EXCLUSIVE

Bankruptcy, Receivership: the Fundamental Differences

By **Natalie Dolce** | National | March 4, 2015

SAN DIEGO—Historically the approach to handling a defaulted loan was fairly straightforward—the borrower would file bankruptcy or the lender would foreclose. In recent years other remedies, in particular receivership, have emerged as effective alternatives. That is according to **William Hoffman**, chairman and CEO and **David Wallace**, general counsel of locally based Trigild.

In the co-authored commentary below, the team discusses the confusion between bankruptcy and receivership and what savvy investors need to understand. The views expressed in this column are the author's own.

Confusion between bankruptcy and receivership is quite prevalent, but the two are actually quite different. The most basic and fundamental difference is fairly simple. A bankruptcy is an action usually filed to protect a borrower/debtor from collection actions by creditors. Bankruptcy rules are primarily aimed at protecting the borrower, not the creditor.

On the other hand, receivership is an ancillary action filed during a foreclosure or other legal proceeding in which one party seeks to protect its security by having an independent third party take possession of that security. In comparison, receivership is typically faster and less expensive than bankruptcy, as the process is not mired in rules or complications.

Ultimately, there are benefits and detriments to both. The following is an overview.

Receivership Basics

Simply defined, a receivership is an “ancillary remedy” proceeding in which an impartial third party – a receiver – is empowered by the courts to take charge of a troubled asset during a pending legal action such as foreclosure. While receivership is even older than bankruptcy laws, it is seeing a resurgence in lender usage when workout solutions fail. Lenders who simply chose to leave a defaulting borrower in place until foreclosure risk the borrower allowing the property to deteriorate, diminishing its value.

Since receivers are also often involved in the disposition of properties, this approach ultimately benefits lenders and prospective buyers seeking opportunistic investments. Because it has evolved into a key industry function, it is also a process of which loan servicers and asset managers should be well aware.

When a property owner is headed toward foreclosure a receiver, as an agent of the court, can step in to control operations, protect the value of all assets, monitor and approve expenses and determine the best course of action for the property. This could include choosing to cease or continue operations, preserving or liquidating collateral, and/or preparing the property for a quick sale.

If construction has not yet been completed, the receiver’s purview would include working with the lender in deciding to continue, or suspend construction as appropriate.

As an unbiased agent, the receiver helps guard against further losses to the property that represents the security for a defaulted loan. This entails striving for optimal returns while preventing physical and financial damage. To do so, the receiver maintains oversight of all aspects of accounting, including receipts and disbursements, and other financial records. To make the receiver’s job possible, the lender may, at its discretion, fund operating losses to maintain or repair the asset as needed until a sale or other outcome is reached.

Properties placed in receivership can be traditional real estate holdings such as multifamily housing, shopping centers or office building. Often making the situation more complex, the asset might also have an enterprise component, as with hotels, gas stations, restaurants and entertainment venues. These properties may involve a host of businesses and legal issues – among them liquor licenses, franchise agreements, multiple bank accounts and vendor agreements -- and require specific knowledge of the business and its industry.

In all situations, the receiver is charged with securing all necessary approvals, permits and licenses, as well as making sure documents are properly recorded. Other responsibilities may include selection and oversight of contractors and vendors.

The bottom line? A myriad of complicated commercial and business issues are involved in the receivership process, making it critical that the appointed receiver have significant legal expertise.

Bankruptcy 101

Bankruptcy in the United States is governed under the United States Constitution which authorizes congress to enact "uniform laws on the subject of Bankruptcies throughout the United States." Congress has exercised this authority several times – most recently by adopting the Bankruptcy Reform Act of 1978, commonly referred to as the Bankruptcy Code.

While there are many types of bankruptcy, the two most common forms are Chapter 11 and Chapter 7 filings. A debtor files for Chapter 11 bankruptcy in order to gain time to resolve financial problems while maintaining business operations. Chapter 7 filings are for purposes of liquidating a business.

Although generally more expensive than receivership, bankruptcy can be a beneficial remedy for a lender, especially if the lender thoroughly understands the bankruptcy process. Following are some important aspects:

Automatic Stay and Requesting Relief.

The filing of a bankruptcy petition, whether voluntary or involuntary, operates as a stay, or halting, 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. The automatic stay prevents any act to create, perfect or enforce any lien against property of the debtor's estate. This includes foreclosure proceedings, even if already begun. A commercial lender has no choice but to comply with the automatic stay. 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.

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 so. A notice and a hearing would be need to be held first. 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.

Use of cash collateral in Chapter 11 typically requires that the debtor follow an agreed-upon budget. Any excess cash can be swept into an account for the benefit of the creditor to the extent necessary to provide that creditor with adequate protection.

363 Sales.

The 363 section 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 363 sale, the bankruptcy court must determine whether the sale constitutes the highest and best offer, 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 non-bankruptcy 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 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. Given the uncertainty here, both the debtor and the lender have an incentive to negotiate with one another 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.

A bankruptcy filing can significantly alter the rules affecting loan recovery efforts, so it is key 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.

If a receiver has been appointed prior to a bankruptcy filing, the lender must determine if an effort should be made to persuade the bankruptcy to allow the receiver to remain in possession. 1The 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 filing for relief from the automatic stay.

If a bankruptcy has been filed *prior* to the appointment of the receiver, the above scenario does not apply. In the past all too many lenders assumed in this case that most of its options were now gone, or at least suspended for a potentially long time while the bankruptcy action was pending. However, the lender need not be a passive observer since its cooperation or consent will still be required in the bankruptcy setting.

While receivership and bankruptcy differ, they sometimes do overlap. Some professionals who serve as receivers may also work as trustees or other officers in bankruptcy matters. In other instances, business owners might file for bankruptcy after the receiver has been appointed, in order to regain possession of the property. If this occurs, lenders may seek to remove the assets from the bankruptcy court's jurisdiction by way of a "relief from stay" motion, allowing foreclosure action to proceed. In order to do so, the lender will have to provide a compelling argument as to why the debtor should not regain possession and the bankruptcy court should leave the receiver in possession. A common argument for removing a property from the bankruptcy estate is the lack of any equity beyond the lender's security and therefore the absence of any value to remaining creditors.

Conclusion

Because both tactics will continue to play an important part in the commercial real estate markets, savvy commercial real estate and finance professionals should understand the nuances both of receivership and bankruptcy law to keep an edge in today's ever-evolving marketplace.