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IN PRACTICE

BANKRUPTCY

Fending Off the Appointment of a Receiver

The plight of commercial property owners when a tenant files for bankruptcy

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In today's stressful economic climate, commercial property owners often are the victims of their tenants' problems. While a national tenant may file for bankruptcy with the expectation of reorganizing under Chapter 11 of the Bankruptcy Code, the landlord is left having to service the mortgage without cash flow from that tenant or any ability to commence an eviction or related action as a result of the automatic stay. 11 U.S.C. § 362. Sooner or later (likely sooner), the landlord's bank will come calling, in the form of a foreclosure action.

While the defaults under the mortgage present their own challenges (the rapid accrual of default interest, late fees and attorney fees and costs), the likely first step in the foreclosure action will be a motion to appoint a receiver; indeed, this requested relief often is sought contemporaneously with the filing of the foreclosure complaint. The motion will seek the appointment of a receiver simply to collect rents or, more often these days, to take full managerial and operational control over the property, divesting the landlord of all its rights and interests (though not title, as of yet).

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This article details some defenses the borrower, i.e., the landlord, can assert to ward off the appointment.

A lender usually will offer two bases in support of its claim that it is "entitled" to the appointment of a receiver to "operate and manage" the property: (i) a contractual provision in the mortgage; and (ii) the alleged need to protect its security interest. However, under controlling New Jersey law, a contractual provision within the loan documentation does not automatically permit the appointment of a receiver, and a court must look instead to the underlying facts to evaluate how best to protect the asset. This is because the "contractual provision for the appointment of a receiver upon mortgage default usurps the judicial function and thereby contravenes public policy." *Barclays Bank v. Davidson Ave. Associates*, 274 N.J. Super. 519, 522-523 (App. Div. 1994). As the *Barclays* court held in reversing the automatic appointment of a receiver:

> We disagree with the trial judge's conclusion that plaintiff mortgagee is entitled to a rent receiver as a matter of contractual right and without prior judicial approval as to the necessity of the appointment. We conclude that notwithstanding an express contractual provision for such appointment in the loan documents, an application for the appointment of a rent receiver is subject to the careful review and exercise of sound discretion by the chancery judge.

See *Barclays Bank*, 274 N.J. Super. at 520. In so holding, the *Barclays* court relied on *Tucker v. Nabo Constr. Corp.*, 108 N.J. Eq. 449 (Ch. 1931), in which Vice Chancellor Bigelow established the unyielding precedent that a covenant in a mortgage providing for the appointment of a receiver upon default was not binding upon the court:

> Receiverships, like injunctions and specific performance, are the tools whereby chancery exercises its peculiar jurisdiction and are used *only when the facts warrant their employment*, according to the established practice of the court. The consent of parties, *especially when given several years in advance*, cannot operate to move the court to exercise such powers contrary to settled practice.

(emphasis added) (citing in accord 10 Thompson on Real Property § 5157 (1957) (provisions of a trust deed for a receiver should not be enforced unless equitable considerations so require); 3

Powell on Real Property § 465 (1990) ("parties cannot, by agreement, force a court of equity to grant an extraordinary remedy to a person who does not need the aid"); 59 C.J.S. Mortgages § 663 (1949) (a receivership clause in a mortgage does not automatically entitle the mortgagee to the appointment of a receiver and the question remains with the discretion of the court)).

Thus, rather than vesting reliance upon a contractual provision which divests a court of its proper role in violation of public policy, a receiver "only should be appointed" if "it appears necessary to protect the mortgagee's security." *Tucker,* 108 N.J. Eq. at 524 (citation omitted). A lender usually will offer various arguments in support of its contention that the appointment of a receiver is necessary to protect its security interest in the mortgaged premises, including: (i) an unwillingness by the borrower to satisfy the loan obligations; (ii) the need for a third-party, impartial manager; and (iii) the value of the loan exceeding the value of the property. To the extent a borrower can demonstrate that it is best served to protect the security interest, it can delay, or even entirely ward off, the appointment.

First, particularly in the event of an anchor or other large tenant filing for bankruptcy, it is not the "unwillingness" of the borrower to satisfy its loan obligations, but rather the temporal inability. The court considering the application should be directed to the bankruptcy proceeding with an explanation as to its procedural posture, the details of a proposed plan of reorganization, and the expectation that the debtor will assume the lease contract and satisfy (even partially) outstanding rents. In this respect, the amounts due on the loan can and will be satisfied upon confirmation of a plan of reorganization requiring payment to creditors — including the borrower/landlord. It is just a matter of time. The appointment of a receiver will not expedite this process, and the receiver, too, will be unable to pursue any claims against the debtor/tenant during the pendency of the bankruptcy proceeding. Accordingly, the borrower has done nothing to threaten the security interest, and the receiver will be in no better position to protect it.

Second, it is difficult to argue that a receiver — a stranger to the property, its tenants and operations — is better positioned to protect the lender's security interest than the landlord; even if a technically defaulting borrower. In the case of a large or complex property, it can take weeks or months for a receiver to familiarize itself with the property's tenants, operations and employees. Worse, the receiver's time is added to the amount outstanding on the loan and thus billed to the borrower — an unreasonable and inequitable result. Further, because the borrower still has legal title to the property, the risks of the appointment impact upon both the lender and borrower. See *Pols v. Strand of Atlantic City*, 136 N.J. Eq. 1, 8 (N.J. Ch. 1944) (denying request for appointment of a receiver because it would "disrupt the present [property] management" and "might well result in a management less competent than at present and result to the detriment of not only the [borrower] but the [lender]").

Third, a lender also may argue that the sums due under the loan exceed the value of the mortgaged premises. Of course, some of this amount may include default interest, late fees, attorney fees and other costs arising after the default — rather than being keyed to the actual amount outstanding on the loan. As a result, a lender simply may offer this conclusion without any support in the form of affidavits, valuations, appraisals or similar evidence. A court should be made aware of this defect as it can, and should, impact upon its consideration of the purported need to protect the lender's security interest. See *Pols,* 136 N.J. Eq. at 8 (denying appointment of receiver where plaintiff failed to demonstrate that the value of the property was less than the encumbrances against it); *New Jersey Nat'l Bank & Trust v. Morris*, 9 N.J. Misc. 444, 445 (Ch. Div. 1931) (denying appointment of a receiver where plaintiff failed to show "that the security is uncertain or precarious").

Finally, the borrower, or its attorney, carefully should review all of the loan documents to ensure that there are no mistakes. A technical error — even a typo — in certain provisions can create a factual dispute to delay, or even defeat, the motion to appoint. For example, an error in the property description risks the appointment of a receiver over too much (or even too little) of the security interest. Similarly, mistakes in the deed can frustrate the lender's ability to enforce the loan documents. While these items may be cured, delay works to the advantage of the borrower and its cooperation in resolving these matters may permit the advent of settlement negotiations and a favorable resolution of the action.■