

Foreclosure Or Receivership? Evaluating The Options

In many circumstances, appointing a receiver may enable a lender to minimize losses on a property loan in default.

By William Hoffman

The rate of loan defaults among a broad spectrum of commercial projects, from condo construction to restaurant chains, continues to increase at an alarming rate.

While there are no simple solutions in this dismal real estate market, one thing is certain: Lenders who complacently wait until the foreclosure process is complete can expect the value of their security or asset to continue to steadily decline.

In all likelihood, the current borrower - seeing no recapture of equity in the near future - may allow crucial operating, marketing, maintenance and other needs to be neglected in order to retain available cash prior to losing the property.

Some borrowers may voluntarily deliver possession of the property to the lender, offering either a deed-in-lieu of foreclosure or some other form of cooperation in exchange for relief from debt obligations. But most experienced lenders and servicers recognize the potential pitfalls in opting for a deed-in-lieu - not the least of which is stepping into the borrower's shoes as owner and possibly inheriting some obligations or other surprises, such as unpaid debt.

Another circumstance occurring with great frequency is when the borrower simply tosses the keys to the lender, effectively walking away from the property. In this case, the prudent lender will ask the borrower to stipulate to the appointment of

a receiver to provide for immediate protection of the property and everyone's interest.

In the case of construction loans, by the time the default has reached the stage for the lender to pursue foreclosure, the previous funding draws have been exhausted. Many subcontractors and vendors might not have been paid or are no longer working. Substantial portions of the project may remain unfinished, and permits and entitlements may be in danger.

If the developer/borrower has decided to walk away, there will most likely be a need for protection of the property, including construction or repair work, maintenance of buildings and personal property, upkeep of curb appeal and prevention of deterioration. This is when a receiver - a court-appointed third party - can be particularly advantageous.

To that end, the rise in commercial loan defaults has seen a parallel increase in the use of receivers to protect the lender's security assets during the foreclosure period. A word of caution: As the foreclosure rate increases and work continues to diminish for developers, brokers, appraisers, management companies and others, we can expect many more real estate professionals to claim receivership ca-

pability in order to generate income during a dry spell in their own line of work.

Managing the property

There are many reasons that a lender may opt for receivership over simply waiting through the foreclosure process. Common reasons include homeowner-association issues, health and safety concerns, possible future warranty issues, environmental questions and other reasons to avoid coming into title.

A receiver shields the lender not only from borrower claims of liability based on the lender's active participation in the property's operation, but also from deep-pocket syndrome, which inevitably emerges when various other creditors expect the lender to make everyone else whole again.

The receiver gives the lender impartial third-party control of the asset and allows a quick start on assessing current status, determining operating expenses, planning options for optimal recovery and preparing the property for sale through appropriate strategies.

Unlike bankruptcy, which is aimed at protecting borrowers from their creditors and usually allows the debtor to remain in possession, receivership is primarily used by lenders to protect their security.

The receiver is an agent of the court (not of the lender) that is appointed to protect assets that are the subject of another legal action - in this example, a foreclosure. While bankruptcy is governed by very specific and rigorous



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rules, receivership law is quite flexible, allowing the court to grant authority to the receiver that it deems necessary to carry out the receiver's duties and responsibilities.

While there is one national bankruptcy law standard, receivership law is governed by a wide variety of state and federal laws.

In the case of a default on unfinished construction, the receiver will apply for and maintain all necessary permits and licenses, verify that documents are being properly recorded, secure approvals, select and monitor vendors and contractors, and most importantly, assure that the project moves along carefully and swiftly.

In addition to taking legal possession, the receiver is charged with managing the property, either personally through a third-party management firm or, with the court's permission, through the receiver's own company or affiliate. The latter should result in reduced total fees and expenses.

In the case of business enterprises connected to the real property (e.g., hotels, restaurants, convenience stores), a management company with specific experience and skills will be necessary, as many more technical issues (e.g., franchise agreements, liquor or gaming licenses, vendor contracts or employment issues) will be involved.

The receiver, unlike a management company hired directly by a lender after a foreclosure or deed-in-lieu, will be able to effectively continue the operations of the business under the current and existing licenses or permits of the borrower. This continuity can be critical in certain scenarios - for example, when dealing with a chain of casual dining restaurants that survive on liquor sales.

Additionally, the recent spike in failed construction projects has left many unfinished developments abandoned and many lenders stuck with projects they cannot unload.

A receiver can be granted the authority to complete construction, help maneuver through the entitlement and permit system, and work with the city and the state to get extensions on permits, orchestrate the necessary inspections to keep the project on track and

negotiate lien settlements to ensure the property is not encumbered in a way that would limit the lender's ultimate recovery.

Appointment procedures

The Order Appointing Receiver is the all-important guide and rulebook and should include key provisions to cover every unusual circumstance. In today's economy, lenders should play extra-close attention to this key legal document.

The action to have a receiver appointed is normally heard by the court after notice is given to all parties and they are given time to respond and prepare for a hearing on the matter. With courts' calendars becoming increasingly backlogged, the delay in getting a hearing date can result in further damage or loss of value to the property.

To help circumvent this problem, when the facts of the case show sufficient urgency or emergency, some courts allow for an *ex parte* hearing, held after very short notice (sometimes 24 hours) to the opposing party. If the court appoints a receiver in this circumstance, it will usually schedule a subsequent hearing in 10 days or so to confirm whether or not that *ex parte* appointment was correct and should remain.

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 reasons such as those mentioned above.

Parties seeking the appointment of a receiver will often find that there are relatively few attorneys with expertise in receivership law, unlike bankruptcy, which is a recognized specialty. In fact, it is not unusual to find judges with very limited experience in receivership, especially in smaller courts outside major metropolitan centers.

This situation can be either a problem or an opportunity for a skilled receiver who, as the court's agent, is able to argue for many unique powers, making it unnecessary to repeatedly return

to court for further instructions, thereby reducing the ultimate cost to the lender.

All of the receiver's duties and authority are governed by the Order Appointing Receiver issued by the court. A proposed order is drafted by the lender's counsel, as well as its recommendation of a receiver to be appointed. It is always wise for the lender's attorneys to talk with the proposed receiver prior to filing the necessary motions and proposed order to ensure any unique circumstances are addressed.

Disposition and recovery

The Order Appointing Receiver may also include authority for the receiver to sell part or all of the assets of the receivership estate.

Some legal jurisdictions provide the receiver with the authority to sell, some preclude sales and some are virtually silent on the issue. In recent years, courts that have not granted absolute authority for the receiver to sell a property may instead grant a right to market the property.

In a declining real estate market, the benefit to the lender is obvious: The sooner a property is offered for sale, the higher the offering price is likely to be. A skilled receiver can get the property on the market in a matter of weeks, rather than months.

Receivers are also increasingly being used to market and sell properties before they are foreclosed upon, resulting in higher recovery amounts.

When an offer is received by the receiver - even if it is unsolicited - it can be presented to the parties and the court for consideration. Because any sale must have final approval of the court, even when the receiver has been given the power to sell, the "right to market" may, in practice, lead to the same result. Even if a sale is not approved, the receiver, the parties and the court will have a real picture of true market value.

Another benefit of a sale by the receiver is that the property is sold "as is, where is, with all faults" - meaning without warranties or representations of any kind. In addition, such sales are usually all-cash, with short due diligence and escrow periods, and with very few contingencies.

The purchase and sale agreement is typically drafted jointly by the receiver's counsel and the lender's counsel. While the lender is not the owner or the seller, it will have the right to approve or object to the sale when presented to the court, and the receiver will save time by getting its opinion in advance.

Because of their relative simplicity, receiverships are ultimately less expensive than bankruptcy or the true

cost of waiting for the foreclosure process to run its course. Additionally, receivership typically has less of a stigma and little or no negative impact on crucial relationships with the troubled company's trade creditors.

The traditional - and lengthy - sequence of default, filing of the notice, waiting out the jurisdiction period, conducting the foreclosure, engaging a broker, marketing the asset for a reasonable

period and negotiating the sale can be dramatically shortened, which will ultimately maximize loan recovery. **CMI**

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