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Real Estate Update

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The *Ibanez* Case: Massachusetts Rejects Undocumented Mortgage Assignments

The Massachusetts Supreme Court recently issued a highly-anticipated opinion in the case of *U.S. Bank National Association v. Ibanez.* The Court affirmed a Land Court ruling that invalidated two foreclosure sales after the foreclosing banks failed to show they were the legal holders of the mortgages at the time they foreclosed.

The Massachusetts Supreme Court in *Ibanez* decided two cases with similar facts and legal issues, which had been consolidated in the Land Court. The plaintiffs, U.S. Bank (whose mortgagor was named Ibanez) and Wells Fargo Bank (whose mortgagor was named LaRace) had foreclosed on mortgages under the Massachusetts statute permitting non-judicial foreclosure under power of sale, and were seeking a Land Court declaration that they held valid title to the foreclosed properties. In both cases, the bank was not the original mortgagee under the mortgage: it was a trustee for a securitization trust, which had acquired a large number of mortgages (1,220 in the *Ibanez* case) which were pooled so that interests in the pool could be sold as mortgage-backed securities (MBS). When the mortgages went into default, the banks foreclosed upon the properties, bought them by a "credit bid" at the resulting auction sale, and then sought orders confirming they had valid title to the foreclosed properties. The Land Court ruled against the trustee banks, and the Supreme Court upheld this ruling.

In both cases, the mortgage in question had purportedly been transferred on several occasions before being transferred to the trustee bank. In both cases, the record holder at the time of the foreclosure was an earlier party in the chain of assignments, Option One Mortgage Corporation ("Option One"). In both cases, an assignment of the mortgage to the trustee bank

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Practical and Legal Perspectives on Deed in Lieu Transactions

When a borrower defaults on its mortgage, a lender has a number of remedies available to it. In recent years, lenders as well as borrowers have increasingly chosen to pursue alternatives to the adversarial foreclosure process. Chief among these is the deed in lieu of foreclosure (referred to as a "deed in lieu" for short) in which the lender forgives all or most of the borrower's obligations in return for the borrower voluntarily handing over the deed to the property.

During these difficult economic times, deeds in lieu offer lenders and borrowers numerous advantages over a traditional foreclosure. Lenders can diminish the uncertainties inherent in the foreclosure process, reduce the time and expense it takes to recover possession, and increase the likelihood of receiving the property in better condition and in a more seamless manner together with a proper accounting. Borrowers can avoid expensive and protracted foreclosure fights (which are usually unsuccessful in the long run), manage continuing liabilities and tax implications, and put a more positive spin on their credit and reputation. Even so, deeds in lieu can also pose substantial risks to the parties if the issues attendant to the process are not thoroughly considered and the documents are not properly drafted.

A deed in lieu should not be considered unless a professional appraisal values the property at less than the remaining mortgage obligation. Otherwise, there is the threat of another creditor (or trustee in bankruptcy) claiming that the transfer is a fraudulent conveyance and, in any case, the borrower would obviously be reluctant to relinquish a property in which it might stand to recover some value following a foreclosure sale. Also, a deed in lieu transaction should not be forced upon a borrower; rather, it must be a free and voluntary act, and a repre-

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was delivered and recorded after the foreclosure sale (one year after the sale in the Ibanez case and ten months after the sale in the *LaRace* case).

After an initial adverse ruling in the Land Court, the banks submitted to the Court various documents to support their argument that the mortgages had in fact been transferred to the trustee banks prior to the date of the foreclosures. In the *Ibanez* case, the bank claimed that the mortgage in question had been transferred from Option One through intermediate holders, and then transferred to the securitization trust pursuant to a trust agreement. However, no copy of the trust agreement, signed or unsigned, was delivered to the Court. Instead, the trustee bank delivered a private placement memorandum prepared for prospective investors in the MBS offering, which stated that the mortgages "will be assigned into the trust." Moreover, no schedule identifying the Ibanez loan as included in the mortgages assigned to the securitization trust was submitted to the Court. In the *LaRace* case, the bank delivered a pooling and servicing agreement (PSA), a common document in MBS transactions, which was claimed to pertain to the LaRace mortgage, but the PSA was unsigned and did not include schedules identifying the specific mortgages being transferred. Finding this evidence insufficient to document the trustee banks' ownership interests in the mortgages, the Court upheld the Land Court ruling that the trustee banks had failed to show that they were the owners of the mortgages at the time of the foreclosure sale, and as a result, the foreclosure sales were void. The Court also rejected the banks' arguments that (1) the banks' possession of the underlying promissory notes gave them a sufficient interest in the mortgages to foreclose, and (2) the banks' receipt of assignments *after* the foreclosure sales gave them standing to foreclose.

The Court explained that because state law provided the banks with substantial nonjudicial power to foreclose, they were expected to strictly follow the procedures for doing so. One of the requirements of the foreclosure law is that only "the mortgagee or his executors, administrators, successors or assigns" can exercise the statutory power of sale. As prior cases have held, any attempt to foreclose by any other party renders the foreclosure sale void.

The *Ibanez* holding—that to fulfill the statutory power of sale requirements, a foreclosing party must be "[t]he mortgagee or his administrators, successors or assigns"—does no more than apply basic legal principles and requirements well established under Massachusetts law. On the other hand, the

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sentation and warranty reflecting this should be memorialized in the agreement. Otherwise, there is a risk that the transaction could be vitiated by a court in a subsequent proceeding on the basis of undue influence or similar theories. If a borrower is resistant to completing a deed in lieu transfer, then a lender intent on recovering the property should instead commence a traditional foreclosure.

Ensuring that there are no other adverse liens on the property, and that there will be no such liens pending the delivery and recordation of the deed in lieu of foreclosure, is perhaps the biggest pitfall a lender must avoid in structuring the transaction. Subordinate liens on the property can only be discharged through a foreclosure process or by agreement of the adverse creditor. Therefore, before initiating, and again before consummating, the deed in lieu transaction, the lender must do a sufficient title check; after receiving the report, whether a lender will move forward will usually be a case-by-case decision based on the existence and amount of any discovered liens. Often it will be prudent to attempt to negotiate for the purchase or satisfaction of relatively minor third party liens. If the lender does decide to proceed with the transaction, it should evaluate the benefits of obtaining a new title insurance policy for the property and to have a non-merger endorsement included in it.[1]

For protection against known or unknown subordinate liens, the lender will also want to include anti-merger language in the agreement with the borrower, or structure the transaction so that the deed is given to a lender affiliate, to enable the lender to foreclose (or use leverage by reason of the ability to foreclose) such other liens after the delivery of the deed in lieu. Reliance on anti-merger provisions, however, can be risky. Cancelling the original note can endanger the lender's security interest, so the lender should instead provide the borrower with a covenant not to sue. This also affords the lender flexibility to retain any "bad boy" carve-outs or any other continuing liabilities that are agreed to by the parties, including environmental matters. Depending on the jurisdiction or particular factual circumstances, however, another creditor might successfully attack the validity of the attempt to preclude merger. Moreover, a non-merger structure may, in some jurisdictions, have a transfer tax consequence. The bottom line is that if there is not a high degree of confidence in the property and the borrower, the lender needs to be especially vigilant in structuring the transaction and setting up the appropriate contingencies.

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decision has received a great deal of attention for at least two important reasons: first, because of the explosion of MBS transactions, particularly over the last decade, there is a huge number of transactions that have been documented—or have failed to be documented—in the manner that the *Ibanez* and *LaRace* transactions were, in Massachusetts and elsewhere around the country, and are subject to delay. Second, there are a large number of foreclosures that have either occurred or are in process that could be attacked on similar grounds, creating uncertainty for lenders (and oftentimes for those that may have purchased properties out of flawed foreclosures), as to who properly holds title to the property.

For foreclosures that have not yet been commenced, the impact of the holding may simply require more work: in a concurring opinion, one of the justices criticized "the utter carelessness" that the banks demonstrated in documenting their ownership of the mortgages and pointed out that before, and not after, commencing a foreclosure action "the holder of an assigned mortgage needs to take care to ensure that his legal paperwork is in order." Although more attention to the necessary paperwork will be required going forward, some of this work may not be as simple as it appears to be, because a number of parties in the MBS world are either in bankruptcy or have ceased to exist since the beginning of the financial crisis.

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One significant benefit of a carefully structured deed-in-lieu process is that there will be a detailed agreement setting forth the conditions, representations and provisions that are contractually binding and which can survive the delivery of the deed and related releases. Thus, in addition to the normal pre-foreclosure due diligence that would be conducted by a lender, the agreement will provide a roadmap to the transition process as well as critical information and representations regarding operating accounts, accounting, turnover of leasing and contract documents, liability and casualty insurance, and the like. Indeed, once the lender takes possession of the property through a voluntary deed process as opposed to foreclosure, it will likely (both as a legal and practical matter) have greater exposure to claims of tenants, contractors and other third parties, so a well-crafted deed-in-lieu agreement will go a long way toward enhancing the lender's comfort with the overall process while at the same time providing order and certainty to the borrower.

Another substantial concern for the lender is to make certain that the transfer of the property from the borrower to the lender fully and unequivocally extinguishes the borrower's interest in the property. Any remaining interest that the borrower maintains in the property may later give rise to a claim that the transfer was not an absolute conveyance and was instead an equitable mortgage. Therefore, a lender should strongly resist any offer from the borrower to lease, manage, or reserve an option to purchase any part of the property following the transaction.

These are just a few of the most important issues in a deed in lieu transfer. Other significant issues must also be considered in order to protect the parties in this relatively complex process. Indeed, every transaction is unique and can raise different issues, and each state has its own rules and customs relating to these arrangements, ranging from transfer tax issues to the fact that, for example, in New Jersey, deed in lieu transactions likely fall under the state's Bulk Sales Act and its requirements. However, these issues should not dissuade—and certainly have not dissuaded—lenders and borrowers from increasingly using deeds in lieu and thereby reaping the substantial benefits of structuring a transaction in this way.

1. For many years it was also possible—and highly preferred—for the lender to have the title insurance company include a creditors' rights endorsement in the title insurance policy. This protected the lender against having to defend a claim that the deed in lieu transaction represented a fraudulent or preferential transfer. However, in March of 2010, the American Land Title Association decertified the creditors' right endorsement and thus title companies are no longer offering this protection. It should be further noted that if the deed in lieu were set aside by a court based on undue influence or other acts attributable to the lender, there would likely be no title coverage because of the defense of "acts of the insured."

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Update—*Destiny USA v. Citigroup*

In the March 2010 *Real Estate Update,* we reported on the 2009 trial and appellate court decisions against Citigroup relating to the Destiny USA project in upstate New York. The project, an ambitious 800,000 square foot extension to the giant Carousel Center Mall in Syracuse, New York, had commenced in 2007. After the project was substantially underway—with developer equity and government development agency funds expended, and Citigroup, as agent for itself and other lenders, having advanced $85 Million of the $155 Million construction loan—Citgroup declared that the loan was "out of balance" because there were insufficient remaining unfunded loan proceeds and other funding sources to both complete construction and pay for tenant improvement costs ("TI Costs"). The developer objected, claiming that the TI Costs were not part of the "loan balancing" formula. The trial court issued a "mandatory injunction" ordering Citigroup not to include TI Costs in its computations, and the Appellate Division confirmed the main points of trial court ruling.

With Citigroup's appeal of the court decisions still pending, the parties have jointly announced a settlement and their intentions to pursue completion of the project. The details of the settlement were not disclosed.

Much has changed since the litigation over the project began. The banking and financial crisis was a backdrop to the *Destiny USA v. Citigroup* lawsuit at the lower court stages, leading some to speculate that Citigroup's larger financial troubles were the source of the bank's unwillingness to continue funding the project. What has also changed is the perceived demand for large-scale retail and entertainment projects such as Destiny USA.

Nevertheless, seeing a stalled project move forward rather than continuing to be mired in litigation must be seen as a positive development, and a preferable outcome—especially to the developer and the local economy—to carrying a slow and costly court battle to its conclusion.

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Blank Rome Significant Representations in 2010

The Real Estate Practice closed over $6 billion in transactions valued for 2010. Some of the publicly reported deals include:

- Owners of the "Lipstick Building" in a prepackaged bankruptcy that resulted in the restructuring of debt and equity positions in one of the fastest turnarounds in the Southern District of New York.
- Sunoco, Inc. in an acquisition of 25 convenience store sites in New York State from Lehigh Gas for the purchase price of nearly $25 million.
- George Comfort & Sons Inc., the landlord, in lease agreements with the public broadcaster WNET, and the medical information services firm WebMD Health Corp. for their new headquarters at 825 Eighth Ave., known as Worldwide Plaza.
- U.S. Bank NA, in a complex workout of a hotel property in Manhattan's Hell's Kitchen neighborhood.
- CARS-DB4 in a private placement issuance of $463.3 million in net-lease mortgage notes secured by mortgage liens on 83 automobile dealership properties.
- DRA in a $176 million sale of a three-building office complex located in Houston, TX.
- Financial institutions and national developers in connection with financings aggregating in excess of $2.5 billion for the refinancing, acquisition and construction of more than 100 multifamily, commercial and mixed-use real estate properties.

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