Receivership in Real Estate Transactions

A Practical Guidance® Practice Note by Richard Paul Ormond, Buchalter PC

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This practice note provides an overview of receivership in real estate transactions. It discusses the legal basis for receivership, the role and powers of a receiver, the process of appointing a receiver, and the benefits of receivership over potential alternatives. It also includes guidance for lenders and secured creditors when seeking the appointment of a receiver and reviewing an appointment order.

For more information on workouts in the commercial real estate context, see Workouts of Commercial Real Estate Loans. For more information on foreclosures, see Foreclosure of Real Property. For more information on defaults and remedies in commercial real estate financing transactions, see Commercial Real Estate Loan Defaults and Remedies.

Overview

What Is a Receiver?

A receiver is a court-appointed officer that acts as a "neutral" to manage assets (real property or personal property) or even manage businesses as going concerns when they are the subject of a legal dispute. A receiver can also be appointed to act as a liquidator of such assets or businesses. A receiver's primary role is to efficiently preserve assets in trust for all creditors.

Receivership is a legal remedy that exists in federal and state courts and provides an aggrieved party the option of placing an asset or business into legal custody, meaning that the court dispossesses the party in control of that asset or business and puts it into the hands of a court-appointed agent—the receiver.

Technically, the receiver is an officer of the court whose authority is derived through the equitable powers of that court. In federal court, the appointment of a receiver is authorized by Fed. R. Civ. P. 66; in state court, it is authorized under both common law and statute. Receivers are, by the nature of their appointment orders, fiduciaries of the court much like a trustee in a bankruptcy context. As a result, actions taken by the receiver are seen as actions by the court.

In essence, the receiver is the arm of the court, taking action that a judge himself or herself cannot take without stepping down from the bench. In addition, the receiver is the eyes and ears of the court, and the receiver (and its agents) are neutral, transparent, and fully report all of their actions and decisions to the appointing court. Further, the receiver's role as a court officer provides court oversight of the receiver's actions and business decisions and provides a forum in which interested parties can challenge or support a receiver's decision or action.

Why Appoint a Receiver?

In many circumstances, there are clear advantages in seeking the appointment of a receiver—usually, a situation in which a receiver will be able to preserve a disputed asset or business and maximize its value in the marketplace. For example, it is very common to seek a receiver on behalf of an unpaid lender whose borrower is in default and there is valuable collateral to preserve while litigating the dispute.

While receivership may be considered an extreme remedy under the law, in the fractured world of litigation and business, many circumstances do arise where a court will simply remove management (or an owner-operator) and replace it with a receiver. Receivers can be a helpful tool, by supplanting "bad managers" with a transparent neutral agent of the court. The receiver is often appointed to look after the best interest of creditors and other aggrieved third parties, not just equity holders. It is also an effective legal remedy if you are a significant creditor or claimant and the circumstances warrant divesting an operator or owner from their business operations.

Once appointed, receivers have broad equitable powers and can operate a business, sell assets, or unwind a business, simply depending on what is best for all of the parties involved. An experienced receiver will be able, through a well-crafted court order, to stabilize the day-to-day operations of a business, provide transparency to lenders, identify specialized third-party asset managers to operate any on-site facilities, manage in-flow and outflow of monies or goods, identify claimants, or resolve or reduce those claims.

The neutrality and transparency of the receiver alone provide a tremendous advantage to the court, lenders, and creditors, and allow the parties to accurately evaluate how best to restructure or dispose of collateral and estate property.

A receiver also has other advantages including what is known as quasi-judicial immunity, meaning that a receiver typically cannot be sued for undertaking his or her duties under court supervision or court order. For example, if a receiver sells real property, the sale will be consummated by the entry of a court order selling those properties "as is, where is" with no representations or warranties—all blessed by that court. This eliminates the risk of third-party claims against the receiver or the assets in the estate subject to that sale. Conversely, if a foreclosing party (or its agent) were to sell the property, the selling party would bear the burden of the liability, consumer protection regulations, and many more representations and warranties related to the sale.

As an inherent feature, the appointment of a receiver provides insulation to lenders and creditors from claims and liabilities arising from certain responsibilities. Those responsibilities are, instead, shifted to the court through the receiver, who can present equitable solutions to the court. From the sale of inventory to the more complex task of resolving creditor of claims, the receiver can be granted the authority to resolve issues and eliminate hurdles prior to a disposition of the disputed property. This saves the litigants the burden of liability, known or unknown, that may arise.

A receiver's appointment can be short or may last many years, all depending on the circumstances warranted by each case and how best to maximize the estate's assets' values.

Creditor Considerations

When a business is put into receivership, it certainly should raise concern for its creditors, suppliers, and customers. Seeking legal guidance is always helpful and direct communication with the receiver (or its agents) is key. Receivers, by law, are required to be transparent and file reports with the appointing court, but it is a legal process and not always easy for parties to navigate. When a party is in receivership, the receiver is usually the best source of information about the status of claims, receivables, payments, and operations.

Knowing the nature of the receivership is critical. Is it a liquidating receiver, there to simply sell off assets and wind down the operations? Or is it a restructure, where the receiver will sort through claims and streamline operations? Or is it something else entirely, such as babysitting a business while warring partners work out their differences? Each has different implications for outside parties and litigants.

Finally, receivers are also used in creative ways to effectuate workouts and turnarounds as an alternative to bankruptcy. In most instances, a receivership is less costly than a Chapter 11 bankruptcy and it is more flexible, as it is not overburdened by the highly complex Bankruptcy Code. Receivership is an established alternative to bankruptcy when implemented smartly.

Legal Basis for Receivership

The appointment of a receiver is an equitable procedure that a court uses when it believes that a party to an action is not in a position (or, in some circumstances, refuses) to comply with the desires of the court. Appointment of a receiver is also a provisional remedy that allows courts to preserve and/or maintain assets, so that waste does not occur and the value of an asset in dispute can be preserved pending final adjudication. This concept of waste in recent times has given receivers broad authority to maximize the value of businesses, receivables, and other assets through effective management and sale.

Article III, Section 2

As a matter of constitutional law, the United States traces its equitable courts to U.S. Const. Art. III, § 2, which established the judicial power of the federal government to all cases "at law and in equity." The U.S. Supreme Court, in Heckers v. Fowler, 69 U.S. 123, 128–29 (1864), held that the administration of insolvent enterprises, investigations into the reasonableness of public utility rates, and the performance of other judicial functions often require the special services of masters in chancery, referees, auditors, and other special aids.

In *Heckers*, the Court held the practice of referring pending actions to a referee to be coequal with the organization of the federal courts under Article III. The leading case of Ex parte Peterson, 253 U.S. 300 (1920), centered on a U.S. district court's appointment of an auditor with power to compel the attendance of witnesses and the production of testimony.

In *Peterson*, the district court authorized the auditor to conduct a preliminary investigation of facts and file a report on them to simplify the issues for the jury. This action was neither authorized nor prohibited by statute, but rather emanated from the court's equitable powers.

In sustaining the action of the district judge, Justice Brandeis, speaking for the Court, declared:

> Courts have (at least in the absence of legislation to the contrary) inherent power to provide themselves with appropriate instruments required for the performance of their duties. . . . This power includes authority to appoint persons unconnected with the court to aid judges in the performance of specific judicial duties, as they may arise in the progress of a cause.

Peterson, 253 U.S. at 312.

Federal courts sitting in equity have exercised the power to appoint auditors (or neutrals) from their very beginning, and here it was held that this power is the same whether the court sits in law or equity.

Rule 66

In federal courts, Rule 66 of the Federal Rules of Civil Procedure authorizes the appointment of receivers by federal court judges with the following language:

> The practice in the administration of estates by receivers or by other similar officers appointed by the court shall be in accordance with the practice heretofore followed in the courts of the United States or as provided in rules promulgated by the district courts.

Fed. R. Civ. P. 66.

The federal system, unlike many states, relies primarily on decisional law—the reported usages of equity—rather than on statutes to delineate when and under which circumstances receivers may be appointed. "[T]he district court has broad powers and wide discretion to determine the appropriate relief in an equity receivership." See SEC v. Hardy, 803 F.2d 1035, 1037–38 (9th Cir. 1986); accord, SEC v. Lincoln Thrift Ass'n, 577 F.2d 600, 606 (9th Cir. 1978). The basis for broad deference to the district court's supervisory role reflects the reality that most receiverships involve multiple parties and complex transactions. See Hardy, 803 F.2d at 1037.

Additionally, some districts have interpreted these powers to be extremely wide in breadth. The Ninth Circuit in SEC v. Hardy acknowledged that a primary purpose of equity receiverships is to promote orderly and efficient administration of the estate by the district court for the benefit of creditors. Hardy, 803 F.2d at 1038. See also SEC v. Wencke (Wencke II), 783 F.2d 829, 837 n.9 (9th Cir. 1986); First Empire Bank New York v. FDIC, 572 F.2d 1361, 1368 (9th Cir. 1928), cert. denied, 439 U.S. 919 (1978).

According to the *Hardy* decision:

> A district judge supervising an equity receivership faces a myriad of complicated problems in dealing with the various parties and issues involved in administering the receivership. Reasonable administrative procedures, crafted to deal with the complex circumstances of each case, will be upheld. A district judge simply cannot effectively and successfully supervise a receivership and protect the interests of its beneficiaries absent broad discretionary power. We would be remiss were we to interfere with a district court's supervision of an equity receivership absent a clear abuse of discretion.

See Hardy, 803 F.2d at 1038.

State Law and Authority

Many states also have a specific statutory schemes devoted to the appointment of receivers. For instance, in California, applicable provisions of the Code of Civil Procedure, commencing at Cal. Code Civ. Proc. § 564, govern the appointment of receivers. See Cal. Code Civ. Proc § 564 et seq.

Most states confer considerably broad power to the receiver to operate a business, sell real and personal property, and, in some instances, even seek to restructure debt or liquidate the assets of a business. Receivers can also collect and enforce accounts receivable, obtain and sell trademarks and domain names, and transfer liquor licenses, among other broad powers, all for the benefit of creditors and claimants.

Secured Lenders and Receivers

Receiverships, in general, tend to become more prominent in distressed economic times. When used properly, a receivership can be a flexible and creative avenue to assist in the restructuring or turnaround of a business, real property, or other asset.

Protecting Collateral

A common situation in which a receiver is appointed is one where a secured lender seeks to harbor or preserve its real property collateral. It may be as simple as having a receiver manage a rental property and continue to collect rents until the dispute relating to the real property is adjudicated, or it may result in a more complicated situation where a receiver is asked to take over the day-to-day operations of an ongoing business in order to preserve or ultimately liquidate that business.

Protection from Liability

In the context of real property, a receiver can insulate a financial institution from many claims and hardships that the financial institution would inherit by foreclosing or otherwise taking title to real property and assuming the burdens and liabilities of ownership. To this end, financial institutions and special servicers may seek the appointment of receivers to remediate and rehabilitate assets and, rather than following the traditional route of foreclosure, obtain a court order for the receiver to sell the real property assets out of the receivership estate and turn over proceeds to the appropriate parties.

Importantly, particularly from a lender's perspective, the legal liability of actions that a receiver takes, such as the remediation of an environmental hazard or the eviction of tenants, falls not on the lender that sought the receiver's appointment, nor on the party being dispossessed of their business or assets. Rather, the liability belongs to the receiver, which benefits from quasi-judicial immunity.

Receivership and Workouts

A lender typically wants to take immediate action to protect and maintain the value of its real property collateral. As a mechanism for maintaining the status quo during workout negotiations, the appointment of a receiver serves to protect the value of the collateral while at the same time giving the parties the time to discuss and negotiate a potential workout. Absent the protections that the receiver affords, the parties may be unwilling to devote substantial resources to discussing a workout due to the fear that the property could be losing value during the workout negotiations.

For more information on workouts in the commercial real estate context, see Workouts of Commercial Real Estate Loans.

Costs of Receivership

Before seeking the appointment of a receiver, lenders should consider a variety of factors to determine if it is a viable option. One of the principal concerns lenders have when considering the appointment of a receiver is the cost involved. In the typical receivership, the receivership estate is responsible for all fees and costs, including administrative costs, the receiver's fees, and the fees of other professionals that the receiver retains, if necessary.

The receivership estate is usually funded from one or more of the following sources:

- Income that the receivership property generates (i.e., rents)
- Proceeds from the receiver's sales of estate assets
- Advances that the lender makes to the receiver during the pendency of the action

The costs of the receivership could result in a net reduction of the lender's recovery. Depending on the real property, though, incurring these costs may be in the lender's best interest, especially when the receiver can maximize the value of the property, whether by completing construction, finalizing entitlements, or taking other action that increases the property value. In these situations, the potential recovery outweighs the costs of the receiver.

Benefits of Receivership and Consideration of Alternatives

Taking title to the real property, whether through a deed in lieu, foreclosure, or other form of transfer, guarantees

that all of the costs, liabilities, and problems associated with that property will absolutely become the burden of the lender. Even if the lender identifies new management, that management will not share in the insulation that the receiver enjoys. And management will likely be equivalent in cost.

For example, if the receiver sells units at the property, those sales will be consummated by the entry of a court order selling the units "as is, where is," with no representations or warranties—a proverbial "get out of jail free card" for lenders that never touch or take title. Conversely, if the lender (or its agent) sells the property, construction liability, consumer protection regulations, department of real estate requirements, and many more representations and warranties will become the burden of that lender.

Lenders and servicers do not want to take title to assets or real property collateral if it can be avoided. Since most real property is an operating and going concern, maintenance, management, and day-to-day operations—and, of course, all of the liabilities that come with such responsibilities—will be in the hands of the lender (or its designee) if it takes title through foreclosure or a deed in lieu. Further, the operational costs will fall squarely on the lender rather than being funded by a protective advance, receivership certificate, or other protected means of advancing secured funds in a receivership.

This creates lawsuit exposure for the lender, which is now on title forever. While the applicable law is complex, it is unequivocal that the lender will be seen as a deep pocket in any known or unknown future litigation. Any action that a lender can take to protect itself and insulate itself from claims has an enormous value.

Powers of a Receiver

In many instances involving real property, there are multiunit structures, open escrows, operational concerns, remaining construction, affiliated management, and other problems particular to the property at issue. When considering the appointment of a receiver, it is helpful to establish a clear roadmap of what the parties expect from the receiver and what benefit the receivership will provide. From the simple completion of construction to the more complex resolution of claims, the court can grant the receiver the authority to work out issues prior to a disposition of the real property (whether by sale, foreclosure, or some other means). Seeking the appointment of a receiver provides numerous benefits for the lender while avoiding a host of potential problems. A receiver can:

- Limit exposure and liability to the lender by providing a shield against claims, and by keeping lender off of title
- Provide the receiver the ability to sell real property "as is, where is," thus limiting exposure to the lender/servicer and the receiver
- With court guidance, manage complex construction issues and make claims on completion bonds or other sureties
- Address problems with homeowners' associations, entitlement concerns, and other state or federal regulatory requirements
- Renew, obtain, or forfeit governmental licenses and permits
- Acquire, confirm, and/or reinstate insurance (including wrap-up policies)
- Bring interested third parties, including governmental agencies, before the court, if needed to effectuate the receiver's mandate
- Provide experienced day-to-day management for the real property
- Provide expertise in hospitality, operations, construction, property management, and other skills (depending on the business needs and property needs)
- Allow for funding to complete projects through receiver certificates
- Provide lenders with transparency into ongoing operations
- Encourage a borrower's continued cooperation, motivating the borrower to see the project through and avoid insolvency
- Assess and, in many instances, reduce exposure to mechanics' liens
- Provide for equitable powers of the court usually beyond those of a bankruptcy court
- Secure and maximize the value of the asset

Importantly, the receiver can accomplish these aims without disrupting the ongoing operation of the property or waiving the lender's rights against borrowers or guarantors (or vice versa).

With respect to complex debt structures (senior and mezzanine debt), the court can craft a receivership order to work within the existing terms of the intercreditor agreement, expand the terms of the intercreditor agreement, or even, if necessary, modify the terms of the intercreditor agreement in a manner that will best protect and preserve the asset. Further, a claimant (such as the

lender) can make its case to the court if, at any time, it disagrees with the actions of the receiver.

A well-crafted order can also give the lender options when it finds that maintenance of a receiver is no longer cost effective or is diminishing the value of collateral. For example, a primary tenant may vacate a property in receivership, reducing the revenue that the asset generates, or a party to the dispute may file bankruptcy, restricting the receiver's ability to manage or monetize the collateral. By placing triggers such as these in the order, the court allows the lender to maintain a modicum of control to steer the fate of the receiver and the receivership estate. While not absolute, as part of a court order, they will provide further assurances to the lenders.

Important Factors in Considering a Receiver

The lender must carefully craft its preparation of a lawsuit and application to appoint a receiver. Each case is different and the complaint and appointment order must be tailored to each situation. Some of the factors to be mindful of include:

- Are the borrower and tenants cooperative?
- Are the borrower and commercial tenants solvent or operating?
- If applicable, is the general contractor cooperative?
- Is there an equipment lease in place?
- Is the borrower an individual or legal entity?
- Is there a guaranty?
- Where is the property located? (A foreclosure action must be filed in the district in which the property lies; the court's jurisdiction must be in rem.)
- Are there any code violations, state regulatory concerns, or other administrative or legal problems?
- What funds are available in the estate?
- Are there construction defect claims?
- Are there mechanics' liens?
- Are there other secured lenders? Are they priority or subordinate claims?
- Are there tax liabilities (recorded and unrecorded)?

Proposed Order Provisions

The appointment order is the most important pleading because it is the document that creates the parameters in which the receiver may operate. If an important provision is missing from the order, a receiver may be limited in its ability to carry out his or her duties properly. (Note that as a case progresses, it may be necessary from time to time to amend the receiver's confirming order.)

The order should anticipate the powers and instructions that the receiver may require. It is beneficial to have the proposed receiver review the order before it is filed. Also, the proposed order should account for issues such as filing of taxes, authority to open cabinets, authority to change mailing address, and other minute details. A receiver's powers are, in essence, much broader than those of a bankruptcy court or a bankruptcy trustee.

An order appointing a receiver may contain provisions authorizing the receiver to:

- Operate and/or liquidate a business
- Enter into contracts or leases (a receiver has general authority to enter into leases for up to one year in length, including any option periods, or minor contracts without specific court authorization)
- Redirect mail
- Use a locksmith to enter the receivership premises
- Bring unlawful detainer actions (or possibly to engage in other litigation)
- Investigate, report about, and maintain adequate insurance coverage regarding the receivership estate
- Use the tax identification number(s) previously used in connection with the operation of the receivership business or property
- Borrow funds
- Sell real or personal property of the estate
- Apply at any time for further instructions
- Open bank accounts
- Collect rents, income, profits, etc.
- Compromise debts
- Avoid liens

A receiver's ability to hire employee and professionals is critical in many receiverships and the employment of such professionals should be explicit in the receiver's appointment order. Note that, typically, a receiver cannot employ an attorney without a specific court order authorizing such employment. Most courts require that an application to employ an attorney be in writing and state the necessity for the employment, the name of the attorney, and that the attorney is not the attorney for, is not associated with, and is not employed by an attorney for any party to the action.

The order may state that all obligations and liabilities that the receiver incurs are incurred solely in his or her official capacity and are to be satisfied by receivership funds only. It should also include a provision regarding payment of the receiver's fees and costs, as well as the fees and costs of other professionals that the receiver employs. The typical provision specifies that these fees and costs may be paid from the receivership estate each month upon service of the receiver's monthly report, subject to future court confirmation. Copies of the detailed bills of the receiver and other professionals should be included in the receiver's monthly reports. Note that the court orders typically give the parties a specified time period (usually 5–14 days) in which to object before the receiver may pay such fees and costs. If there is an objection in such an instance, the court will intervene (upon request) to resolve the objections.

The order, similar to a broad injunction, should be recorded in every county where receivership estate real property is located.

Conclusion

Receivership law provides imaginative, equitable, and practical solutions to complex problems, giving courts and litigants flexibility in reaching a commonsense remedy during the course of a lawsuit or judgment enforcement.

From protecting assets to running a business, a receiver can protect, harbor, and preserve value of assets that form the basis of a civil dispute, and provide transparency in a situation where the parties are not in a position to fully trust each other. It is one of the mainstays of common law and sets the common law system apart from other judicial systems that do not have these powers of equity, thus limiting their ability to fashion remedies.

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Richard P. Ormond has over 20 years-experience that includes business law, real estate, banking, receivership, cannabis regulations, commercial litigation, and restructuring. He has tried numerous cases in State Court, Federal Court and Bankruptcy Court and has arbitrated dozens of matters. Mr. Ormond is recognized as one of the nation's leading experts concerning receivership law and cannabis regulations, banking and financing.

Mr. Ormond serves as the chair of the California Receivers Forum and he is the former Chair of the Remedies Division of the Los Angeles County Bar Association. Mr. Ormond also teaches Cannabis Business Law at Loyola Law School and Continuing Legal Education courses on dispute resolution, debt enforcement, secured transactions, cannabis law and receiverships.

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