

What to Expect When A Receiver Takes Over A Troubled Property

by Andrew L. Herz and Joshua Stein.¹

Early in any judicial foreclosure action, the lender that started the foreclosure will often ask the court to appoint a receiver to take control of the property away from the borrower. Though this article primarily addresses receiverships in New York, where foreclosure actions typically take several years, many of these principles apply in other jurisdictions as well.

Appointment of a receiver represents a crucial step in the foreclosure process. It immediately changes the dynamics and the relationship between borrower and lender. Before the era of nonrecourse carveouts for voluntary bankruptcies, appointment of a receiver often drove a borrower to file bankruptcy almost immediately, in the hope that this might keep the lender and the receiver at bay.

Because a receivership typically lasts as long as a foreclosure, it can potentially continue for several years, as borrower and lender try to resolve their claims about the property (or try to delay the resolution of those claims). While the foreclosure action wends its way through the courts, the presence of a receiver is intended to protect the lender from the risk that the borrower will mismanage or steal from the property. The receivership is also intended to assure that the property does not deteriorate under the control of a distracted and penniless borrower.

Any well-drafted mortgage usually states that the holder of the mortgage can have a receiver appointed if the lender starts a foreclosure action. At least in New York, the lender can do that fairly easily. Assuming the mortgage has the right language in it, a New York borrower isn't even enti-

led to notice of the motion to appoint a receiver and the lender's right to appoint a receiver doesn't depend on whether the loan is "underwater." It's enough for the loan to be in default.

A foreclosure court in New York generally must choose the receiver from a list of candidates who have qualified to become a receiver and are not otherwise disqualified under the Rules of the Chief Judge. Other states may have similar limits on the court's choices in appointing a receiver. In any large and complicated foreclosure action, the judge will often ask the lender's counsel to nominate potential receivers.

For a borrower, appointment of a receiver doesn't need to mean the end of the world. Conversely, a lender shouldn't assume that appointment of a receiver turns the lender into the immediate king of its collateral, entitling it to act as if it owned the property. Indeed, a principal reason a lender wants to see a receiver in place is to protect the lender from liability that the lender could face if it actually took possession of the property itself.

The receiver is appointed by and works for the court, with the goal of preserving the property for the benefit of the parties, trying to assure that whoever ultimately wins control or ownership of the property will get something worth controlling or owning. The receiver does not take orders from the lender, but may seek suggestions from both parties. To the extent that the receiver needs the lender to advance funds to preserve the property, though, the receiver will pay particularly close attention to the lender's suggestions.

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What to Expect When A Receiver ...

continued from page 4

In many ways, arrival of a receiver is much like a transfer of the property – or at least its management -- to a new buyer or manager, except that it typically occurs without the cooperation of the borrower, as the transferor. Instead, it occurs by court order, often without prior notice and on a very compressed and sometimes chaotic schedule.

Before the receiver can actually step in, the receiver will need to obtain a bond and file an oath, both quickly accomplished by any knowledgeable receiver. The receiver will also need to obtain a new taxpayer identification number and open new bank accounts into which all receivership funds will be deposited.

The receiver often will want to document the property's physical condition at the commencement of the receivership by walking through, preferably with a camera, perhaps accompanied by advisers on construction issues and safety issues.

The receiver will need to consider just how to manage and preserve the property during the receivership. This will typically require the receiver to retain its own counsel, hire a property management company (though its responsibilities will vary widely depending on the type and status of the property), and often hire a security company.

The existing insurance program should be extended to cover the receiver, typically a much easier and more cost effective process than replacing the existing insurance. The receiver will, however, need to worry about any pending or upcoming cancellation of insurance that might result from changes or other issues at the property.

In general, when a property goes into foreclosure, something is seriously wrong. The

easiest case from a receiver's perspective consists of a perfectly respectable property, such as a fully leased and operating office building or shopping mall, that has just been overleveraged and therefore cannot cover debt service. From the receiver's perspective, the inability to pay debt service is not a problem – debt service is the one expense that the receiver can leave unpaid, as the foreclosure process itself will resolve the debt on the property.

At the other end of the spectrum lies a property that is either under construction but unfinished, or finished but entirely vacant. Because the receiver acts in the first instance as a "receiver of the rents," if no rents exist or the existing rents won't cover expenses, the receiver faces a very serious problem. In such a case, the receiver, before taking on responsibility for the property, needs to figure out, as well as it can, how much cash the receiver will need.

The receiver will consider not just monthly shortfalls to pay operating expenses, but also deposits with vendors and utility companies and payment of the receiver's expenses and commissions. For a property that is vacant, or that has incomplete construction, the receiver may need to worry about immediate repairs that must be undertaken -- including remediation of mold and safeguarding the property. The receiver will also need to identify alternatives to remediate mold or other dangerous conditions to demonstrate that it has addressed any problem in a thoughtful manner.

Even if the property produces no income, the receiver will still need some source of funds just to try to preserve the property. For any receiver, the lender will typically represent the only likely source of funds. Most mortgage documents do allow the lender to spend money to protect its collateral, and then recover those expenses from the borrower as part of the borrower's secured obligation. Once a receiver is in place,

continued on page 6

What to Expect When A Receiver ...

continued from page 5

those expenses will run through the receiver, with the lender adding them to what the borrower owes from a lender.

A receiver will want to try to assess what it will cost to run the property and will want a clear understanding about the lender's commitment to cover any property-related costs if property revenues won't cover them. If the holder of the mortgage loan is not an institutional lender – for example, a “loan to own” investor – the receiver may insist on a reserve for expenses, perhaps on an “evergreen” basis covering projected expenses for some reasonable time. These expenses could well include provision for the receiver's fees and expenses.

Often, a potential receiver -- or the lender appointing the receiver -- will want to have a full and frank discussion about the receiver's fees. Normally, in New York, the court sets a receiver's commission, which cannot exceed five per cent of the funds that pass through the receiver's hands.

If the property generates a great deal of cash, the lender will generally negotiate a commission at a lower percentage rate and will seek to have the court bless that agreement early in the proceedings. At the other end of the spectrum, a vacant property generates no revenue but may require a great deal of effort and decisionmaking by the receiver, especially during any construction. In such instances it is not uncommon to compensate the receiver at an agreed hourly rate, but the receiver and the lender should seek early court approval of the fees.

Over time, as the receiver becomes more familiar with property operations, the receiver should develop a budgeting process to prevent surprises and fine-tune the amount of any reserve account.

Any prospective receiver will typically raise and try to resolve any operational or financial concerns before the receiver's appointment becomes effective. In that process, the receiver will also try to become familiar with the property and prepare to take control as soon as appointed. That process will vary widely as properties can vary. A single article of reasonable length cannot do justice to every possibility.

The receiver will probably obtain an updated title search and a litigation search. Particularly for a construction project, the receiver will probably want an updated violations search. The receiver might have an expeditor pay an early visit to the building department to understand the status of construction and permits; whether any serious issues exist on the job; and which permits will need to be reissued or amended once the receiver comes into the picture.

The court's order defines what the receiver can and cannot do. Thus, both a lender and a prospective receiver will want to review the order carefully, to try to minimize any need for amendments once the receiver starts work. The receiver will want, among other things, to minimize the need to obtain approvals for minor actions or decisions from the lender or, even worse, from the court.

Any receiver acts as an officer of the court. Thus, any receiver should operate with as much transparency as possible. The more that the receiver discloses to all parties, the better. The receiver may want to set up a computerized list-serv to assure that each interested party receives as much information as possible.

The receiver has no special duty to any party – only to the court and the property – and nothing is confidential. Borrower, lender, and their counsel must remember this fact when communicating with the receiver and filter their communications accordingly.

continued on page 7

What to Expect When A Receiver ...

continued from page 6

If the receiver sends all parties copies of all contracts, bids for services, bills, bank statements, and financial reports and invites comment, the receiver sends an important message: the receiver is really trying to keep everyone advised of developments. That doesn't mean the receiver needs to ask anyone's permission, as long as the receiver complies with the order of appointment. Even so, early and frequent communication should estop parties from complaining later on. A prudent receiver will use separate stationery to indicate his status as receiver.

The receiver will need to operate, or at least maintain, the property – if possible – in a way that does not require much court involvement because each trip to the courthouse will produce expense and delay. Thus, within reason, any lender having a receiver appointed will want the receiver to have fairly wide authority, within broad constraints.

As its first responsibility, any receiver will identify and gather the assets for which it is responsible. Taking possession of a building is usually only the first step. With it should come all related books and records, permits, insurance policies, lease security deposits, letters of credit, personal property, contracts, keys, and anything else ancillary to the property. In some cases, depending on the structure of the lender's collateral, the receiver will take control of property-related bank accounts.

The receiver will typically start this process by giving written notice to the borrower's counsel, with a copy of the order of appointment. At the same time, the receiver will serve any tenants with notice of the receiver's existence, again with a copy of the order of appointment, and will direct the tenants to pay their rent to the receiver. If the borrower does not deliver keys to the receiver, the receiver may need to enlist a locksmith to take physical possession of the property – and will then need to maintain security starting immediately.

For property under construction or substantial renovation, the receiver's task becomes more complicated. The first question, of course, is asking whether the receiver even has the power or authority to continue construction – or is simply responsible for preserving the property. The answer to that question depends on the receiver's order of appointment.

To begin to understand the questions the receiver needs to ask itself, the receiver first needs to know who is already working on the job and under what terms. This will require copies of all contracts. A newly appointed receiver will want to see payment records and lien waivers to understand where the project stands financially.

The receiver must quickly assess which existing contractors and professionals it wants to keep. To replace the project architect or structural engineer during construction, for example, will probably leave the project in serious limbo.

In many cases, the lender will have obtained letters from the project architect and perhaps other major service providers, in which they agreed to keep working if the lender were to foreclose and take over the project. But does the letter say anything about what happens if a receiver is appointed?

Often, no. In the real world, though, regardless of what the loan closing documents say, any project architect and almost all other professionals would like to finish any projects that they start. As long as they keep getting paid, they will most likely stay on.

Paid for what? Any receiver will typically not pay for prior work, but only for work going forward. In most cases, architects and service providers will stay on the job on that basis, even if not contractually obligated to do so.

continued on page 8

What to Expect When A Receiver ...

continued from page 7

Contractors and subcontractors raise larger issues. Certain trades -- such as plumbers and electricians -- whose signoffs are needed to obtain governmental approvals can be very problematic. So too will be any roofing subcontractor, whose 20-year warranty may vanish if the subcontractor stops work and doesn't finish the job.

Usually contractors and subcontractors first want to be paid for work they have already done, before talking about future work. A receiver, however, has no obligation to pay for past work, and any liens arising from past work will usually be subordinate to the mortgage being foreclosed. Indeed, if the receiver pays for prior work without appropriate approvals, the receiver could face liability.

As a practical matter, contractors whose work is finished will not be paid. Contractors who aren't finished but will compromise and settle their claims will be paid and kept on the job. Those who won't will be replaced.

Before the receiver can resume any construction, the receiver must understand the status of permits and approvals for the project. In most cases, some permits and approvals will be in progress and open, and the receiver will want to take control of that process. This will usually require reissuing permits and applications in the receiver's name -- a process that the receiver will ideally have already understood at the moment of appointment. If the building has a temporary certificate of occupancy, one of the receiver's first questions will relate to the expiration date of the TCO. Its renewal may become one of the receiver's first tasks.

Depending on the nature and status of the property, leasing may raise at least as many concerns as construction for the receiver, the lender, and the borrower.

If the foreclosing lender wants to see new leases -- or no leases -- get signed, then the order of appointment should grant or deny the receiver authority to enter into leases. In most cases, receivers have very little authority to enter into leases, at least for longer than a year or two, because of concern that long-term leases could reduce the appeal of the property to possible bidders at a foreclosure sale, and thus reduce the selling price of the property. On the other hand, leases that last no longer than the foreclosure proceeding can create revenue without chilling bidders.

Leases for more than two years usually require court approval. If the property consists of an office building, the receiver may want to sign ordinary leases. These may make sense for the property, but it usually won't be just the receiver's decision. The receiver will need court approval, which will require the receiver to make a convincing case. Toward that end, the receiver may enter into a lease that expressly says it is subject to court approval. That approval process will give borrower and lender an opportunity to have their views heard and should protect the receiver against claims that it acted imprudently.

Leases costs money. Usually the receiver as landlord will need to pay for (a) the costs of any base building work needed for the tenant's premises, (b) a tenant improvement allowance and (c) brokerage commissions. To the extent that the receiver is fortunate enough to have these funds on hand, he is indeed in an enviable position. Usually this is not the case -- if it were the case, the property probably wouldn't be in foreclosure -- so the receiver must either seek the funds from the foreclosing lender or seek to minimize them by having the tenant, for example, assume responsibility for the brokerage expenses or agree to forgo a tenant improvement allowance. To the extent that the tenant assumes these responsibilities, the tenant will pay less rent.

continued on page 9

What to Expect When A Receiver ...

continued from page 8

The fact that the signed lease will be submitted to the court for approval can give the receiver a powerful negotiating tool. The receiver can take the position that the lease must be at or above market in order to get approval, and the receiver can take a hard line in negotiations. To the extent any party objects to the lease terms, the receiver may be able to push the rent up further.

Who pays ordinary expenses of the property? If the property produces rental income, the receiver will collect it (i.e., “receive” the income; hence the title “receiver”). The receiver will use that rent to pay expenses, typically holding any remaining net operating income pending the outcome of the proceeding. The receiver won’t pay the lender’s debt service, absent agreement between the parties or a court order.

An important element of any receivership consists of careful recordkeeping and bookkeeping. All communications and agreements should be carefully and systematically filed so that they may be produced when needed. Every cent that comes into the receiver’s hands must be accounted for and every expenditure fully documented. If a property manager has been engaged, its approval of all expenditures should be documented.

The receiver will also use some of the property income to pay management fees and the receiver’s own fees – perhaps monthly or quarterly but, in each case, subject to court approval.

In entering into agreements, the receiver must limit its liability and make clear that it has no personal liability. Just signing as the receiver will not necessarily suffice. A prudent receiver will include in every contract that it signs a disclaimer much like this: “The temporary receiver shall have no personal liability under this Agreement. In the event of any actual or claimed breach of this Agreement by the temporary receiver, recourse may be had only against the receivership assets.

No personal assets of the temporary receiver shall be subject to claim or levy.”

Although no borrower is ever delighted to see a receiver enter the picture, the borrower can respond in various ways. The borrower’s choices at the beginning of the process will help determine just how painful the receivership will turn out to be for the borrower.

If a borrower can demonstrate competence, reliability, and knowledge, the receiver may have greater confidence in the borrower and greater willingness to accept the borrower’s suggestions and ideas about how the receiver should oversee the property. In contrast, if a borrower decides to “fight the receiver,” that will certainly produce more visits to court and more expense – but it will not get rid of the receiver nor enhance the borrower’s dealings with the receiver.

Serving as a receiver can be a very satisfying experience. The receiver has the opportunity to come into a troubled situation and make it better for all involved. Even maintaining the status quo for a significant property where the parties are at war can be a Herculean task. If the receiver can keep in mind that its task is a simple one – just to do the best that he or she can for the benefit of the property, while keeping everyone fully informed – the receiver can look back (and tell the court) that the receiver did his or her job honestly, fairly, transparently, and with a goal of not unfairly prejudicing any party. ■

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