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Distressed Owner Transactions: Common Questions

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FOR A WHILE THERE it seemed like the real estate market in the New York metropolitan area was going to fly high forever, but it teetered with the economy in the early to middle parts of 2008, and then slid precipitously by the end of the summer. Now the good times seem like long ago. Some of you have never represented a client in connection with a loan workout, a bankruptcy sale or a deed in lieu of foreclosure; of the members of that group, most will not be able to make that claim for long.

Those of us who have been through a down market know that the problems that consistently arise in such an environment are different than those that come up during better times. Questions that never seem to get asked in a strong market are on the front burner in a down one.

This article is intended to lay out some of the more common questions and answers that are coming to the foreground, laying out the justification for these answers. Hopefully, you will find it a helpful guide in resolving common, everyday problems and issues that come up in the context of distress sales, deeds in lieu and foreclosure sales, bankruptcy sales and loan workouts. Remember, there may be income tax ramifications for your transaction as well, which are beyond the scope of this article.

Here are some of those common problems, in a question and answer format.

1. Seller has filed a petition under Chapter 11 of the Bankruptcy Code and is in the process of getting a plan of reorganization confirmed. It intends to convey certain commercial real property located in New York City, but is not waiting until the plan is confirmed. Can it convey without paying any transfer taxes? What if it has a provision included in the order confirming the sale that states that the conveyance is to be made without payment of transfer taxes?

Pursuant to §1405(b)(8) of the New York Tax Law, conveyances made "pursuant to the federal bankruptcy act" are exempt from New York state real estate transfer tax.[1] This exemption applies whether the bankruptcy is a Chapter 7, 11 or 13, or whether or not the conveyance is made pursuant to a confirmed plan.[2]

There is no exemption contained in the New York City Real Property Transfer Tax (NYCRPTT). There is, however, a Bankruptcy Code provision that exempts transfers made under a plan confirmed under 11 USC §1129 from any law imposing a stamp or similar tax.[3] The NYCRPTT is a "stamp or similar tax" under 11 USC §1146(a),[4] but how does it apply to our facts?

In the past, the New York City Department of Finance had expressed a willingness to allow such a transfer to take place without payment of the NYCRPTT in Chapter 11 proceedings[5] if certain requirements were met. However, a recent U.S. Supreme Court decision clearly held that the 1146(a) stamp- tax exemption applies only to transfers made pursuant to a Chapter 11 plan that had been confirmed before the transfer.[6]

Accordingly, the transfer is exempt from NYSRETT, but is subject to NYCRPTT.

2. Seller is going to give a deed in lieu of foreclosure to the holder of the mortgage on certain real property used for commercial purposes. How are the transfer taxes calculated?

Under Article 31 of the Tax Law (which governs the NYSRETT), consideration is, generally speaking, the value given in exchange for the real property, including the amount of any mortgages or other liens that survive the conveyance, whether or not these mortgages or liens are assumed. Accordingly, the consideration for a deed in lieu is comprised of:

(a) that balance of the debt secured by the mortgage, including the principal balance, the interest thereon and any other accruals secured by the mortgage; and

(b) the total amount of the liens remaining on the property after the transfer, whether or not they are assumed or taken subject to; and

(c) any other amounts paid to or on behalf of the grantor for the property.[7]

However, where the indebtedness secured by the mortgage that is the subject of the deed in lieu is recourse debt, consideration is calculated as set forth above, provided, however, that if the sum of (a) and (b) above exceeds the fair market value (FMV) of the property being conveyed, then the consideration will be deemed to be the FMV of the property plus the amounts in (c) above.[8]

With respect to the NYCRPTT, the results are dramatically different because there is no fair market value cap whether or not the debt is recourse. With respect to deeds in lieu of foreclosure, the consideration for the transfer is the sum of (a), (b) and (c) above.[9]

3. Client is the assignee of a successful bid in a foreclosure sale, and is getting a deed from a referee. How many sets of transfer tax forms need to be prepared? What is the "consideration" for the deed?

As in the case of a deed in lieu of foreclosure, the calculations to establish the consideration for a referee's deed in foreclosure are different under the NYSRETT than under the NYCRPTT. The assignment of bid simply adds another element to the equation.

Under the NYSRETT, where the debt is nonrecourse and the grantee is the mortgagee, its agent, nominee, or an entity wholly owned by the mortgagee, the consideration is the higher of (i) the bid price plus the liens that survive the conveyance, whether or not such liens are assumed or taken subject to, or (ii) the amount of the judgment of foreclosure and sale plus the liens that survive the conveyance, whether or not such liens are assumed or taken subject to.[10]

In the case of debt that is recourse in nature and the grantee is the mortgagee, its agent, nominee, or an entity wholly owned by the mortgagee, the consideration is calculated in the same manner as is set forth above, provided, however, that should the resulting amount be greater than the fair market value of the property, then consideration shall be equal to the fair market value of the property at the date of conveyance.[11]

Where the grantee is a person unrelated to the mortgagee that is the foreclosing party, the consideration is the bid price plus the liens that survive the conveyance, whether or not such liens are assumed or taken subject to.[12]

Under the NYCRPTT, in the case of a referee's deed in foreclosure, the consideration is the amount bid for the property, senior liens not cancelled by the foreclosure sale, advertising expenses, taxes and other costs paid by the purchaser.[13] There is no consideration given to the nature of the indebtedness (recourse or nonrecourse) or who the grantee is (related or unrelated to the foreclosing mortgagee).

The assignment of bid is a separate conveyance on which both state and city transfer tax forms need to be filed and taxes paid. With respect to both the NYSRETT and the NYCRPTT, the consideration is the amount paid for the bid.[14]

4. Mortgagee is going to take a deed in lieu of foreclosure on certain real property, or is foreclosing on a mortgage on real property. How does this affect the title insurance that the mortgagee presently has? Does it need to purchase a new policy?

Pursuant to Section 2 of the Conditions of the ALTA 2006 Loan Policy of Title Insurance, which is the primary loan policy available in New York, a loan policy remains in effect after the insured acquires title to the estate or interest insured, whether by deed in lieu or foreclosure action. There are similar provisions in the ALTA 1992 Loan Policy form (which was previously used) and in the New York Board of Title Underwriters form that was used before that.[15]

The policy in effect remains a loan policy, however; the fact that the insured has (purportedly) acquired an ownership interest does not "convert" the policy to an owner's policy. This is important because the circumstance under which an insured can establish a loss for policy purposes is much broader in the case of an owner's policy than it is in the case of a loan policy.

In general terms (and, obviously, subject to the exclusions and defenses the company may have in an individual case), the existence of a lien or encumbrance that is insured against in the policy is enough to trigger the loss

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provisions in an owner's policy. That is not the case with a loan policy.

In order to suffer a loss that could be, under any circumstance, compensable under a loan policy, an insured would have to (i) establish the existence of a lien or encumbrance that is insured against in the policy, and (ii) acquire the estate or interest that was the subject of the mortgage, and (iii) be unable to market the estate or interest because of the lien or encumbrance that is insured against.

Whether or not an owner's policy should be purchased in connection with a deed in lieu is a judgment call. Certainly, if the property was acquired as a result of a contentious foreclosure action, or if a settlement involving a deed in lieu was difficult to negotiate, that would gravitate in favor of purchasing an owner's policy. So would a situation where the insured had a need to dispose of the asset quickly, or where the property was heavily encumbered and the encumbrances were disposed of in connection with the insured's acquisition.

5. Client is the holder of a mortgage on real property located in New York state. The loan is presently in default, and the owner and mortgagee are negotiating an agreement that restructures the loan. It includes a provision whereby the repayment of the existing accrued but unpaid interest is deferred to the end of the loan term, with interest on the amount so deferred at a rate of 6 percent. Does this trigger a mortgage recording tax? What if no interest is charged on the sum so deferred?

Such an instrument triggers mortgage tax to the extent of the accrued but unpaid interest, the repayment of which is deferred. Charging interest on this sum "capitalizes" it (or imposes interest-on-interest), and tax is due on the amount so treated. Further, even if interest is not charged on the amount, the recording of such an instrument triggers an obligation to pay tax on the amount of the accrued but unpaid interest.[16]

6. Client is the holder of a mortgage on real property located in New York state. The loan is presently in default, and the owner and mortgagee are negotiating an agreement that restructures the loan. The agreement includes a change in interest rate, converts the loan to interest only, shortens the term of the mortgage and makes other changes. How does this affect the title insurance that the mortgagee presently has? What if there is a subordinate mortgage recorded? Does it need to purchase a new policy?

For recording purposes, New York is a race-notice jurisdiction. Under a race-notice statute, a purchaser (in this case, the second mortgagee) takes free and clear of an interest (in this case, the enhanced amounts of the first loan) provided that she paid value without notice of the interest and recorded prior to the recording of the other interest. Here, the second mortgagee paid value (the mortgage amount) without notice (the subordinate mortgagee had notice of the vested, recorded rights under the first mortgage, but not the rights as modified) and recorded her interest before the modification was recorded. Accordingly, the subordinate mortgagee takes subject to the rights of a first mortgagee only to the extent that the subordinate mortgagee has notice of those rights.

A subsequent modification of the first mortgage would create a broken priority and would be subordinate to the subordinate mortgage to the extent that the modification creates new rights in favor of the holder of the existing first mortgage, to the extent that repayment of the first mortgage is rendered more onerous, or to the extent that the rights or interest of the subordinate mortgagee is impaired by reason of the modification.[18]

In the event of such a modification, a loan policy insuring the first mortgage would remain in effect, as of its date, insuring the lien of the mortgage as it was originally made. Of course, the policy would not cover any loss arising by reason of the modification.

As for the second part of this question, it has always been my opinion that a new policy (or endorsement to the existing policy) should always be considered whenever a modification agreement is to be made. There are two reasons for this view.

First, as stated above, the execution and recording of a modification can result in a loss of priority in part; it can also trigger the imposition of additional mortgage recording tax even if new principal is not being advanced (see question five above), and would impair the enforceability of the mortgage lien.[19] A new policy insuring the lien of the mortgage as modified (and including a mortgage tax endorsement) protects the mortgagee against these pitfalls.

Second, it is important to remember that a title insurance policy is more than a contract of indemnity; it is also a contract agreeing to defend the title or the validity and priority of the insured mortgage lien. This means that a title company has a duty (subject to the conditions, exclusions from coverage and the exceptions to title) to defend the priority of the mortgage lien as it is insured should a subordinate lienholder assert priority over the mortgage. This duty would not apply should a subordinate lienholder assert priority over the mortgage lien by virtue of the modification (or if it asserted priority to the extent that it was impaired by the modification and the mortgage was not insured as modified). Such an assertion in this context is quite common.

7. Mortgagee is going to take a deed in lieu of foreclosure on certain real property. Should the mortgage be discharged or kept alive? What are the advantages/disadvantages of doing so?

There are two common reasons to keep the mortgage alive when taking a deed in lieu of foreclosure. The first is the existence of liens subordinate to the lien of the underlying mortgage, with the idea being that such subordinate liens could be cut off in a subsequent foreclosure. The second is to keep the underlying mortgage alive for mortgage tax purposes, so that the property can be conveyed in the future subject to the lien of the mortgage, thereby saving the purchaser mortgage tax. This would make the property more appealing to a prospective buyer than a similar property that doesn't have the potential mortgage tax savings.

> The problems that consistently arise in a down market are different than those that come up during better times. Some lawyers have never represented a client in connection with a loan workout, a bankruptcy sale or a deed in lieu of foreclosure.

Both of these purposes have been viewed as suspect, and courts have barred foreclosure by deeming the fee and the mortgage merged, even where title was transferred to an entity separate from the mortgagee.[20]

If the decision is made to keep the mortgage alive in this context, it cannot be kept alive in name only; the mortgage must continue to secure a bona fide indebtedness, otherwise there is nothing to foreclose (or assign). Accordingly, two things need to be kept in mind.

First, the title must be taken in an entity that is legally distinct from the entity that holds the mortgage. A mortgage cannot be foreclosed or assigned if the indebtedness or obligation secured thereby is not bona fide,[21] and if the fee title and the mortgage come into common ownership, there is no bona fide debt.[22]

Second, the mortgage and the indebtedness must in fact be bona fide. That means that the note and the mortgage call for periodic payments that are what the market would bear, and which periodic payments are in fact made (and must be made continuously for the entire period the land and the mortgage are owned by related entities).

8. Your client is purchasing real property from a seller who is in Chapter 11. The sale is to take place pursuant to a confirmed plan of reorganization (or under 11 USC §363(c) of the Bankruptcy Code). At the hearing at which the order confirming the plan (or authorizing the sale) was to be issued, several creditors made their unhappiness known, and made it clear that they intended to appeal any such order. Nevertheless, the bankruptcy judge issued the order. Seller wants to close within 48 hours after entry of the order confirming the plan (or authorizing the sale). What are your risks? Can your sale be upset if a creditor files a timely appeal of the order?

The Bankruptcy Code, at §363(m), states as follows:

> The reversal or modification on appeal of an authorization under subsection (b) or (c) of this section of a sale or lease of property does not affect the validity of a sale or lease under such authorization to an entity that purchased or leased such property in good faith, whether or not such entity knew of the pendency of the appeal, unless such authorization and such sale or lease were stayed pending appeal.

The purpose of this provision is to bring a measure of finality to bankruptcy proceedings.[23] Accordingly, a court-ordered sale of debtor property under 11 USC §363 will not be upset by an appeal provided that (i) the entity purchased in "good faith"[24] or (ii) a stay of the same was not in place prior to the sale.[25] This would even be so if the sale took place prior to the expiration of the 10-day time period in which to file an appeal.[26]

A similar rule applies to the upholding of orders confirming a plan of reorganization under 11 USC §1129. Courts have consistently upheld orders confirming plans (and sales that have taken place in reliance thereon) provided that (i) no stay is in place, (ii) the plan has been substantially consummated, and (iii) the relief being requested would affect the rights of parties not before the court or the success of the plan.[27]

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1. This exemption also applies to the so-called mansion tax imposed by Tax Law Section 1402-a.
2. NY Adv Op Comm T&F TSB-A-90-(9)R.
3. 11 USC §1146(a) (formerly 11 USC §1146(c)).
4. *In re Jacoby-Bender Inc.*, 758 F. 2d 840 (2d Cir. 1985).
5. There is no similar provision exempting transfers made under Chapter 7 or Chapter 13 of the Bankruptcy Code.
6. *Florida Department of Revenue v. Piccadilly Cafeterias Inc.*, 128 S.Ct. 2326 (2008).
7. 20 NYCRR §575.11(a)(2)(i). A common example would be the assumption by the grantee to pay the transfer tax relating to the transaction, which is, by statute, a grantor obligation.
8. 20 NYCRR §575.11(a)(2)(ii).
9. 19 RCNY §23-03(d)(1).
10. 20 NYCRR §575.11(a)(3).
11. Id.
12. 20 NYCRR §575.11(a)(3)(ii). There are also specific rules that apply in instances where the grantee is a person in part related and in part unrelated to the mortgagee that is the foreclosing party.
13. 19 RCNY §23-03(d)(2).
14. 19 RCNY §23-03(d)(4).
15. The provision in the NYBTU form related only to the insured's acquisition of the estate or insured by foreclosure and not by deed in lieu.
16. 20 NYCRR §648.1(b)(3).
17. New York Real Property Law §291 (McKinney, 2007).
18. *Mead v. York*, 6 N.Y. 449 (1852); *Truscott v. King*, 6 N.Y. 147 (1852); *Fulbany Realty Inc. v. Perkins*, 16 Misc. 2d 597 (Sup. Ct., N.Y. Co., 1959).
19. New York Tax Law §258(1) (McKinney, 2007); *Commonwealth Land Title Insurance Company v. Lituchy*, 161 A.D.2d 517 (1st Dept. 1990).
20. *Cambridge Factors Inc. v. Thompson*, 215 A.D. 2d 427 (2d Dep't., 1995).
21. See *Long Island City Savings & Loan Association v. Gottlieb*, 90 A.D. 2d 766 (2d Dept. 1982); New York Real Property Law §275 (McKinney, 2007).
22. But see *Garans v. People of the State of New York*, 259 A.D. 2d 313 (1st Dept. 1999) and *Cambridge Factors Inc. v. Thompson*, 215 A.D. 2d 427 (2d Dept. 1995). In each case the court held that the doctrine of merger applied to extinguish the mortgage, though title was transferred to an entity related to the holder of the mortgage where that entity was an alter ego of the mortgage holder that was created for the purpose of defeating the rights of subordinate lienors, or was a sham corporation with the apparent purpose of perpetrating a fraud.
23. *Onouli- Kona Land Co. v. Estate of Richards*, 846 F2d 1170 (9th Cir., 1988).
24. The question of whether a purchaser is acting in good faith can be determined by establishing that there was no collusion, or any attempted fraudulent behavior or effort to take unfair advantage. *In re Abbotts Dairies*, 788 F2d 143 (3d Cir. 1986); *In re Shamblin*, 878 F2d 324 (9th Cir. 1989).
25. But see *Huddleston v. Estate of Hunt*, 109 B.R. 197 (N.D. Texas 1989), where the court argues, in dicta, that a lack of subject matter jurisdiction in connection with the original order is grounds to void an order.
26. USCS Bankruptcy R 8002.
27. *In re Texaco*, 92 BR 38 (SDNY 1988); *Manges v. Seattle-First National Bank*, 29 F3d 1034 (5th Cir., 1994), cert. denied, 513 U.S. 1152 (1995).

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