

Housing Initiative Clinic Briefs

Deeds in Escrow under Illinois Law

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May 2014

This Housing Initiative Clinic Brief reviews Illinois law regarding the enforceability of deeds in escrow, which are occasionally used by mortgage lenders to obtain additional security in real estate transactions and serve as an alternative to formal foreclosure proceedings. The City of Chicago also requests similar deeds, known as reconveyance deeds, to be signed in connection with certain transactions in order to secure the performance of redevelopment obligations.

Overview

It is generally accepted that deeds in escrow used in connection with an original mortgage transaction are null and void. Courts find deeds in escrow used in connection with an original mortgage to be against public policy because such documentation deprives individuals of their redemptive rights regarding foreclosure thereby clogging the equities of redemption. In some states, deeds in escrow are more likely to be found enforceable when used in connection with loan workouts or modification agreements. The City of Chicago sometimes requires real estate developers to sign reconveyance deeds to ensure certain affordability or use obligations are performed in connection with City programs. The legal doctrines discussed in this Housing Initiative Clinic Brief have potential implications on the structure used recently in these transactions with the City.

Deeds in Escrow Definition

A deed in escrow is created when the borrower signs a deed conveying the applicable

property from the borrower to the lender. This deed is then held in escrow by a third party, such as a title company. The third party holding this deed is informed to release the deed to the lender immediately if the borrower defaults on his or her payment obligations or another triggering event occurs.¹ A homebuyer who takes out a mortgage and signs a deed in escrow at the time of obtaining the mortgage from the lender can lose his or her house upon default without a cure period because the deed would be taken out of the escrow account and publicly recorded, thereby conveying legal title of the property to the lender.

Clogging the Equities of Redemption

It is well-established that “a mortgagee should not have a collateral advantage besides interest on the mortgage debt.”² The statement originally related to usury laws, in which lenders could only charge reasonable interest rates up to a certain threshold amount. This equitable principle expanded into what is now known as an individual’s right of redemption prior to real estate foreclosure. Under states’ consumer law regimes, homeowners who default on their mortgages have a right to redemption which gives them a period of time and other procedural protections to get back in good standing under their mortgage and to cure the default before a foreclosure sale ensues. Because a deed in escrow takes away a borrower’s right to redemption prior to a foreclosure because the deed is immediately recorded upon default, a mortgagor can argue to a court that the transaction which includes a signed deed in escrow constitutes an impermissible “clog” of his or her right to redemption relating to the property. The “clog”

¹ Murray, John C., “Deeds in Escrow: Are They Enforceable?,” The American Law Institute Continuing Legal Education Group, http://files.ali-cle.org/thumbs/datastorage/skoobesruoc/source/CR047_12--Murray,%20J--Deeds%20in%20Escrow%20-%20March%2003_thumb.pdf (2005).

² “Clogging the Equity of Redemption,” 13 Harv. L. Rev. 595 (March 1900).

occurs because the pre-signed document precludes the borrower from exercising his or her statutory and equitable rights to save the property from a foreclosure.³

Applicable Illinois Statutes and Case Law on Deeds in Escrow

Illinois statutes directly discuss deeds in escrow as they relate to mortgage foreclosures and the debtor's redemptive rights. According to 735 ILCS 5/15-1601(a), "...no mortgagor of real estate which is residential real estate at the time of such attempted waiver may waive the mortgagor's rights of reinstatement and redemption, or either of them, and any such waiver shall be void." Along with this statutory right of redemption, Illinois also has a recognized equitable principle in which the "equitable right of redemption is inherent in every transaction constituting a mortgage ... which right can be cut off only in the manner prescribed by law, such as by a regular and proper foreclosure. This right ... arises at the time of default and generally lasts until a foreclosure sale occurs, after which the mortgagor can only redeem his or her property under redemptive rights provided in statute."⁴

An Illinois appellate court confirmed Illinois' policy on the equitable right of redemption. In *First Illinois National Bank v. Hans*, the court reaffirmed a per se rule that parties involved in a real estate transaction cannot, even by express agreement, transform the mortgage into an outright conveyance upon borrower's default. Such an agreement deprives the mortgagor of his or her equitable redemptive rights, and courts are therefore supposed to strike down these clauses

³ Murray, John C., "Deeds in Lieu of Foreclosure – Current Developments," First American Title Insurance, <http://www.firstam.com/title/resources/reference-information/jack-murray-law-library/deeds-in-lieu-of-foreclosure-current-developments.html> (2011).

⁴ *Williams v. Williston*, 146 N.E. 143 (1924); *Casper Nat. Bank v. Jenner*, 108 N.E. 998 (1915).

and declare the provisions null and void.⁵

Therefore, under statutory law and case law, Illinois courts are very likely to find deeds in escrow to be unenforceable as a matter of law when used in connection with granting an original mortgage. However, if individual homebuyers have been asked to sign this documentation in order to obtain their original mortgages, lenders may thereafter threaten to publicly record the deed and immediately convey the property back to the lender if borrower defaults on any payment obligations. Even if courts would find such signed deed to be null and void, threats by lenders to immediately take back the property may be effective against borrowers who are unaware of Illinois strong policy favoring redemptive rights.

Deeds in Escrow in Connection with a Loan Workout or Modification Agreement

Although Illinois courts have not addressed the enforceability of deeds in escrow in the context of loan workouts, several other states' courts have held that deeds in escrow are enforceable when used in connection with loan workouts under certain circumstances. Loan workouts occur when lenders and borrowers enter into a transaction to restructure the borrower's debt in order to avoid foreclosure. In these situations, the borrower did not initially sign a deed in escrow, but is asked to sign one in connection with the subsequent negotiations after default, but before foreclosure, in order to keep the property.⁶

A Florida appellate court held that a deed in escrow in connection with a mortgage loan workout was enforceable and did not violate Florida's public policy against clogging the equities of redemption. The Florida state court found it important in coming to this conclusion of

⁵ First Illinois Nat. Bank v. Hans, 493 N.E. 2d 1171, 1174 (Ill. App. 2 Dist. 1986); see also 27A Ill. Law and Prac. Mortgages § 362 (collecting Illinois cases relating to equitable redemption).

⁶ Murray, John C., "Deeds in Escrow: Are They Enforceable?," at page 2.

enforceability that (1) the transaction involved commercial real estate and not residential real estate, (2) all parties involved were represented by legal counsel, (3) separate consideration was given to the borrower, (4) the agreement between the parties was reached in light of an impending foreclosure action, (5) the remaining balance due under the mortgage was greater than the borrower's equity ownership in the property, and (6) it was financially impossible for the borrower to pay the remaining balance due under the original mortgage.⁷

A Michigan appellate court confirmed the general rule that a borrower's waiver of his or her redemption rights as part of an original mortgage is invalid. However, the Michigan court then went on in dicta to state that a real estate transaction that included a deed in escrow would not clog the equities of redemption if (1) the transaction was entered into after a borrower's default under the original mortgage, (2) the parties acted in good faith, and (3) the deed in escrow was signed as part of a contract that was separate and distinct from the original mortgage, and which included good consideration.⁸ Good consideration as part of a loan workout transaction may include more favorable terms for the borrower as compared to the original mortgage, a lower applicable interest rate, or a lower principal amount due to the lender.

A strict reading of 735 ILCS 5/15-1601(a) implies that Illinois courts would find at least some deeds in escrow unenforceable when used in connection with a loan workout. Illinois law contemplates a borrower waiving his or her redemptive rights after commencement of a foreclosure proceeding, but not before.⁹ Therefore, loan workouts that include the signing of a

⁷ Ringling Brothers Joint Venture v. Huntington National Bank, 595 So. 2d. 180 (Fla. Dist. Ct. App. 1992).

⁸ Oakland Hills v. Lueders Drain District, 537 N.W. 2d 258 (Mich. Ct. App. 1995).

⁹ 735 ILCS 5/15-1601(c) states that "After commencement of a foreclosure proceeding under this Article a mortgagor of residential real estate or other mortgagor who is otherwise so prohibited may waive the mortgagor's rights of reinstatement and redemption, or either of them, if (i) the mortgagor expressly consents in writing to the entry of judgment without such right of reinstatement or redemption, (ii) such written consent is filed with the clerk

deed in escrow while a foreclosure is being litigated would be more likely to be found enforceable as compared to loan workouts that avoid commencement of a foreclosure proceeding altogether. Under the current state of Illinois law, it seems unlikely that an Illinois court would find a deed in escrow to be enforceable even when used in connection with a loan workout if the deed is signed and held in trust prior to a foreclosure proceeding. However, since other states are moving towards accepting deeds in escrow in these situations when certain positive factors are present, it is possible that Illinois will take a similar stance to that of Florida and Michigan at some point in the future.

Applicability to City of Chicago Reconveyance Deed Requirements

The City of Chicago enters into real estate transactions whereby the City requires real estate developers to use property subject to certain conditions. These conditions may include redevelopment obligations and requirements to use the land in a certain way. In order to secure these promises, the City of Chicago requires the real estate developer to sign a document known as a reconveyance deed. Reconveyance deeds are documents granting the City the right to take back the property upon breach of some condition. If the developer breaks a covenant included in the redevelopment agreement, the City can automatically record the reconveyance deed and again become the legal owner of the property. The reconveyance deed therefore operates like a possibility of reverter except the City does not have to go to court in order to enforce its future interest in the property.¹⁰ Like a deed in escrow, the grantor or mortgagee can forego any legal

of the court, and (iii) the mortgagee consents and agrees to waive any and all rights to a deficiency judgment.”

¹⁰ A possibility of reverter or reverter interest is a reversionary interest that is subject to a condition precedent. This type of future interest is retained by a grantor after conveying property so that the grantee’s ownership in the property terminates and reverts back to the granting if a terminating event occurs. The grantor transfers the estate here, but attaches a special limitation that usually operates in the grantor’s favor. See Possibility of Reverter, Black’s Law Dictionary (9th ed. 2009).

proceedings by immediately recording the previously signed deed.

The City of Chicago reconveyance deeds do not secure loan obligations like the deeds in escrow discussed above. These reconveyance deeds are instead securing other obligations consistent with the real estate developer's obligations as outlined in a redevelopment agreement. For example, a non-profit may sign a redevelopment agreement with the City agreeing to develop affordable housing on the property and keep rents at below market prices. In connection with the redevelopment agreement, the City may require the non-profit to sign a reconveyance deed securing the development and affordability obligations outlined in the redevelopment agreement. If the non-profit does not adhere to the covenants included in the redevelopment agreement, then the City can immediately record the reconveyance deed and again become the legal owner of the property.

Clogging the equities of redemption and courts' reluctances to find deeds in escrow enforceable in certain situations have implications on the City's use of reconveyance deeds. Reconveyance deeds related to the City of Chicago transactions are not used to secure a mortgage as with the deeds in escrow discussed above. In the case of deeds in escrow, the borrower has signed away his rights to a foreclosure proceeding by signing a deed when the loan was made. In the case of reconveyance deeds with the City of Chicago, the current property owner has signed away his rights to argue his case in a court proceeding that a use covenant in the redevelopment agreement with the City has not been violated, thereby not triggering termination provisions under that agreement.

Illinois statutory and case law has not yet addressed the use of reconveyance deeds by the City of Chicago to secure use obligations in redevelopment agreements. Because of the parallels between deeds in escrow used to secure a mortgage on a property and these reconveyance deeds,

it is possible that Illinois courts would find the transactions with the City of Chicago to be similarly concerning as they relate to the doctrine of clogging the equities of redemption.