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PERPECTIVE

Setting the record straight: bankruptcy vs. receivership

By David Wallace

Historically, the approach to handling a defaulted loan was fairly straight-forward — the borrower would file bankruptcy or the lender would foreclose. In recent years, other effective alternatives, in particular receivership, have emerged.

Receivership is increasingly popular and is often mistakenly viewed as the mirror image of bankruptcy. In fact, confusion between bankruptcy and receivership is quite common, even with creditors and attorneys, especially those who do not handle both on a regular basis. The most basic and fundamental difference is fairly simple. A bankruptcy is an action usually fled to protect a borrower/debtor from collection actions by creditors. Bankruptcy courts and rules are primarily aimed at protecting the borrower, not the creditor. On the other hand, receivership is an ancillary action fled during a foreclosure proceeding in which the creditor seeks to protect its security by having an independent third party take possession of that security.

Bankruptcy

The commercial real estate industry is seeing an uptick in bankruptcy flings, and the operative word in this arena is "valuation." Whether a lender is oversecured or undersecured can determine what options are available to the lender within the bankruptcy. While there are many kinds of bankruptcy, the two most common types are liquidations and reorganizations. A "Chapter 7" bankruptcy, named for its place in the bankruptcy code (11 U.S.C. Section 701) is fled for the express purpose of liquidating the assets of a business or company and winding up its affairs. A "Chapter 11" bankruptcy (11 U.S.C. Section 1101) is fled when a debtor seeks to reorganize its business and exit the other side of bankruptcy with a clean slate.

Automatic stay and requesting relief. The fling of a bankruptcy petition, whether voluntary or in-voluntary, operates as a stay against any action or proceeding against the debtor — including any act to enforce a judgment against the debtor's estate or obtain possession of property of the estate. 11 U.S.C. Section 362. The automatic stay prevents any act to create, perfect or enforce any lien against property of the debtor's estate, including fore-closure proceedings, even if already begun. However, many secured lenders will file a motion for relief from the automatic stay to complete the foreclosure process outside the jurisdiction of the bankruptcy court. The bankruptcy judge must evaluate various factors to determine if relief from the automatic stay will be granted, but it is a useful option for lenders to consider and can provide a quicker, less expensive way to get the collateral away from the protection of the bankruptcy court, so more traditional remedies for default can be enforced.

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Negotiating a favorable cash collateral order. Under the bankruptcy code, the debtor cannot use a secured party's "cash collateral" (e.g., 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 orders after notice and a hearing. This order is called the "cash collateral order." For the debtor to use cash collateral, the debtor must assure the creditor that the collateral will not decline in value during the course of the bankruptcy, also known as giving the lender "adequate protection." 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 and creates an opportunity for the lender to obtain benefits and protections to which it is not otherwise entitled.

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. To approve a Section 363 sale, the bankruptcy court must determine whether the sale constitutes the highest and best of-fer, that terms and conditions of the sale were negotiated at arm's length, that the sale is in the best interest of the bankruptcy estate and its creditors, and that the purchaser and the sale itself is being conducted in good faith. If these factors are met, but the proceeds are not enough to pay the secured creditors in full, the sale cannot be approved over the objection of the creditor, unless there is nonbankruptcy law that is applicable and could force the creditor to accept the sale.

Plan of reorganization. For Chapter 11, a plan of reorganization typically must be confirmed by the bankruptcy court before the case can be brought to a successful close. There are other requirements for confirmation, such that the plan must be "accepted" by each "impaired" class of claims or interests. Even if the plan is not accepted by all, 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.

If a receiver has been appointed prior to a bankruptcy fling, counsel for the lender must determine if an effort should be made to persuade the bankruptcy to allow the receiver to remain in possession. 11 U.S.C. Section 543 of the bankruptcy code allows a custodian (the receiver) of borrower's property to temporarily remain in possession to protect the asset from damage or waste. This relief can be sought by the lender while simultaneously fling for relief from the automatic stay.

In the past all too many lenders assumed a bankruptcy fling extinguished all of its options, or at least suspended them for a potentially long time while the bankruptcy action was pending. As discussed above, lender's counsel can use the bankruptcy code strategically to obtain favorable cash collateral orders — in addition to being an integral part of the drafting of the plan of reorganization that is ultimately confirmed.

Receiverships

Many lenders seek state or federal court appointment of a receiver — an impartial third party — who can oversee and protect an asset during the foreclosure process and ideally maximize loan recovery.

The motion to appoint a receiver is fled after a suit is already in progress or contemporaneously with the fling of the original complaint — and the exact timing is dependent on the jurisdiction in which the receiver is appointed. Receivership is designed to protect a lender's security inter-est in a debtor's asset(s) during an interim period, for example, while a foreclosure action is pending. A receiver can also be appointed on an ex parte basis in special circumstances, as well as by stipulation between all parties.

In this case, the secured creditor (lender) is asking the court to protect its security (land, buildings, business income, cash, etc.) until the foreclosure is resolved. Accordingly, the court will appoint an independent person, not connected to either the plaintiff (lender) or defendant (borrower) in the foreclosure action. That independent party "takes possession" of the asset(s) on behalf of the court and remains in control of the asset(s) until the default of the loan is cured, the property is sold in receivership or the foreclosure is completed.

A receiver is authorized to act when an Order Appointing Receiver (OAR) is entered by the court. A receiver's authority and responsibility is governed by the OAR and any additional instructions or orders of the court. As a result, it is beneficial for lender's counsel to speak with the proposed receiver.

A receiver does have the authority to expend funds to correct safety hazards, avoid deterioration and to maintain the asset and its value. The following are some more receivership issues to consider:

Sales during receivership. The sale of property through a receivership is one of the most notable and largest changes produced by the current real estate cycle. This is largely be-cause many creditors do not want to take title to a property through the foreclosure process, either because they are not in the business of owning real estate or they do not want to be in the chain of title of an environ-mentally challenged property.

Receiver's certificates for additional advances. If a property does not generate sufficient income to maintain itself, 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.

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Because both tactics will continue to play an important part in the mending of CRE markets, an in-formed real estate attorney needs to be well versed in both receivership and bankruptcy basics — as well as all of the available workout tools to effectively maximize the ultimate loan recovery.


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