.

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Borrower Considerations

While a deed in lieu can be an attractive exit strategy, borrowers need to be aware that the transaction raises a number of issues that are not immediately obvious, including the following:

- **Tax Exposure**. Depending on whether the mortgage is discharged as part of the transfer, a deed in lieu can trigger both transfer taxes and income taxes. The tax implications vary significantly by jurisdiction and deal structure, and the consequences can be substantial. We cover these tax traps in detail in the next article in this series.
- **Title Insurance**. The lender's existing mortgage title policy does not convert into an owner's policy when the lender takes title through a deed in lieu. The lender will require a new owner's policy, and title companies scrutinize deed-in-lieu transactions more heavily than standard sales. Borrowers may be required to clear subordinate liens and bear additional closing costs as a result. Our title insurance article explores this in depth.
- **Releases and Guarantor Exposure**. Borrowers and guarantors naturally expect to be fully discharged in exchange for surrendering the property. But releases in a deed in lieu are negotiated, not guaranteed. Environmental indemnities almost always survive, and some lenders impose a "tail" period of continuing guarantor obligations after closing. The scope of what is released and what survives is one of the most critical negotiation points. Environmental obligations, in particular, deserve close attention. It is common for a deed-in-lieu agreement to require the borrower to fund a post-closing escrow (often) to cover the cost of completing any environmental remediation that remains outstanding at the time of transfer. This obligation persists even after the borrower no longer owns the property, and the borrower typically remains responsible for achieving whatever regulatory completion standard the applicable state environmental agency requires. In some transactions, a separate escrow may also be required to secure the

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borrower's obligation to complete an ecological risk assessment or similar environmental study that the relevant regulator has not yet approved as of closing. These escrow obligations can represent significant post-closing financial exposure that borrowers and guarantors should anticipate and factor into their negotiations. We address guarantor considerations, including environmental surviving obligations, in a dedicated companion article.

- **Bankruptcy and Fraudulent Conveyance Risk**. If the borrower files for bankruptcy after the deed in lieu, or if the property's value exceeds the outstanding debt, the transaction could be challenged as a preferential transfer or fraudulent conveyance. Lenders will require solvency representations and may ask for a covenant not to file for bankruptcy during the preference period. This topic will be addressed in a future installment.

An important theme running through this entire series is that every borrower should understand its BATNA (i.e. "best alternative to a negotiated agreement"), which is always a standard foreclosure. While foreclosure has significant drawbacks, it also carries certain borrower-side advantages, including equitable remedies and the potential to avoid certain liabilities discussed in the articles that follow. A borrower should also recognize that the lender may have a stronger interest in pursuing a deed in lieu than it does in foreclosing, but the lender has no authority to impose a deed in lieu without the borrower's cooperation. Understanding when the lender is motivated to avoid foreclosure gives the borrower real leverage in negotiating the deed-in-lieu terms.

Key Takeaways

A deed in lieu of foreclosure can be a smart and efficient exit strategy for a borrower in default, but it requires careful planning, competent legal counsel, and a clear understanding of the risks and negotiation dynamics involved. This article has covered the basics; companion articles in this series will take you deeper into the tax traps, title insurance requirements, and guarantor considerations that every borrower needs to understand before signing on the

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dotted line.

In the meantime, if you have questions or would like further guidance on the structural, tax, and post-closing aspects of deed-in-lieu transactions, please contact the authors or any attorney with the firm's Commercial Real Estate Finance team.

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