Foreclosure or Deed in Lieu: What's Right for You?

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In Virginia, a lender holding a defaulted loan secured by a deed of trust has two primary means to enforce its remedies under that deed of trust: foreclosure by a trustee's sale and conveyance by a deed in lieu of foreclosure. We've put together a brief primer summarizing the key strengths, weaknesses and procedural guidelines for each alternative to help you determine which option works best for your needs, timeline and budgetary constraints.

I. **Trustee's Sale.** The most common procedure for foreclosure is the sale of the property by a trustee, a non-judicial action. A trustee can act only in a manner authorized by the express or implied terms of the trust instrument or as authorized by statute. If the deed of trust does not provide otherwise, the provisions of the Virginia Code control as to the authority of the trustee. Foreclosure by a trustee's sale can usually be completed within thirty (30) to forty-five (45) days after the expiration of any cure period provided by the loan documents for the default giving rise to the foreclosure, if the lender acts promptly.

A.

The Trustee.

1. **Duties and Obligations.** A trustee is a fiduciary for both the debtor and the creditor. The trustee must not place himself in a position where the trustee's personal interests conflict with the interests of the parties to whom he owes a fiduciary duty. A trustee who is counsel to or an employee of the noteholder must be sensitive to the obligation to discharge his fiduciary duties in an impartial manner. The mere fact that a trustee in a deed of trust securing a debt due to a corporation is a stockholder, member, employee, officer or director of, or counsel to, the corporation, however, does not disqualify him from exercising the powers conferred by the trust instrument. Trustees cannot act as purchasers, directly or indirectly, at their own sales; when a trustee buys directly or indirectly at his own sale, that constitutes constructive fraud, and the transaction is voidable. This rule also applies to a trustee who is named in a deed of trust but does not act.

2. **Substitution of Trustee.** If the person who is to conduct the foreclosure is not named in the deed of trust as trustee, a substitution of trustee is needed. When an instrument appointing a substitute trustee has been executed by the holders of more than fifty percent (50%) of the secured obligations, the substitute trustee can immediately execute all powers granted to the prior trustee.

B.

Initial Procedures.

1. **Documentation.** A trustee should secure the proper documentation from the noteholder, which includes the deed of trust, the original note, title evidence (including title policies and surveys), copies of any correspondence between the noteholder and the debtor, copies of mortgage insurance or guaranty agreements, appraisal, written direction to proceed with the foreclosure and engagement letter. The trustee should verify that the noteholder has complied with all notice requirements set forth in the deed of trust.

2. **Diligence.** A trustee should contact the local commissioner of accounts regarding fees charged for approving and examining accounts as well as any local requirements, including proper advertisement procedures. Though the trustee is only charged with selling the property encumbered by the deed of trust, the noteholder should consider any relevant diligence issues affecting the property prior to initiating foreclosure proceedings, including environmental matters, permits, insurance, utilities, leases, appraisal, physical condition and rights in fixtures. In addition, though there is no statutory right of redemption in Virginia, the debtor does have the right to pay off the secured indebtedness before the sale; some deeds of trust provide for reinstatement of the debt if the debtor cures all defaults and pays all expenses in the manner and time provided in such deeds of trust.

3. **Title.** While the doctrine of caveat emptor applies in a foreclosure sale, a trustee must be aware of all liens and encumbrances affecting the property. A trustee cannot sell a greater interest in the property than the deed of trust gives him authority to sell, and any sale by the trustee will be subject to encumbrances having precedence over the deed of trust. A trustee must be aware of all encumbrances on the property, including federal tax liens, in order to properly notify all interested parties, to exercise proper discretion as to whether a fair sale can be had, and to make a lawful distribution of the proceeds of the sale. A trustee should order a title rundown of the property from the date of the original title policy, which can be obtained for approximately $100-$250.

C.

Notice. The trustee has no authority to exercise the power of sale or to obtain possession of the property until such time as the debtor defaults under the terms of the note and the trust instrument. The trustee must satisfy himself that the note and the deed of trust are actually in default before initiating foreclosure proceedings, including providing any pre-acceleration notice required by either document.

1. **Requirements; Timing.** The present owner of the property must be given written notice of sale

at his last known address as such address and owner's name appear in the records of the secured party, which must be personally delivered or sent by registered or certified mail at least fourteen (14) days before the date of the foreclosure sale. It is a good idea to send a separate notice to each owner by regular mail. Each such must provide the date, time, and place of sale and is sufficient if it contains the same information set forth in the public advertisement of the sale. 'Inadvertent' failure to give notice imposes no liability on either the trustee or the secured party, and failure to comply with the notice requirements will not affect the validity of the sale. A purchaser for value will have no duty to ascertain whether proper notice was given. Actual receipt by the owner of the foreclosure notice is not required, and a defective statutory notice does not affect the validity of a foreclosure sale.

2. **Other Parties.** Notice should also be given to any guarantors of the indebtedness, subordinate lienholders, private mortgage insurers, the United States (if a federal tax lien affects the property) and any government agencies that are involved with the secured loan. If a federal tax lien affects the property and has been filed for at least thirty (30) days before the date of the proposed sale, notice should be given to the United States at least twenty-five (25) days prior to such sale.

D.

Advertisement. A trustee must conform the advertising to the terms of the deed of trust, and any material departure will invalidate the sale. Substantial compliance, however, is sufficient as long as the rights of the parties are not materially affected. Section 55-62 of the Virginia Code provides a permissible form of notice that must include the time, place, and terms of sale, including the amount of any deposit required. The advertising provisions are mandatory and override the discretion of the trustee, regardless of the contractual agreement of the parties.

1. **Requirements; Timing.** The advertisement must briefly describe the property to be sold by street address, if any, and, if there is no street address, the general location of the property with reference to routes, streets, and known landmarks. The tax map identification number of the property may be used but is not required. The advertisement must also include the name, address, and telephone number of the trustee and the secured party, or the secured party's agent or attorney, to respond to inquiries from the public about the sale. Advertisement of the foreclosure must be made in a newspaper having a general circulation in the city or county where the property being sold or any portion thereof lies. The sale can be held no earlier than eight (8) days after the first advertisement and no later than thirty (30) days after the last advertisement.

2. **Number of Publications.** If the deed of trust provides for the number of publications by using language such as "advertisement required," then the direction of the deed of trust must be followed. In any event, if the newspaper advertisement is published on a weekly basis, it must be published not less than once a week for two weeks before the sale; and if published on a daily basis, it must be published not less than once a day for three days, which may be consecutive days. If the deed of trust does not provide for the number of publications, the Virginia Code requires that "the trustee shall advertise once a week for four successive weeks; provided, however, that if the property or some portion thereof is located in a city or in a county immediately contiguous to a city, publication of the advertisement five different days, which may be consecutive

days, shall be deemed adequate."

E.

The Sale. There are virtually no rules regarding bidding at a foreclosure sale, other than that the purchase price of the property must not be so low as to 'shock the conscience'. The sale may take place "at the premises or at such other place in the city or county in which the property or the greater portion thereof lies, or in the corporate limits of any city surrounded by or contiguous to such county." Most sales take place on the front steps of the city or county circuit court building. In the absence of specific direction in the trust instrument, the trustee is authorized to sell "upon such terms and conditions as the trustee may deem best." This language has been interpreted to include the power to sell either for cash or on credit. The trustee must be present and either conduct or supervise the sale. In the absence of specific authority in the deed of trust, a trustee cannot, even with the consent of the lender, delegate the power to sell and be absent from the sale; the trustee may employ an auctioneer to cry out the sale. Prior to bidding, the trustee should announce the terms of sale and answer any general questions from the public. The trustee should disclose fully any known liens or encumbrances. A contract of sale between a trustee and a purchaser is complete when the trustee knocks down the property to the highest bidder and makes and signs a memorandum of the sale and its terms. The trustee may require a deposit, and a closing will be scheduled for approximately ten (10) to thirty (30) days after the sale, all as set forth in the advertisement. In the event that there was a federal tax lien on the property, the government has a right of redemption for a period of one hundred twenty (120) days, meaning that the government may take the property and reimburse the purchaser for the amount paid within this time frame. The trustee may request the waiver of such right upon the delivery of the notice of sale.

F.

Settlement and Accounting. A purchaser can only require a deed with special warranty of title from the trustee. The trustee is not responsible for conveying good title, because a trustee can sell only the interest conveyed to him under the deed of trust. Recordation tax to be paid upon recordation of the deed is the greater of the amount bid at the sale or the assessed value of the property. The trustee must receipt for the proceeds. Any proceeds from the sale must be applied in the following order: to discharge the expenses of executing the trust, including the trustee's commission; to discharge all taxes, levies, and assessments, with costs and interest, including the due pro rata thereof for the current year; and to discharge in the order of their priority, if any, the remaining debts and obligations secured by the trust instrument, and any liens of record inferior to the trust instrument under which sale is made, with lawful interest. Any residual proceeds shall be paid to the debtor or his assigns. Within six months of the sale, the trustee must file an accounting of sale, including the original note, and all vouchers for his expenses with the local commissioner of accounts. The secured party may sue the debtor or any guarantor for any deficiency between the amount of the proceeds of the sale applied to the note and the amount of indebtedness outstanding thereunder.

G.

Advantages and Disadvantages. In Virginia, a trustee's sale is a relatively quick and efficient

means of foreclosing on real property. Once the sale has been completed, the purchaser will own the property free and clear of other junior encumbrances (provided that the junior lienholders were properly notified). However, the lender must be cognizant of the procedural and timing requirements in order to properly coordinate the trustee's sale, and the foreclosure process can be more expensive than acquir4ing the property by a deed in lieu.

II. **Deed in Lieu of Foreclosure.** With a deed in lieu of foreclosure, the grantor transfers the fee simple title to the property encumbered by the deed of trust to the lender under the deed of trust. The lender contemporaneously releases the lien of the deed of trust and forgives or stipulates the liability of the obligors under the obligations secured by the deed of trust.

A.

Advantages. Acquisition by a deed in lieu can be advantageous to a debtor, as the process minimizes damage to the debtor's reputation and credit rating by avoiding a formal foreclosure and creates substantial savings in costs, expenses, attorneys' fees and trustee's fees. The lender may find significant benefits as well, such as efficiency and the ability to obtain quick control of the property to effect its completion, rental or sale to a third party.

B.

Disadvantages. A lender should be aware of the potential disadvantages to obtaining property by a deed in lieu of foreclosure. The lender will own the property subject to junior encumbrances (which are normally extinguished by a foreclosure sale) and all obligations of the former owner (including building code violations and environmental responsibilities). The debtor's creditors may attack the sale as a fraudulent or voluntary conveyance if the value of the property greatly exceeds the value of the loan forgiven; and any guarantor that did not consent to the transaction may assert that the guarantors and debtor are released from any deficiency claim.

For more information about this topic, please contact Jamie Watkins Bruno at 804.420.6922 or or any member of the firm's Financial Services & Real Estate Team.

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