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Is a bank required to take a deed in lieu? - by Thomas Kearns

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Non-recourse loans are the market standard for sophisticated New York real estate transactions. Non-recourse means the lender only has recourse against the property itself. There is no liability for the borrower or any principal of the borrower for any shortfall other than what are known as carve-outs – those are certain enumerated bad acts such as fraud, a bankruptcy filing and environmental issues. Non-recourse loans typically include a guaranty from a credit-worthy person for any damages due to such bad acts. If a bad act occurs the lender can sue the guarantor and not be limited by the non-recourse nature of the loan. Lenders who make non-recourse loans usually limit the amount of the loan to a certain maximum level of debt. A typical limit is 65% of appraised value at the time of making the loan. If the value of the property goes down as of the maturity date of the loan due to market conditions, the borrower's investors first lose their equity and the lender gets paid in full unless the value goes below the amount outstanding on the loan in which case the lender takes a loss for the difference. The theory is that by limiting the loan to value ratio at the time of the making of the loan the lender eliminates or limits the loss if the value of the property diminishes.

If the borrower's equity is fully lost the borrower has little incentive to keep operating the property. Why spend operational and management resources on a property that is under water? The lender's sole right in these circumstances is to foreclose on the property and attempt to maximize the price paid at a foreclosure sale or to bid the property in at that sale and operate and/or sell it outside of the foreclosure process. The lender could, of course, write the loan off and not incur the expense of a foreclosure. This might happen if there was a bad environmental issue, but it is rare since obtaining some value on a foreclosure makes the most economic sense.

If a major hit to value occurs and the borrower realizes that their equity is gone and will likely never return, is the borrower entitled to simply give the lender a deed in lieu of the foreclosure process? The borrower could decide that the ongoing headaches of operating the property essentially only for the benefit of the lender might not make sense.

In a recently filed action in New York (New West Harlem Owner LLC v. SIG RCRS A/B MF 2023 Venture LLC), the borrower has tried to do just that. The borrower purchased a residential rental building shortly before the 2019 statutory amendments that severely damaged the value of residential rental properties in New York. The borrower has in effect given up on ever making any part of its equity back and wants the lender to take a deed in lieu. Curiously, the lender is refusing. In filed papers the lender cites its right to elect remedies. But in a non-recourse loan, assuming there are no carve outs from the non-recourse nature of the loan, what is the other remedy? Walking away? The publicly filed papers don't appear to mention whether the lender has approved a short sale where the borrower could conduct a public sale outside of foreclosure and deliver the net proceeds of the sale to the lender in full satisfaction for the loan. Short sales are subject to the lender's approval.

As a policy matter, should New York law require the lender to accept a deed in lieu in these circumstances? Logic would indicate that it should since there is no other remedy that the lender has. Is it proper to make a borrower operate a property for the lender's benefit for a significant and indefinite amount of time? (Note the lender should always have whatever rights they have for damages under the carve out guaranty.) What is the rationale for not taking title?

The borrower in the New West Harlem litigation is helped by the following clause in the loan: "If the Borrower delivers a deed-in-lieu of foreclosure to the Bank, the Borrower shall pay (i) all applicable transfer taxes due in connection with the transfer of the Premises to the Bank, (ii) the cost of a title insurance policy insuring title to the Premises in favor of the Bank or its nominee, and (iii) any other expenses incurred by the Bank including reasonable attorney fees." The lender's response has been that the clause does not expressly require the lender to accept the deed in lieu. Reasonable people may differ but the author can see a court determining that the clause and the non-recourse nature of the loan requires the lender to accept the deed-in-lieu.

As with any new litigation, the New West Harlem litigation may settle before any court rulings, but this issue may continue to arise. If a non-recourse lender won't take a deed in lieu, won't agree to a short sale and won't foreclose, what is a borrower to do?

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