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PERSPECTIVE

## Commercial loan defaults, and calls from clients seeking advice, are on the horizon



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By Bernard M. Resser

**A**t the Mortgage Bankers Association (MBA) CREF Convention in San Diego in March 2023, the MBA released its annual survey results of upcoming commercial and multifamily mortgage maturities. (MBA Chart of the Week: Estimated Total Commercial Mortgage Maturities, March 13, 2023). Here are the pertinent - and challenging - results:

“The analysis estimates that of approximately \$4.4 trillion of outstanding commercial/multifamily mortgages, \$728 billion (16%) matures in 2023 with another \$659 billion (15%) maturing in 2024. Hotels/motels see the largest share maturing in 2023 (34%) followed by office (25%). \*\*\* Among capital sources, 26 percent of the outstanding balance of loans held by credit companies and other investor-driven lenders will mature this year, as will 23 percent of the balances held by

depositories and 22 percent held in CMBS.”

CBRE Group, the world’s largest commercial real estate services and investment firm, reported in July 2023:

“As higher interest rates, economic uncertainty and structural changes in demand lower property values, particularly for office assets, we expect distress to emerge in commercial real estate.”

“CBRE estimates that commercial real estate loan losses for all

lenders could total up to \$125 billion over the next several years, with office loans accounting for approximately \$53 billion.”

(CBRE, Commercial Loan Losses to Create Short-Term Pain, Long-Term Opportunities, July 13, 2023.)

My personal observations since the pandemic from my former office in Los Angeles (Century City) and current offices in Downtown Santa Monica and Midtown Manhattan are that parking structures and elevators are less crowded,

bank branches and coffee shops are closing in high rise lobbies, and office and retail spaces in commercial districts are increasingly downsizing or vacant.

Based on these sobering numbers - and my anecdotal observations - I took out my form files and updated my notes on remedies available to commercial real estate lenders facing loan delinquencies. I want to be ready when clients call about these problems, and so should you.

Hopefully, stricter lending standards since the Great Recession mean commercial real estate lenders will not realize significant losses. But with interest and vacancy rates high, and the need for some borrowers to inject equity to refinance, many lenders will still be required to exercise their contractual and legal remedies to avoid potential losses.

In addition to a loan work-out, foreclosure, assignment for benefit of creditors, asset sales under Bankruptcy Code section 363, Article 9 asset sales, and other options available to creditors, consideration should also be given to a receivership. A receivership can be highly effective in managing risk and maximizing returns, often beyond what can be recovered in foreclosure alone. Which leads us to the primary use for receiverships by commercial property lenders: collecting rents pending foreclosure.

### **Rents and profits receiver pending foreclosure**

A non-judicial foreclosure takes a minimum of about four months to complete in California. During that time between a Notice of Default and a Trustee's Sale, lenders often secure added recovery in exercising their right to collect rents under an Assignment of Rents contained in most commercial real estate loan documents.

Using a Receiver to take management possession of a commercial property to collect those rents avoids "lender in possession" and "partner" risk. See, Cal. Civ. Code § 3434 [limiting lender liability for loss or damage].

**TAKEAWAY #1:** To avoid lender in possession and other liability, self-help is not advised even though that may be allowed in the loan documents.

Moreover, a short receivership affords the lender the opportunity to gather and evaluate information about the property, manage claims, and protect against pre-foreclosure claims. If the lender determines sale of the property in foreclosure may not pay off the loan and costs in full, and there are other assets to recover any deficiency, a judicial foreclosure claim for that deficiency can be included in the action to appoint a Receiver instead of proceeding with non-judicial foreclosure, in which no deficiency judgment is available. Cal. Code Civ. Proc. § 580d.

If the loan documents provide (and most do), a lender need not show "irreparable harm" usually required for provisional remedies such as receivership and (accompanying) injunctive relief. See, Cal. Code Civ. Proc. § 564(b) (11):

"(b) A receiver may be appointed by the court in which an action or proceeding is pending \*\*\* "(11) In an action by a secured lender for specific performance of an assignment of rents provision in a deed of trust, mortgage, or separate assignment document. The appointment may be continued after entry of a judgment for specific performance if appropriate to protect, operate, or maintain real property encumbered by a deed of trust or mortgage or to collect rents therefrom while a pending nonjudicial foreclosure under power of sale in a deed of trust or mortgage is being completed."

Not all judges know this, so be prepared to cite this statute when applying for appointment of a Receiver and a related injunction.

### **Using an operating receiver in special circumstances**

When special circumstances require, an "operating Receiver" may be worth considering. In cases where property is still in development or requires renovation or remediation to maximize asset value, a Receiver becomes the *de facto* owner and operator of the property and project, managing the completion and sale for the benefit of the lender.

Examples in which lenders should consider use of an operating Receiver include: expiring entitlements and/or permits; incomplete CC&R's, HOA budgets and/or bylaws; de-

fective or contested easements; insurance issues; construction issues; environmental issues; EIR vs. Negative Declaration; EPA action forcing shutdown of borrower operations; borrower fails to remedy environmental contamination (see, Cal. Code Civ. Proc. § 564(c) [specific provision regarding hazardous material abatement by Receiver]); mechanic's liens; assessment districts; and other "clouds" on title.

A court's authority to allow and confirm the sale of property through a Receiver is established by statute. Cal. Code Civ. Proc. § 568.5.

Case law allows sale of property even by a rents and profits Receiver provided the sale is later confirmed by the Court. *Cal-American Income Property Fund VII v. Brown Development Corp.*, 138 Cal.App.3d 268, 274 (1982) [Receiver had power to sell property subject to court confirmation even when stipulation and order of appointment did not expressly authorize sale]; *Resolution Trust Corporation v. Bayside Developers*, 43 Fed.3d 1230, 1243 - 1244 (9th Cir. 1994). *But see, Wachovia v. Downtown Sunnyvale* No. 1-109-CV-153447 [not binding on any other court; again, some judges don't know]. The Court of Appeal in *Cal-American* noted that although sale was not specifically authorized: "The order authorized the receiver 'generally to do such acts respecting the property as the court may authorize.'" 138 Cal. App.3d at 274. Because a Receiver can do only what the Order says the Receiver can do, it is best to include broad powers in the initial order.

**TAKEAWAY #2:** If you may even remotely want the Receiver to do something, such as sell the Property, put authority to do so in the Order appointing even a "rents and profits" Receiver.

### **Advantages of selling assets through a receiver**

Using a Receiver to sell the real property security for a loan makes sense in some circumstances. It can save time and expense as it eliminates time and fees of a trustee's sale and can maximize the price by exposing the property to the market over time. A Receiver can secure and preserve the value of the property and deal with "chal-

lenged" projects/properties. A receivership can minimize or even fully eliminate potential future liability and losses for both the lender and borrower.

Superior Courts are given considerable deference by appellate courts even where the trial court confirms extraordinary action by the Receiver, such as a sale or the demolition of real property. *City of Santa Monica v. Gonzalez*, 43 Cal. 4th 905, 931 (2008).

Borrowers and junior lienholders will often agree to a receivership sale if there is little or no equity in the property to satisfy any junior lienholders. Also, if there are existing valid personal guaranties and the lender and borrower are able to reach a resolution regarding the guaranties, the borrower will typically not object to a sale of the property by the Receiver.

When using a Receiver to sell property, it is often worth seeking agreement from the borrowers and junior lienholders to the initial listing price and broker. Otherwise, it is important to deal with objections as soon as possible to avoid disrupting or delaying the sale.

A court-approved sale by a Receiver can be made free and clear of junior liens and mechanic's liens, provided the liens are junior to the lender's deed of trust. *First National Bank of Cleveland v. Shedd*, 121 U.S. 74 (1887); *Van Huffel v. Harkelrode*, 284 U.S. 225, 227-228 (1931).

Accordingly, reputable title companies routinely insure title to properties sold through a receivership sale approved by order of a California court.

A sale by a Receiver can also insulate the lender and Receiver from construction defect liability associated with the sale of new construction.

**TAKEAWAY #3:** A Receiver can provide unique protection from claims against a lender, including claims arising pre-sale and pre-foreclosure.

### **Disadvantages/limitations when selling assets through a receiver**

As with any legal or equitable remedy, limitations and disadvantages should be considered before employing receivership. A Receiver can do only what there is money to

pay for; otherwise, the party seeking appointment will be responsible. Receivership fees and expenses become a first priority lien on the property. So before employing a Receiver, the lender and counsel need to determine: Is there cash flow and/or sufficient asset value to support the receivership and come out ahead?

Other questions to consider are: Will the Receiver have borrowing authority, including from the existing lender? Are there objections by junior lienholders? Are there objections/litigation by the borrower/debtor? Litigation may often be overcome, but at added time and expense.

There are also risks associated with failing to give notice to all lienholders, known creditors, government agencies, or anyone with a potential claim, however vague.

Thus, it is important to obtain a “litigation guaranty” from a title company to help identify the parties to name in the action to appoint a Receiver and smooth the way later for insuring title in any sale.

### **Strategies and procedures for selling assets out of a receivership**

When a Receiver is used to sell property, care should be taken to make sure the sale is “As Is—Where Is” and to limit any Receiver liability. Objections by borrowers and junior lienholders should be anticipated and eliminated through negotiation or prompt court action. Third parties such as title insurers should be consulted early as part of the process. Where necessary, attention must be paid to modification, sale, and assumption transactions.

**TAKEAWAY #4:** Carefully select/nominate an experienced and respected Receiver who has a reputation for communicating proactively with borrowers, junior lienholders, tenants, and title companies to limit objections and ease the process of managing and selling assets through closing.

### **Conclusion**

“While especially troubling for small community banks, [projected] loan defaults are not expected to be enough to destabilize the U.S. financial system.” (CBRE, *ibid.*)

While thankfully that may prove true, increased commercial loan defaults are coming. We who work for and advise commercial real estate lenders need to be prepared to address them.

With planning and readiness, lenders facing the challenges of

increasing loan delinquencies and defaults and their counsel can minimize risk and maximize returns by the effective use of Receivers and receivership sales.

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