JOINT EDITORIAL BOARD
for
UNIFORM REAL PROPERTY ACTS

May 18, 2011

Committee on Scope and Program
Uniform Law Commission
111 N. Wabash Ave., Suite 1010
Chicago, IL 60602

Re: Recommendation for Study Committee on Real Estate Receivership

Members of the Scope and Program Committee:

As discussed below, the Joint Editorial Board for Uniform Real Property Acts (JEBURPA) recommends that the Uniform Law Commission (ULC) appoint a Study Committee to study the desirability and enactability of a uniform law that would govern the appointment and powers of real estate receivers.

Introduction and Background. Receivership is a fundamental equitable remedy sometimes sought by a mortgage lender seeking to enforce a mortgage that is in default. Typically, a commercial real estate mortgage or deed of trust explicitly provides that upon default, the mortgagee may seek the appointment of a receiver from a court with jurisdiction over the mortgaged premises; frequently, the mortgage or deed of trust purports to provide mortgagor consent for such appointment. If appointed, the receiver takes possession of the mortgaged premises and, pursuant to the court's order of appointment, preserves and manages the mortgaged property pending the completion of a foreclosure sale.

Traditionally, mortgage lenders have sought the appointment of a receiver pending foreclosure for one of two basic reasons (or, in some cases, both):

- The mortgaged property is located in a state where the foreclosure process takes a substantial period of time (e.g., six months or longer) and during such period, the mortgaged premises will generate rents that have been assigned to the mortgagee as security for the loan and could be applied to reduce the mortgage debt. Obtaining the appointment of a receiver allows the mortgagee to prevent the mortgagor from diverting rents to other creditors or insiders of the mortgagor pending a foreclosure sale.

- The mortgaged premises is subject to waste, deterioration, or some other immediate physical harm that threatens to reduce the value of the mortgaged property and thus threatens the mortgagee's security.

Existing Law and the Need for Greater Clarity Regarding the Appointment and Powers of a Receiver of Mortgaged Property. Unfortunately, there is little comprehensive statutory guidance regarding the appointment and powers of receivers for mortgaged real estate. Receivers are appointed pursuant to a court's general equitable power to appoint a receiver; only a few states provide statutes that address the appointment and powers of real estate receivers in any detail. Although the Uniform Assignment of Rents Act (promulgated in 2005 and adopted in Nevada, Utah and New Mexico) does explicitly address the evidentiary showing necessary to obtain the appointment of a receiver, UARA has not yet obtained wide enactment, so there remains significant state to state variation regarding the standards for appointment of a receiver, including such issues as whether the mortgagee must prove that the security is inadequate and/or subject to waste and whether the mortgagor's prior consent in the mortgage itself is sufficient grounds for the receiver's appointment.[1] Morris A. Ellison, Lawrence M. Dudek & Samuel H. Levine, *'Tis Better to Receive — The Use of a Receiver in Managing Distressed Real Estate,* ACREL Papers (October 2009).

Furthermore, nothing in UARA explicitly addresses the scope of the powers that a receiver of real estate may exercise prior to foreclosure. To some extent, the scope of a receiver's powers can be clarified by the court's order appointing the receiver. Nevertheless, it is sometimes the case that after taking possession, a receiver may be faced with the need to take actions in managing the premises that may not have been specifically addressed in the receivership order. For example, in the absence of explicit authorization in the order of appointment, case law is not clear regarding:

- Whether the receiver may borrow funds as needed for maintenance or renovation of the mortgaged property — or even completion of the mortgaged property, where the mortgaged property is under construction and incomplete — or is instead limited to expenditure only of rents collected;

- If the receiver does borrow funds, what priority the receiver's lien would receive for such borrowings as compared to other liens;

- Whether the receiver has the power to reject existing unfavorable leases;

- Whether the receiver has the power to enter into new leases, the terms of which would extend beyond the anticipated duration of the receivership; and

- Whether the receiver can sell the mortgaged premises, either subject to the existing mortgage or free and clear of the mortgage and subordinate liens (i.e., in the latter situation, whether a sale by the receiver will have the same effect as a foreclosure sale).

This latter point is of increasing importance because traditionally the receiver's role upon appointment was understood to be primarily custodial, *i.e.*, to operate, maintain, and preserve the property pending the foreclosure sale. The foreclosure sale itself would occur by execution sale (in a

[1] In a more comprehensive act, UARA § 7 would presumably provide a suitable template for a provision governing the standards for appointment of a receiver.

judicial foreclosure) or, where permissible by the mortgage documentation and state law, through a nonjudicial auction sale. More recently, however, mortgage lenders have begun advocating the possibility that a receivership could be an effective way to dispose of mortgaged property. There are two specific contexts in which a sale by the receiver may be perceived as advantageous:

- **Sale of property securing commercial mortgaged-backed securities (CMBS) loans.** CMBS loans are held in real estate mortgage investment conduits ("REMICs"), which are special purpose vehicles used for the pooling of mortgage loans and issuance of mortgage-backed securities. The Internal Revenue Code forbids REMICs from issuing new debt or making new loans, but do permit some modifications to an existing defaulted loan. Thus, when a REMIC completes a foreclosure sale, it cannot make a new loan on a seller-financing basis; however, if the property can be sold (through a receiver or by the borrower directly) with the buyer assuming the mortgage, the mortgage loan can be modified and restructured under the REMIC rules. Often, this can produce a sale at a higher value than by comparison to a cash sale, and thus is attractive to lenders who want to avoid foreclosing on a property that is worth less than the outstanding mortgage debt. *See generally* John C. Murray and Kenneth R. Jannen, *Public and Private Sales of Real Property by Federal Court Receivers*, ACREL Papers (March 2011).

- **Foreclosure sale at "arms-length" rather than "distress sale."** Under current foreclosure law in all 50 states, a foreclosure sale is a "distress sale," i.e., a public auction sale, typically "on the courthouse steps." Foreclosure by sale has been justified as a means to protect the mortgagor's equity in the mortgaged property, particularly by comparison to the historical approach under which a defaulting borrower simply forfeited its interest in the mortgaged property (and any equity the borrower may have accumulated either through principal reduction or market appreciation). Nevertheless, there is both anecdotal and empirical evidence to suggest that foreclosure sales do not bring prices that reflect the intrinsic or fair market value that might be obtained in an arms-length, non-distress sale. By contrast to a traditional foreclosure, a receiver could theoretically market the mortgaged property to potential buyers in the context of its operation of the property. Marketing of the property in an arms-length context could permit potential buyers to perform more meaningful and complete due diligence; further, a sale subject to judicial review and confirmation could produce greater finality regarding the title acquired by the buyer by virtue of the sale. In theory, providing potential foreclosure buyers with better information regarding the mortgaged property and greater certainty of foreclosure title might be expected to produce sale prices higher than those that would be produced by distress foreclosure sales — which in turn should provide reasonable protection of the mortgagor's equity, if any, in the mortgaged property.

Unfortunately, as discussed below, most existing state statutes do not specifically authorize a receiver of mortgaged property to conduct a sale of the mortgaged property; furthermore, courts have not consistently held that receivers have inherent equitable authority to conduct such sales. As a result, a uniform state statute addressing the appointment and powers of real estate receivers is warranted.

Under existing federal law, 28 U.S.C. § 2001 explicitly authorizes a receiver appointed by a federal court to sell mortgaged property. While the statute does not explicitly state that such a sale would be free of subordinate liens (and thus serve the same title-clearing function as a foreclosure sale), § 2001(a) provides that the receiver may sell "upon such terms and conditions as the court directs." Thus, it seems clear that if the court orders a sale free and clear of subordinate liens, that sale would have the effect of extinguishing any subordinate lien (unless the holder of that lien did not receive notice and a reasonable opportunity to challenge the appointment of the receiver or the sale itself). Furthermore, the federal statute also permits the receiver to dispose of the property by a private sale:

> After a hearing, of which notice to all interested parties shall be given by publication or otherwise as the court directs, the court may order the sale of such realty or interest or any part thereof at private sale for cash or other consideration and upon such terms and conditions as the court approves, if it finds that the best interests of the estate will be conserved thereby. [28 U.S.C. § 2001(b)]

As a result, many lenders seek the appointment of a federal court receiver, ancillary either to an action to foreclose the mortgage or for specific performance of the borrower's assignment of rents. Nevertheless, in the typical case, one could obtain a federal court receiver only if there existed sufficient diversity of citizenship among the parties to warrant federal jurisdiction. *See generally* Toni Pryor Wise, *Federal Receiverships — A New Old Tool for Selling Distressed Commercial Properties?*, ACREL Papers (March 2011).

Under state law, there is no comparable assurance of the receiver's powers of sale. A few state statutes do explicitly grant the power of sale to the receiver, *see, e.g.*, Ind. Code § 32-30-5-7 (receiver may "sell property in the receiver's own name, and generally do other acts respecting the property as the court or judge may authorize"); Wash. Rev. Code Ann. § 7.60.260 (granting receiver the power to sell mortgaged property with the court's approval after notice and hearing), most state statutes do not comprehensively address real estate receiverships and do not explicitly address whether the receiver has a power of sale. Further, in some states, there is judicial authority for such sales. In New Jersey, cases have "recognized the inherent authority of an equity court to sell assets within the custody of a court-appointed receiver," *In re Valley Road Sewerage Co.*, 685 A.2d 11 (N.J. Super. 1988), and courts in Pennsylvania have held that a receiver may sell property free and clear of liens where there is "a reasonable prospect that a surplus will be left to be distributed among general creditors." *Bogosian v. Foerderer Tract Committee, Inc.*, 264 Pa. Super. 84, 399 A.2d 408 (1979).

In other states, however, there is substantial doubt as to whether, or in what circumstances, a state court receiver could conduct a sale of mortgaged property. For example, in South Carolina, courts have held that the purpose of a receiver is to preserve the "status quo," and do not permit the receiver to dispose of the property. *See, e.g., Kirven v. Lawrence*, 244 S.C. 572, 137 S.E.2d 764 (1964); *Andrick Dev. Corp. v. Maccaro*, 280 S.C. 103, 311 S.E.2d 95 (Ct. App. 1984). Under this view, the receiver could not properly sell the mortgaged real estate even if the receivership order purported to authorize such a sale.

The recent decision in *Shubh Hotels Boca, LLC v. FDIC*, 46 So.3d 163 (Fla. Dist. Ct. App. 2010) provides a timely and representative example of how the absence of state statutory law effectively discourages or prevents the use of a state court receivership to effect a sale of mortgaged property. Shubh Hotels Boca, LLC (Shubh) owned a 180-room hotel in Boca Raton, subject to $28.8 million mortgage loan. In May 2009, the lender instituted a judicial foreclosure proceeding following financial defaults by Shubh, and the lender obtained the appointment of a receiver to collect rents during the foreclosure proceeding. 46 So.3d at 165. By January 2010, the receiver reported that the hotel was losing $28,000 each month; further, the receiver was unable to raise borrowed funds to continue operating the hotel. The lender immediately moved to have the property sold as soon as a buyer could be identified. The trial court granted this motion, authorizing the receiver to market the hotel. After a month, the receiver identified a buyer willing to pay $9 million for the hotel, but Shubh objected to the sale on the ground that the receiver had no legal authority to sell the hotel and could not convey title. The trial court rejected this objection and entered an order authorizing the sale. *Id.*

On appeal, however, the Florida District Court of Appeal reversed the trial court, noting that no Florida statute authorizes a court-appointed receiver in a foreclosure case to sell the mortgaged property. Turning to the language of the mortgage itself, the court noted that the language of the mortgage did not authorize the receiver to sell the property, but only "to protect and preserve" the mortgaged property, to "operate [it] preceding foreclosure or sale," and to collect rents and apply them against the debt. *Id.* at 166.

The court then addressed whether a sale could be justified under Florida common law governing the powers of a receiver. The court noted that under existing Florida decisions, "the mere appointment of a receiver does not itself confer any of the owner's power or authority to sell such property" (citing *Eppes v. Dade Developers, Inc*., 126 Fla. 353, 170 So. 875 (1936)). Further, the court held that "the role of a receiver in a foreclosure action is only to preserve the property's value" (citing *Cone-Otwell-Wilson Corp. v. Commodore's Point Term Co*., 94 Fla. 448, 114 So. 232 (1927) and *Alafaya Square Ass'n Ltd. v. Great Western Bank*, 700 So.2d 38 (Fla. Dist. Ct. App. 1997)) and that implying a power of sale would be inconsistent with that role. Finally, the court noted that under Florida law, every mortgagor has a statutory right of redemption until the issuance of a certificate of sale by the clerk of court, and held that "[r]ecognizing a general interim power of a receiver to sell mortgaged property in a foreclosure case would contravene" that redemption right. *Id.* at 167.

Criteria for Uniform Acts. The JEB is of the opinion that a uniform law clarifying the apppointment and powers of receivers of mortgaged property would satisfy the appropriate ULC criteria for uniform acts. The law governing state court-appointed receivers is plainly an appropriate subject for state legislation. ULC Criteria 1(a). As discussed above, a uniform law governing the appointment and powers of real estate receivers would be a practical step toward uniformity of state law by creating clear rules on a subject where uniformity is desirable. ULC Criteria 1(b), 1(c)(1). This uniformity is desirable because it would produce "substantial benefits to the public through improvement in the law," by permitting greater flexibility in the method of disposition of mortgaged property. In turn, this should facilitate the renegotiation of distressed CMBS loans and could produce higher sale prices than those that prevail under current state law (under which all foreclosure sales occur at public auction). ULC Criteria 1(c)(iii).

In addition, the JEB believes that there is a reasonable probability that such an Act could obtain wide enactment. ULC Criteria 1(c)(ii). First, if the Act is limited to commercial mortgage loans and excludes residential mortgage loans, the Act would not encounter objections from consumer advocates. Second, by clarifying the authority of a receiver to sell mortgaged property and the integrity of the buyer's title, the Act should have the enthusiastic support of lenders (both portfolio and CMBS lenders) and the title insurance community.

Finally, the JEB notes that the subject matter of this Act potentially overlaps, but only slightly, with the Uniform Assignment of Rents Act. The JEB believes that a comprehensive act on the appointment and powers of a real estate receiver might be easily "packaged" with the existing UARA by the ULC legislative staff and could thus help provide the impetus for additional enactments of UARA.

Potential Stakeholders. A study committee would prove useful to help identify additional potential stakeholders and/or participants in the drafting of an Act regarding appointment and powers of receivers. Evident stakeholders would include commercial real estate mortgage lenders (both portfolio and CMBS lenders), title insurers (ALTA and its constituent organizations), and professional organizations such as the ABA Real Property, Trust and Estate Law Section, the American College of Mortgage Attorneys, and the American College of Real Estate Lawyers. In addition, participation would be critical from among the community of developers and commercial property managers, such as ICSC and similar organizations.

Conclusion. For the reasons discussed above, the JEB unanimously recommends that the ULC appoint a Study Committee to explore the desirable scope and the enactability of a uniform act regarding the appointment and powers of a receiver of mortgaged real estate.

Respectfully submitted,

R. Wilson Freyermuth
Executive Director, JEBURPA