

Real Estate Receivers— Who They Are, What They Are Doing in the Credit Crisis, and How Commercial Agents Will Benefit from Working with Them

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We know our economy is in the grip of something entirely different from the recession of 2001 through 2003. That recession was primarily limited to a collapse in the *real property* market. Our current economic troubles are a *credit* problem. Credit is the financial *air we breathe*, and no one is unaffected.

Who are these receivers that we are beginning to read about and why should we care? In short, because receivers are the people who will have responsibility for many of the income properties and for sale housing projects that are going through foreclosure. They will be hiring real estate agents, property managers, and other third-party service providers to lease, sell, and manage the property under their care. They are a source of commission income.

The Tidal Wave Approaches

Let's first look at the scale of the commercial real estate problem. In the fall of 2007, the collapse in mortgage-backed securities that was created from *home* loans, played a big role in undoing the *residential* sector of the U.S. economy and triggering the global economic recession. Federal Reserve and Treasury officials today are scrambling to prevent the *commercial* real estate sector from

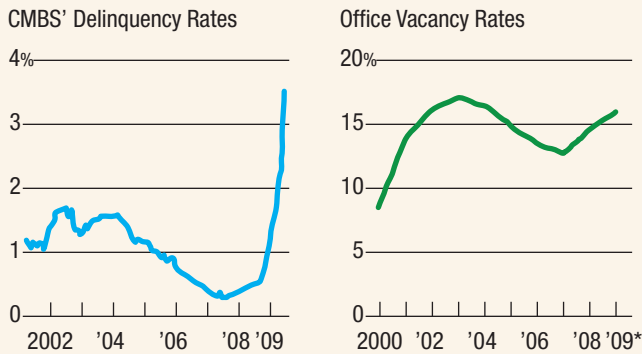
delivering what has historically been an even greater negative impact to the economy.

Of the \$6.7 trillion in commercial real estate that is privately owned, banks hold between \$1.3–\$1.7 trillion (50%) in commercial mortgages and construction loans. In addition, commercial-mortgage-backed securities (CMBS) account for another \$700 billion (22%) in outstanding debt. Life insurance companies (9.54%), savings institutions (9.5%), government sponsored entities (9%), and others hold the remaining debt, most of which was originated between 2000 and 2005. In many cases CMBS were used in hard-to-finance acquisitions, either involving higher loan-to-value ratios or providing debt in markets and on assets that conventional lenders would not finance. CMBS default rates now are rising dramatically as the following charts indicate because of overly optimistic underwriting (that rents would continue to rise) and the inability of property owners to refinance loans bundled into CMBS (even though the cash flows of many of these properties are enough to pay interest and principal on the debt).¹

The worry today is that rising defaults on CMBS debt will *pull down* values on CMBS-financed

Commercial-Property Blues

Defaults on commercial mortgage-backed securities have risen sharply as vacancy rates have mounted.



*As of June 30
Sources: Realpoint LLC (CMBS rates); Reis (vacancy rates)

collateral and in turn, have a *cascading* effect on bank-financed loan collateral, leading to an increase in the default rate of bank loans (banks are deleveraging and want more equity).

In short, it looks like the tidal wave of commercial defaults will hit this winter. Already, properties owned by Opus, General Growth, Maguire, Tishman, and other reputable firms have defaulted or have declared bankruptcy. The tidal wave will begin with retail and hospital-ity properties and then could hit multi-family, office, and industrial product. Commercial brokers who have historically called on tenants and landlords will find that their new customers are receivers and bank REO departments.

Who Are Receivers and What Do They Do?

Although it varies by state, “rents, issues and profits receivers” (“real estate receivers”) are, in most cases, individuals who are nominated in an *appointing order* drafted by the *plaintiff's* legal counsel (typically the lender). In most cases, the nominee is approved and appointed by the court (a judge in the jurisdiction of the loan collateral) to “*protect, preserve and secure rents*” after a loan default, during a foreclosure.² If the receiver is successful, in most cases the loan collateral will have retained its value from the time of the filing of the Notice of Default (N.O.D.) until the foreclosure is effected. If so, the ultimate deficiency to the owner/borrower will be minimized, and proceeds on sale to the lender (whether sold during or after the receivership) is maximized.

Most receivers are attorneys, and the rest are a blend of CPAs, property managers, developers, and others who can show to the court (presiding judge) that they are competent to preserve the value of the asset during foreclosure.

Generally, in the deed of trust or assignment of rents clauses in loan documents that provide for the appointing of a receiver, there are specific performance provisions. This is because lenders fear that when an owner/borrower (typically the *defendant* in the foreclosure action) receives his/her N.O.D. from the lender's trustee (typically a title insurance company that is substituted in, prior to the filing), the borrower will:

- Pocket the rental income (diversion of rents that are intended to first pay the note interest),
- Not maintain the condition of the loan collateral, that is, “waste” the asset (grass won't be watered, tenant improvements will not be funded, brokers and other third-party service providers not paid, and maintenance deferred),
- Not address health and safety issues for the tenants, or
- Abandon a project under construction (site should be secured).

For Whom Does the Receiver Work?

The receiver works for the court. Even though the receiver is typically nominated by the lender (either a bank or a CMBS special servicer), the receiver is an agent or officer of the court and is a neutral third party whose authority is limited to the terms and conditions in the appointing order.

To that end, receivers will often work with the plaintiff's counsel in the drafting of the appointing order to ensure that the authorities provided in the order will allow the receivers to complete their work without having to come to the court (the approving judge) for routine decisions required in the performance of their work.

Before the receiver can be appointed, he/she must obtain a receiver's bond (which is typically equal to the value of one month's rent).

How and When Are Receivers Paid?

Receiver's billing rates are delineated in the appointing order. In some cases it is a fixed fee with certain exceptions, but in most cases it is an hourly rate that varies depending on the level of experience of the person involved in the receivership work (receiver and support staff). In most cases, the receiver submits his/her billings to the judge, the plaintiff, and defendant at the end of each month. If none of these parties object to the charges (10 days is a common waiting period), the receiver is free to deduct said funds from his/her receivership estate account.

Where does the money come from to pay the receivership estate fees? The funds come either from funds transferred from the borrower/owner/defendant's property bank account, from rental income, or from funding of the receivership estate's bank account through receivership certificates. Before accepting a receivership, the receiver should have the assurance that there will be sufficient funding to the receivership estate's bank account to pay his/her fees.

When Are Receivers Appointed?

Typically, receivers are appointed concurrently with the noticing to the borrower of the N.O.D. It is not uncommon that on the day of the appointment, the receiver will (1) notice the owner/borrower of their appointment, (2) make a demand for all documents related to the property, and

(3) submit a request to the owner/borrower's bank to place a hold on their property bank account and a demand to transfer to the receiver's property-specific bank account an amount of funds equal to the security deposits, one month's rent (from all tenants), and a month's operating expenses.

Although the borrower/owner retains title to the real property until either the foreclosure completes or a work-out (or the cure of the underlying default) is affected, the receiver takes possession of the asset (collateral). All rents are paid to the receivership estate, and bills to operate the property are paid by the receiver. The borrower/owner is obligated, at the receiver's request, to provide the receiver with all leases, plans, permits, environmental reports, and other documentation that the receiver deems necessary to properly operate the asset until he/she is discharged. In most U.S. markets, if the owner/borrower refuses to provide the requested documentation, the receiver is authorized in the appointing order to take the requested operating documents with the assistance of local law enforcement. Lenders will often indirectly use the receivership and powers just described for the purpose of obtaining as much property documentation as possible.

What Is the Typical Duration of a Receivership?

In most states, if the property foreclosure completes, the process of an uncontested foreclosure runs between three to five months. (Texas has one of the shortest periods, often less than 30 days.) Receiverships are "at-will" and can be terminated at any time. In some cases, the threat of a receiver is used as a negotiating tool by the lender, and within hours of the receiver's appointment, the parties agree to a loan work-out and the receivership is terminated. In other cases, the parties (and the court) desire to keep the receiver in place for an extended time (e.g., if the receiver is to complete the construction and disposition of property during the receivership estate), so the receivership may remain active for a period of months or years. Because the receivership estate is at-will, all service providers employed by the receiver to effect the proper administration of the receivership must also be at-will.

It is fair to say that in most cases a service provider (i.e., a commercial agent) whose agency agreement (listing) is terminated at the end of a receivership will most likely be hired back by the eventual new owner (typically the lender) because such providers are "in place" and are familiar with the operations and benefits of the property. Here is where agents (brokers) can benefit. By knowing and working with receivers, brokers are put "on the job." This will increase the likelihood that they will be re-hired, post-receivership, by the lender's REO department. But there cannot be an agreement in advance.

Advantages to Receiver Selling a Property

There are compelling reasons for lenders/plaintiffs and borrowers/defendants ("the parties") to agree on

having the receiver sell the collateral property "during" the receivership:

- Because the receiver is an agent (or officer) of the court, the property is sold "as is" (no recourse to the buyer unless fraud is involved), and no post-closing claims can be made against the court and/or receiver for environmental contamination, injury, or in the case of residential property, construction defect liability (typically 10 years).
- The proceeds of the sale are typically the same or more to the lender if the asset is sold during (pre-foreclosure) than after the receivership. The primary difference is that if the lender takes title and then sells, he takes on the liability of future litigation.

A broker listing a property for sale with a receiver should remind any prospective buyer that, in most if not all states, the buyer should complete exhaustive due diligence before a purchase because sales from a receivership are without representations, warranties, or future rights to claims based upon property condition.

During the receivership, the receiver should ensure that all health and safety issues are in good order, that insurance is in place, that the asset is being properly maintained, and that costs to administer the receivership are kept to a minimum.

Important to Distinguish between a Foreclosure and Bankruptcy

Foreclosures and bankruptcies are entirely different. If a receivership is in place and the operating entity *commences bankruptcy proceedings, all efforts to collect a debt against the debtor in bankruptcy are subject to an automatic stay under federal law. Thereafter, the receivership is subject to the automatic stay unless it obtains relief from the stay pursuant to an order of the bankruptcy court. The order of relief from the automatic stay*³ is required in order (1) to separate the real property collateral from the bankruptcy estate (which is administered by a trustee) so that the foreclosure on the collateral can continue (and the lender will receive his proceeds in a timely manner) and (2) to reappoint or to appoint a receiver.

What Happens to Security Deposits?

Security deposits involve an area in the law that, in most states, will be a cause of great concern to many tenants. In most states, receivers are not responsible for security deposits if these are not turned over to the receiver. In most cases, security deposits are co-mingled with other project funds in the property's cash account. So, in cases when funds are transferred to the receiver's bank account, it is very difficult to determine whether any of those transferred funds were in fact, security deposit funds from a specific tenant.

The reality is that it is unlikely the owner/borrower/defendant has performed his/her obligations regarding the disposition of the security deposits at the time of the receiver is appointed.* The result is that many tenants

occupying properties that have been subject to foreclosure may have to challenge their new landlord (or the initial landlord) for the return of all or a portion of their security deposit. In most cases, I suspect they will not recover those funds. Commercial brokers would be wise to advise their tenant clients of this issue and encourage their clients to seek legal counsel on the manner in which they can best protect their pre-paid security deposits.

Handling Tenants Who Default

It is not uncommon in receiverships for the tenants to default on their rental payments. The receiver decides how to deal with the late-pay of the tenants. In some cases, there is little expectation that the tenant will be able to remain current on their rental payments, even if the rent is reduced to the current market rates (typically receivers have the right to modify existing tenant lease terms or execute a new lease for a period of no more than 12 months). In those cases, the receiver files a Notice To Pay or Quit (“Notice”), Summons, and Complaint. In most states, if the receivership is terminated during the Notice process, the Notice can be assigned to the successor-in-interest in the real property.

At the end of a receivership estate, the receiver files a final report and accounting order for the same and the distribution of funds with the court. By court order the bonds are exonerated and estate is terminated.

Opportunities for Brokers

Besides listing property with receivers, commercial practitioners should use receivers to help them identify

lender contacts for post-foreclosure listings. Once a lender has foreclosed, he/she has written down the value of the asset to *fair market value as determined by appraisal, less expected soft costs (commonly five percent to eight percent for legal, marketing, etc.)* and is a motivated seller—the ideal kind of client for the commercial broker.

Today’s “lenders” are, in essence, the owners of real estate. Working with receivers can assist a broker in obtaining a listing. ☞

*In California, in general, the landlord is to transfer to his successor-in-interest the remaining portion of the security deposit and notify the tenant of the transfer, any claims made against the deposit, the amount of the deposit and the contact information for the successors in interest (see California Civil Code 1950.5).

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