

Commercial Loan Recovery 101: How to Obtain Maximum Returns, Part II

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Receiverships

In the past when workout solutions failed, lenders would simply foreclose on the security for the loan and then sell the assets. During the foreclosure process, however, the borrower may allow the property to deteriorate, significantly diminishing the asset value.

An optimum solution may be to seek state or federal court appointment of a receiver – an impartial third party – who can oversee and protect the asset during the foreclosure process and ideally bring a higher recovery on the loan. This can be accomplished by stipulation with a cooperative borrower, or through an adversarial proceeding if necessary.

Most commercial loan documents provide for the appointment of a receiver in the event of a default. Different jurisdictions and judges' attitudes about appointing a receiver can range from viewing it as routine, to seeing it as an extreme step.

In the case of a showing of special circumstances (damage to the value of the underlying security, potential loss of franchise, failure to pay taxes or wages, etc), lender's counsel may seek an *ex parte* hearing, which shortens the notice period, sometimes to 24 hours. When not available, the hearing will be held according to statutory notice rules and according to the court's calendar. A receiver may also be appointed by way of a *stipulation* between the parties, which makes the court's action most predictable. A stipulated appointment often occurs when the borrower is willing to walk away and the lender does not want a deed in lieu of foreclosure, or to ever take title, for whatever reason.

A receiver is authorized to act when an Order Appointing Receiver is entered by the court.

However, in most jurisdictions the receiver must file an oath and bond prior to commencing his/her duties. The purpose of the oath is for the receiver to state that he/she will act responsibly according to the Order. The bond protects the parties in case of any malfeasance by that receiver. In some cases the lender/plaintiff may also be required to file a bond.

A receiver's authority and responsibility is governed by the Order Appointing Receiver and any additional instructions or orders. It is important to include powers to cover all anticipated circumstances. The lender's lawyer will usually talk with the proposed receiver for this purpose.

Most courts distinguish between receivers appointed to take over an entire business entity – often called a *general assets* receiver, and one appointed to take possession of specific assets which secure the loan and any income generated by those assets – usually called a *rents-and-profits* receiver.

Typically, a receiver is responsible for protecting the property that represents the security for the loan – its improvements, furniture, fixtures, equipment, and its income – as well as accounting for all receipts and disbursements and repairs and maintenance, which is particularly important in the case of an operating business.

The receivership estate generally has no legal obligation to debts incurred prior to the receiver's appointment, which protects the lender's interest and also acts as a barrier against some creditor actions such as garnishment, attachment, or repossession of assets without court consent. While dramatic changes or improvements to the property or its business operation are not usually a part of the receiver's duties, the receiver does

have the authority to spend money to correct safety hazards, avoid deterioration and to maintain the asset and its value.

Operating Businesses Present Special Problems

When considering the options, lenders need to remember the vast difference between operating businesses such as hotels and restaurants, and traditional income properties such as office buildings and shopping centers. Receiverships can help deal with the complexities of an operating business such as payroll and employment, tax liabilities, vendor and supplier relationships, utility services, and inventories that may require immediate attention. In addition, an operating business will frequently have other technical issues, such as liquor licenses, franchise agreements, equipment leases, and retail space tenants.

Receiver's Certificates for Additional Advances

If the property does not generate sufficient income to maintain the property, the receiver can ask the court to allow the issuance of "receiver's certificates" for new loans made to the receivership estate by the lender.

Receiver's certificates become a priority over all other final distributions and are noted as such by the court. Assuming that the lender does not expect full recovery on its original loan, the loan to the receivership estate will be paid prior to others, including the lender's original loan. Also, the receiver can repay that loan at any time, and not have to wait until the final discharge and distribution. The issuance of a receiver's certificate requires court approval – such authority should be included in the original Order Appointing Receiver.

State vs. Federal Receiverships

Special issues may arise within receiverships when the collateral is located in multiple states or jurisdictions. Receivership actions are commonly filed in state court in the county in which the debtor – or a significant portion of the lender's collateral – is located. State court jurisdiction, however, is confined to the state and, in many

instances, to the territory of the county in which the court and property are located, while federal receivership actions are conducted in the federal district court. Because of this, federal receiverships allow a receiver to exercise nationwide jurisdiction, which ultimately, can be less costly. However, a lender is afforded a choice between federal and state court only if jurisdiction exists in both courts.

Selling Assets During Receivership

Federal receivership rules have a specific provision for allowing the receiver to sell any or all of the assets in the receivership estate, subject to court approval. But most state courts' receivership rules are less specific and do not automatically provide the receiver with the power to sell.

There are circumstances in which a state court is likely to allow a sale, the most common being a stipulation from both sides that such a transaction is beneficial to all. When borrowers have personal liability or a guarantee, they are more likely to cooperate, which reduces potential loss. In some cases the court will allow the sale – even over the objection of the borrower – when the recovery from an early sale will be higher and there is "no foul" to the borrower.

Bankruptcy vs. Receivership

Confusion between bankruptcy and receivership is common, but the differences are fairly simple. Bankruptcy is a legal process to protect a borrower/debtor from collection actions by creditors, and its rules are aimed at protecting the borrower, not the lender. Receivership is an action in which the lender seeks to protect its security by having an independent third party take possession of the asset. As compared to bankruptcy actions, receivership is normally faster and less expensive as the process is not mired in rules and tedious complications and delays.

The benefits of a receivership are many. The appointment of a third party to take possession of a property and operate the business will shield the lender from liability, since the receiver is an officer of the court, not an agent of the lender. The receivership can be as critical to the lender as the foreclosure itself, since the property's cash now goes into the receivership estate, and the

borrower cannot use it for non-property expenses like legal fees.

It is important to remember that a receivership is not a legal “action,” in itself, but rather an “ancillary remedy” which is sought while another action (for example, a judicial foreclosure) is pending.

Bankruptcy

A lender’s recovery efforts are sometimes interrupted by a bankruptcy filing by or against the borrower. Sometimes, the bankruptcy case commenced by the filing will be a *liquidation* under Chapter 7 of the Bankruptcy Code. More often, it will be a *business reorganization* under Chapter 11 of the Bankruptcy Code. In either circumstance, the nature of the lender’s recovery efforts will necessarily change to some degree. If the lender understands the bankruptcy process, however, it will still be in a position to achieve its recovery goals in many cases. Following are some important aspects of the process that any lender making commercial loans should understand.

Automatic Stay

The automatic stay arises when a bankruptcy petition is filed, whether the case commenced is voluntary or involuntary. Notice to creditors is not required. The automatic stay generally stops collection efforts, foreclosure proceedings and other enforcement actions by creditors, including the commencement or continuation of any judicial, administrative or other action against the debtor, the enforcement of a pre-petition judgment against the debtor or property of the estate, any act to create, perfect or enforce a security interest or other lien against property of the estate and the setoff of any pre-petition debt owing to the debtor against any claim against the debtor. There are a number of exceptions to the automatic stay, but most tend to be narrowly drawn and, accordingly, do not provide relief to many lenders.

To obtain relief from the automatic stay, a lender typically must obtain a bankruptcy court order modifying or terminating (also called “lifting”) the automatic stay. The court may grant this relief for cause, including the lack of “adequate protection” of an interest in property. With respect to a stay of an act against property, the

court may also grant this relief if the debtor does not have an equity in the property and if the property is not necessary to an effective reorganization. Additional grounds for relief may apply in a “single asset real estate” case.

Use of Cash Collateral

Under the Bankruptcy Code, the debtor cannot use a lender’s “cash collateral” (for example, rents derived from improved real property subject to a mortgage or deed of trust with an assignment of rents clause) without the lender’s consent unless a court so orders after notice and a hearing. Because the debtor will normally want to use the lender’s cash collateral to operate its business as soon as possible, this statutory rule incentivizes the debtor to negotiate with the lender, creating opportunities for the lender to obtain benefits and protections to which it is not otherwise entitled. By entering into a cash collateral stipulation with the debtor, the lender can often:

- Introduce cash controls – for example, require deposits to segregated accounts.
- Impose budgetary discipline (operation pursuant to approved budgets).
- Obtain improved reporting – for example, financial reports and operational reports.
- Require modified debt service payments to the lender – for example, lower fixed payments plus certain contingent payments.
- Obtain operating agreements restricting the debtor’s ability to cease operations, dispose of assets, etc. without the lender’s consent.
- Obtain post-petition liens on some or all of the debtor’s assets.
- Acquire a super-priority claim (a claim prior to other administrative expenses) to cover any diminution in the value of the lender’s collateral as a result of the debtor’s use of cash collateral.
- Obtain waivers of the debtor’s rights under provisions of the Bankruptcy Code, including Section 506(c) (surcharge rights) and Section 551 (preservation of avoided transfers for the benefit of the estate).
- Obtain ratification of the lender’s loan documents, confirmation of the lender’s liens and security interests, acknowledgment of the outstanding loan balance, and waivers of various claims and defenses.
- Limit third-party challenges by barring all adversary proceedings challenging the lender’s claims and liens that are not

commenced within a specified period (for example, 60 days).

Debtor-in-Possession Loans

The Bankruptcy Code permits the debtor to obtain post-petition financing that, under certain circumstances, can be secured by a lien on the pre-petition lender's collateral that is senior to the pre-petition lender's lien. Although there are mandatory conditions intended to protect the pre-petition lender (for example, the prepetition lender's interest must be accorded "adequate protection"), there is always the risk that this protection will be insufficient. Also, in negotiating the credit agreement, the lender may be able to "shape the case" in its favor by bargaining for benefits and protections that are not otherwise available to the lender. For those reasons, if the debtor has sufficient assets, it may make sense for the prepetition lender to consider becoming a post-petition lender.

Section 363 Sales

Section 363 of the Bankruptcy Code permits the debtor to sell assets "free and clear" of the lender's lien if the lender consents to the sale. Although there are other circumstances under which the assets could be sold without the lender's consent (*e.g.*, whenever the sales price for the assets exceeds the aggregate value of all liens on the assets), these circumstances rarely apply. As a result, if the debtor is interested in paying or, due to a default under a cash collateral stipulation, debtor in possession loan or other post-petition agreement, is required to pay some or all of its debt to the lender, this statutory provision can be used as the basis for liquidating some or all of the lender's collateral and applying the net sales proceeds to pay down or pay off the loan.

Chapter 11 Plan

In a Chapter 11 case, a plan of reorganization generally must be *confirmed* by the bankruptcy court before the case can be brought to a successful close. Among many other requirements for confirmation, the plan must be "accepted" by each "impaired" class of claims or interests. Under certain circumstances, even if the plan is not accepted by all impaired classes of claims and interests, the court may confirm the plan, as long as it is (among other things) "fair

and equitable." In the case of a class of secured claims, a plan that provides for deferred cash payments of a value at least equal to the value of the lender's collateral (which may be less, perhaps far less, than the total amount of the lender's claim) may be deemed "fair and equitable" for this purpose. This is sometimes referred to as a "cramdown" plan. Given the uncertainty here, both the debtor and the lender have an incentive to negotiate with one another in order to settle prior to the plan confirmation hearing the terms and conditions under which the lender will vote in favor of the debtor's plan of reorganization.

Lender's Exit Strategy

Because a bankruptcy filing can significantly alter the rules affecting loan recovery efforts, it is important for the lender to develop its exit strategy as soon as reasonably practicable. This strategy may include restructuring the terms of the loan pursuant to a plan; negotiating a sale of assets in a "free and clear" sale under Section 363 of the Bankruptcy Code or pursuant to a plan, with the net sale proceeds being used to pay down the loan; filing a motion with the bankruptcy court to lift the automatic stay permitting the lender to foreclose on its collateral; or a combination of the above.

In conclusion, whether the lender's collateral consists of traditional or non-traditional assets, the options for dealing with a non-performing commercial loan are many, ranging from workouts and deeds in lieu of foreclosure to receiverships and foreclosures to note sales and beyond. An informed lender or special servicer needs to be well versed on all of the available tools in order to effectively maximize the ultimate loan recovery.

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