

Deeds-in-Lieu of Foreclosure: Whether to Take an Assignment of the Developer's Agreement

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This Update discusses the analysis that a Wisconsin lender should undertake to determine if it should take an assignment of a developer's agreement as part of a deed-in-lieu of foreclosure transaction.

Deeds-In-Lieu of Foreclosure Generally

Taking back a deed to a property is an alternative to the sometimes lengthy and costly judicial process of foreclosing on a delinquent loan. In a "deed-in-lieu" transaction, the parties agree that the lender will take title to the real property securing the borrower's defaulted note in exchange for the lender releasing the borrower (in full or partially) of its liability under the defaulted note.

Although the lender is both the property owner and lienholder after the deed-in-lieu transaction is completed, the documents (the deed, deed-in-lieu agreement and estoppel affidavit) typically provide that the parties intend not to merge the mortgage into the ownership of the property (the "fee" interest). A non-merger endorsement should be obtained from the title company to insure that the deed and mortgage remain separate.

The debt must be preserved if the lender needs to commence a foreclosure to wipe out junior liens and encumbrances after it becomes the fee owner. This can be done by making the debt non-recourse as to the borrower in the deed-in-lieu agreement. (Note that some courts outside of Wisconsin have held that merger of the mortgage and fee interest *does* occur if the lender takes title with knowledge of one or more junior liens, meaning that the obligations evidenced by the junior liens cannot be extinguished).

Due Diligence

Before agreeing to take a deed-in-lieu, a lender must undertake significant due diligence because it will be taking the real estate subject to all of its risks and potential liabilities – *i.e.*, environmental issues, delinquent taxes, judgments, and other liens and encumbrances. The lender should make sure that it has reviewed all documents affecting the mortgaged property, including easements, plats, encumbrances on the title, the closing book from the borrower's acquisition of the property, all plans prepared in connection with developing the project, and documents evidencing a trademark or trade name for the project.

The lender should also undertake a thorough analysis of any developer's agreement relating to the property before it decides to take an assignment. A developer's agreement is a contract between a municipality and a real estate developer that specifies the municipality's requirements for a development. It could include, for example, provisions requiring that public improvements and infrastructure (such as streets, water, sanitary sewer, storm water drainage) be constructed, requiring that only a certain type of development can be constructed, dictating the maximum number of residential or commercial units, requiring that payments (such as connection fees) must be made to the municipality, requiring that a certain amount of green space must be preserved, or requiring that streets or land must be dedicated to the municipality. Among other things, the lender will want to understand the obligations under the developer's agreement that have been completed, those that remain to be done and the cost of satisfying the remaining obligations.

Lender's Options For Dealing With Developers' Agreements

The lender has different options depending on whether the developer's agreement is subordinate to the lender's mortgage. If the developer's agreement is subordinate to the mortgage, the lender may treat it the same as other junior liens on the property and foreclose out the developer's agreement (if the mortgage and the fee interest do not merge and the debt has been preserved). On the other hand, this may not be the best course of action if future dealings with the municipality are necessary.

If the lender is not going to foreclose out the developer's agreement (or if the developer's agreement is not subordinate to the lender's mortgage), the lender must decide whether to take an assignment of the agreement. The first issue is whether it is assignable. The municipality may have required its prior consent to any assignment. When a developer's agreement does not state whether or not it may be assigned, the general law of assignability controls and, like other contracts that do not expressly permit or prohibit assignment, it would be assignable.

The more difficult question is not whether the lender can take assignment, but whether it should. There is no one factor that drives this decision – rather, the lender needs to weigh the impact of multiple factors to determine what option will best serve its interests.

Principle factors include:

- Whether the lender has provided the municipality with a letter of credit. As part of a developer's agreement, a municipality may require the developer to post a letter of credit as assurance for satisfying the requirements in the agreement. The lender may have provided such a letter of credit. If the lender is "stuck" with the cost of completing the remaining requirements under the developer's agreement anyway, because it has provided the letter of credit, it may make more sense to take an assignment.
- What stage of development the project is in at the time. The lender should determine the stage of the development. If the uncompleted work is significant, the lender may not want to take an assignment of the developer's agreement, as it may not want to commit to doing all that is still required.
- Whether the municipality is willing to negotiate. Instead of taking an assignment, the lender may want to consider approaching the municipality to renegotiate the developer's agreement (for example, permitting a multi-family apartment building instead of single-family lots). If a development has stagnated and the lender believes the existing scheme in the developer's agreement is not marketable under current conditions, the lender might wish to renegotiate a developer's agreement to fit current market conditions. The lender should consider the possibility that it may be tipping its hand to the municipality that a bank is involved, which the municipality could see as a "deep pocket" to finish the development. Most importantly, the lender should reach out to the municipality **only if** the borrower/developer agrees and is, along with its counsel, involved in the discussion, which should minimize or avoid any allegations that the lender interfered with the borrower/developer's business.

Pros and cons associated with taking an assignment of a developer's agreement as part of a deed-in-lieu transaction also include:

Pros:

- The lender has leverage with the municipality by offering to take the assignment and may be in a better position to renegotiate the developer's agreement in connection with the deed-in-lieu transaction (subject, as discussed above, to the borrower/developer's consent and participation).
- By taking an assignment, the lender can further assign the developer's agreement as part of a sale to another developer, enhancing its ability to realize the value of the collateral.
- The lender may be able to reduce or eliminate a letter of credit it has in place with the municipality by taking an assignment and thereby agreeing to complete the remaining obligations under the developer's agreement.

Cons:

- The lender will assume the liability of the borrower/developer for its prior acts or omissions under the developer's agreement.
- The lender may be subject to claims from third parties for work it completes after taking the assignment.
- The lender may need to hire a professional management company to assist the lender with managing the obligations under the developer's agreement.
- If the borrower/developer is in default of provisions of the developer's agreement, the lender may have to expend a significant amount of money to cure such default.
- The municipality might see the lender as a "deep pocket" to complete the remaining obligations under the developer's agreement.

Understand the Fundamentals of Each Unique Situation

Ultimately, a lender's decision whether to take an assignment of a developer's agreement as part of a deed-in-lieu transaction will involve analysis of all of the factors described in this *Update*. This analysis will enable the lender to develop a more complete picture of the merits and risks of taking an assignment before making this important decision.

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