DEEDS IN ESCROW: ARE THEY ENFORCEABLE?

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Introduction

Mortgage lenders occasionally seek to obtain deeds in escrow in connection with loan workouts and mortgagor bankruptcies. The documentation usually provides that the deed will be delivered out of escrow to the mortgagee in the event of a future default or other specified event. The deed may be placed in escrow with a third party, such as a title insurance company. "Clogging" (and other) issues may arise when the mortgagor agrees to give a deed in lieu of foreclosure to the mortgagee in the future if certain events occur. Courts of equity will closely scrutinize these types of transactions because the mortgagor's right of redemption will be cut off by the deed in lieu of foreclosure when the default or other triggering event occurs.[1]

Deed in Escrow in Connection with Original Mortgage

Numerous courts have held that when the mortgagor places a deed in escrow in connection with the initial mortgage transaction, with instructions to release the deed to the mortgagee immediately in the event of a future default, the deed is void and unenforceable. For example, in a case decided by the Illinois appellate court, *First Illinois National Bank v. Hans*,[2] the defendants executed an assignment of their interest as contract-for-deed purchasers for a parcel of land as security for a mortgage loan. The assignment provided that in the event of a default the defendants would "execute to the Assignee a Quit Claim Deed for the property, which shall stand as a deed in lieu of foreclosure."[3] The court declared this provision null and void, holding that the transaction created an equitable mortgage that the mortgagee must foreclose. The court reaffirmed the principle that parties cannot, by an express stipulation in the mortgage, transform the instrument into an outright conveyance upon default. Doing so, the court held, would operate to deprive the mortgagor of his or her redemptive rights.

In a case decided by the Colorado Supreme Court, *Larson v. Hinds*,[4] the parties placed a deed to the property in escrow as part of the loan transaction, with the deed to be immediately delivered to the mortgagee in the event of a subsequent loan default by the mortgagor. The Colorado Supreme Court stated that the agreement "comes as close to a formal security transaction as could have been accomplished without the execution of a mortgage or deed of trust." The court held that the agreement constituted a security transaction as a matter of law because it deprived the mortgagor of any right to redeem the property, and was therefore in violation of the public policy of the State of Colorado.[5]

Deed in Escrow in Connection with Loan Workout

As noted above, courts generally have held that a mortgagor may not be compelled to give or agree to give a deed to the mortgagee or place a deed in escrow as part of the original mortgage transaction. However, several courts have held that a deed that the parties place in escrow may be valid and enforceable if it is delivered in connection with a subsequent workout of a delinquent loan or as part of the mortgagee's agreement not to foreclose or otherwise exercise its contractual and legal remedies.

In *Ringling Brothers Joint Venture v. Huntington National Bank*,[6] the Florida appellate court held that a deed placed in escrow in connection with a mortgage loan workout was enforceable under state law and was not a clog on the equity of redemption. The deed in escrow was given to avoid foreclosure and therefore, the court held that the mortgagor received valuable new consideration to relinquish its right of redemption. The court also found that the mortgagee had not taken unfair advantage of the mortgagor. The court found the following factors relevant in upholding the validity of the transaction:

- The transaction involved commercial real estate rather than residential property
- All parties were represented by counsel.
- Separate and valuable consideration (in the form of new loan proceeds and revised loan documents covering the original loan plus the amount owing under two prior mortgages) was given to the mortgagor.
- The mortgagor acknowledged that it was not able to pay the mortgage indebtedness and had made no attempt to do so.
- It appeared from the trial court record that there was no equity in the property (i.e., the outstanding loan balance exceeded the fair market value of the property).
- The agreement between the parties was reached during a pending action by the first mortgage holder to foreclose its mortgage on the property.[7]

A sample form of deed-in escrow agreement is attached hereto as **Appendix A**.

In *Oakland Hills v. Lueders Drain District*,[8] the Michigan appellate court held that a mortgagor's waiver of its right to equitable redemption made as part of the same contract as the mortgage was invalid, where no separate consideration was given for waiver of the right and the waiver occurred prior to any event of default under the loan However, the court stated in *dicta* that the arrangement would not violate the clogging doctrine and would be valid and enforceable if entered into by the parties in good faith after a subsequent default, for good consideration, as part of a contract separate and distinct from the original mortgage agreement. In an earlier decision, *Russo v. Wolbers*,[9] the Michigan appellate court held that the mortgagor may, after the original mortgage transaction, sell or convey his or her equity of redemption to the mortgagee by a separate and distinct contract entered into for good faith and for valid consideration, but "the exchange must be fair, frank, honest, and without fraud, misconduct, undue influence, oppression or unconscionable advantage of the poverty, distress or fears of the

mortgagor."[10] In *Wright v. First National Bank of Monroe*,[11] the Michigan Supreme Court enforced a deed in escrow in connection with a workout of the mortgage loan, finding that the transaction was a "voluntary settlement between the parties . . . a sale by the plaintiffs of their equity of redemption to the mortgagee, the consideration being the forbearance to foreclose and the acceptance of the property in full satisfaction of the mortgage debt."[12]

In *Verity v. Metropolis Land Co.*,[13]the New York appellate court upheld an arrangement in which the mortgagor agreed, in consideration of an extension of a mortgage loan and release of the mortgagor's personal liability, to deliver a deed in lieu of foreclosure to the mortgagee in the event of a subsequent default. The mortgagee had instituted an action to set aside its waiver of personal liability and unwind the transaction, but the court gave effect to the agreement because it benefited the mortgagor, despite the effect on the mortgagor's equity of redemption.[14]

In *Rothschild Reserve International, Inc. v. Silver*,[15] the Florida appellate court held that a conditional deed given as part of settlement of foreclosure action was not a mortgage within the meaning of a Florida statute dealing with equitable mortgages. The statute[16] provides that conveyances "securing the payment of money" are deemed to be mortgages subject to foreclosure. The borrower was hardly a sympathetic individual. After the court entered a summary judgment in favor of the lender in the foreclosure proceeding against the borrower, the parties entered into a settlement agreement of the foreclosure action. The settlement agreement provided that the borrower would pay all principal and unpaid interest owing on January 30, 2001, all interest due before that date, and the lender's attorney fees. The court noted that the borrower entered into this agreement "through counsel."[17] Pursuant to the agreement, the borrower signed a warranty deed to be held in escrow by the lender's counsel, which deed would be returned to the borrower if and when it satisfied the terms of the settlement agreement. The borrower did not pay any of the required payments under the settlement agreement. The borrower then attempted to delay payment of the amounts it owed by filing for bankruptcy. The lender was able to obtain a lift of the automatic bankruptcy stay and finally recorded the deed. The state court then ratified the deed and entered a writ of repossession (the borrower had agreed, in the settlement agreement, to a court order evicting it from the mortgaged property within tend days after the lender recorded the deed). The borrower subsequently appealed and argued that the deed it gave as part of the settlement was a mortgage under the applicable Florida statute and that its equity of redemption should be protected because the property was worth more than the amount owed to the lender. The court did not buy this argument, viewing this as nothing more than another delaying tactic by the borrower (and hardly a compelling argument for equitable intervention by the court). At no time did the borrower deny he owed the amounts he agreed to pay or allege that he was "coerced" into executing the settlement agreement or that he was disadvantaged by it. Nor did he allege that the lender had engaged in any inequitable conduct in connection with either the foreclosure or the voluntary settlement of the foreclosure proceeding.

The lender obviously thought it was doing the borrower a favor by not pursuing the foreclosure and entering into (a very reasonable) settlement agreement, and the borrower (and his counsel) obviously thought so also. The appellate court stated sagely observed that, "[I]f agreements to settle foreclosure actions are deemed mortgages under the statute, no foreclosure action would ever be settled."[18]

Deed in Escrow as Equitable Mortgage

Numerous courts have characterized an executory deed agreement as a continuing security device or an equitable mortgage, which must be foreclosed in order to enforce the provisions of the agreement. For example, In *McGuigan v. Millar*,[19] the California appellate court held that the evidence indicated the intention of the parties to treat an agreement by the mortgagor to deliver a deed to the mortgagee as a disguised security device designed to create an impermissible waiver of the right of redemption. Courts will not permit a mortgagee to evade the requirement of foreclosing a mortgage, and deprive the mortgagor of its right of redemption, by subterfuge; for example, by taking a deed to the property and granting the mortgagor the right to repurchase the property upon payment in full of the debt.[20]

Several states have enacted statutes specifically addressing whether a deed given by a mortgagor to a mortgagee may constitute a continuing security device. In Minnesota, for example, there is a statutory presumption that a deed in lieu of foreclosure, if absolute in form, is not given as further or new security for the debt.[21] An Illinois statute states that "[e]very deed conveying real estate, which shall appear to have been intended only as a security device in the nature of a mortgage, though it be an absolute conveyance in terms, shall be considered as a mortgage."[22] Other states provide that no defeasance to any deed of real property that is absolute on its face shall be effective to convert the document to a mortgage with respect to third parties unless the grantor's defeasance right is in writing and is recorded in the mortgage records.[23]

Section 3.2(a) of the RESTATEMENT provides that parol evidence is admissible to establish that a deed absolute on its face was in fact intended as security for an obligation and should be deemed a mortgage. Section 3.2(b) provides that the intention of the parties to create a security device must be proved by "clear and convincing evidence." The section further provides that the parties' intention may be shown by the following:

- The statements of the parties.
- The existence of a substantial disparity between the value received by the grantor and the actual value of the real property at the time of conveyance.
- The fact that the grantor retained possession of the real property.
- The fact that the grantor continued to pay real estate taxes.
- The fact that the grantor made improvements to the real estate subsequent to the conveyance.
- The nature of the parties to the transaction and their relationship both prior to and after the conveyance.

Section 3.2(c) of the RESTATEMENT provides that where, in addition to the deed, a separate writing exists that indicates that a financing transaction was intended, parol evidence is admissible to establish that the writings, taken together, constitute a single security transaction.

Effect of Deed in Escrow on Subordinate Lienholders

In a recent Illinois Appellate Court decision, *Klein v. DeVries*,[24] the court held that upon delivery to the first mortgagee of a quitclaim deed, which had been placed in escrow as part of the mortgagor's Chapter 11 reorganization plan, a subordinate mortgagee with knowledge of the arrangement had no right to cure the mortgagor's default or redeem the property. In this case, Metropolitan Life Insurance Company ("Metropolitan") held a first mortgage on Mr. DeVries' property. In 1986, DeVries filed for bankruptcy. Pursuant to the confirmed reorganization plan, which plan was recorded with the county Recorder of Deeds in 1987, DeVries delivered a quitclaim deed to the property to Metropolitan's attorney. The reorganization plan provided that upon any future default by DeVries under the mortgage loan or the plan, Metropolitan was to give notice thereof to DeVries and to any junior lienholders, as well as to all other creditors and parties in interest. The plan also provided that the parties so noticed – but not DeVries – would then have the opportunity to either cure the default or "obtain Metropolitan's position as first mortgage holder by making certain payments to Metropolitan." If none of the noticed parties elected these options, the deed was immediately to be delivered to Metropolitan and title would "pass free and clear of liens and encumbrances, unpaid real estate taxes, and mechanics' liens excepted."

In 1989, DeVries executed and delivered to the plaintiff (Klein) a note secured by three mortgages on the property secured by Metropolitan's first mortgage. These mortgages were recorded with the county Recorder of Deeds on March 27, 1989. DeVries subsequently defaulted on the Metropolitan mortgage, and Metropolitan sent the required default notices to DeVries and other creditors - but not to the plaintiff. On December 7, 1989, Metropolitan recorded the escrowed quitclaim deed. Metropolitan then sold the property to an entity that in turn subdivided it and sold it in various parcels to other parties. In September 1997, the plaintiff filed a complaint for foreclosure and requested a declaratory judgment seeking to have his mortgages declared valid and to foreclose on the mortgages he held on the property. The trial court denied the plaintiff's requests for relief.

The appellate court, in affirming the holding of the trial court, first noted that "[i]n general, a mortgagee can have no greater rights than his mortgagor."[25] The court then turned to the issue of what rights DeVries had when he entered into the mortgages with the plaintiff. The plaintiff argued that at the date of execution of the subordinate mortgages, DeVries still had equitable and legal title to the property and since no default had yet occurred under the first mortgage, he was entitled to cure the default and redeem the property. The appellate court disagreed, finding that DeVries' interest in the property