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WHITEPAPER

You Really Should Workout More: Alternatives to Foreclosure

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You Really Should Workout More:
Alternatives to Foreclosure

Banks are under extreme pressure to consider alternatives to foreclosure. For consumer loans secured by principal residences, Congress' enactment of Dodd-Frank[1] and the creation of the Consumer Financial Protection Bureau ("CFPB") have forced banks to explore alternatives to foreclosure, including workouts as a mandatory requirement. For commercial loans, the risk may not be as high, but the possibilities of significant losses remain. Those potential losses and the possibility that the bank may face the daunting task of operating the business are strong incentives for banks to explore workouts. Foreclosing on any property is an expensive proposition and rarely results in a positive gain for the bank. Clearly, banks have good reasons in addition to regulatory pressures to explore alternatives to foreclosure. It is not uncommon for a borrower, consumer and commercial, to be offered workouts, including loan modifications, forbearance agreements and deeds-in-lieu of foreclosure. We outline workout tools and their associated risks.

Loan Modification

Banks often are willing to modify the terms of the loan – lower the interest rate, write off arrears, or extend the term. Once loan modification appears imminent, obtain a current title examination to determine the existence of any unknown liens. The bank that holds the first priority lien should obtain subordination agreements from all junior lienholders and record them with the loan modification agreement. Junior lienholders should be receptive to entering into a subordination agreement as the loan modification directly benefits them as it prevents a foreclosure sale that would negate the junior lienholder's interest. This benefit may also make a junior lienholder an available source to consider for a settlement contribution when the only

[1] The Dodd–Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111–203, H.R. 4173; commonly referred to as Dodd–Frank) was signed into federal law by President Barack Obama on July 21, 2010.

other alternative is to proceed with foreclosure. Banks holding the first lien should ask if the junior lienholder would be willing to contribute to the workout arrangement.

<u>Forbearance Agreements</u>

This type of agreement is where the bank agrees not to take action against the borrower that it would otherwise have a legal right to take. Typically, the bank forbears from filing a foreclosure action. A typical forbearance arrangement gives the borrower the opportunity to pay an amount up-front to be applied against the arrears and then to pay the remaining balance of the arrearage in six to twelve equal monthly installments, with future monthly payments under the loan as they fall due. The agreement should retain the viability of the bank's declaration of default and pending foreclosure until the borrower has fully performed the forbearance agreement.

<u>Deed in Lieu</u>

Despite workout efforts, the bank may have no choice, but to foreclose. In these instances, banks should explore whether a deed-in-lieu of foreclosure makes sense. This workout method accomplishes the transfer of real property under an agreement between the creditor and the debtor as to the proceeds of the sale without having to incur the costs to foreclose. The debtor can convey the property to the creditor, in consideration of all or part of the debt. A deed-in-lieu of foreclosure can be frustrating if there is a junior lien against the property. Such a lien will not be shed away by a deed-in-lieu of foreclosure. If the junior lienholder does not agree to release its lien for some consideration, then a foreclosure would be mandatory.

<u>What To Do If All Else Fails</u>

Like everything else in today's lending world, banks still have to implement procedures to reduce risk that the borrower may sue or that the workout may result in losing the bank's priority lien position. At a minimum, any agreement should provide that the remedy for default under the terms of the modification will be limited to actions against the property and that the forbearance of this right is the consideration for the agreement. Documentation is also imperative due to the possibility of having a litigation battle regarding the terms of the workout. Banks should also make it clear that they will proceed with foreclosure without hesitation, unless there is an agreement executed by both parties that sets forth an agreed loss mitigation alternative.

Conclusion

The possible pitfalls and areas of concern inherent in the loss mitigation process can fill many more pages than this abbreviated discussion. The ultimate message is that while loss mitigation is worthy of consideration in most default situations, banks should document every step of the process and proceed with caution, especially when considering any misstep could result in prolonged and expensive litigation. **And, always keep a close eye on the new regulatory requirements espoused by the CFPB**.

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