Fending Off Appointment of a Receiver

By Joshua S. Bauchner

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 cashflow 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 attorneys' 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). This article details some defenses the Borrower (*i.e.*, Landlord) can assert to ward off the appointment.

Entitlement to a Receiver

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: 1) a contractual provision in the mortgage; and 2) the alleged need to protect its security interest. However, under many states' laws, 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. Consequently, a covenant in a mortgage providing for the appointment of a Receiver upon default is not binding upon the court, which only may appoint a Receiver 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.

Mortgagee's Security

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. 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: 1) an unwillingness by the Borrower to satisfy the loan obligations; 2) the need for a third-party, impartial manager; and 3) 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 served 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 have an impact upon both the Lender and Borrower.

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, attorneys' 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, affect its consideration of the purported need to protect the Lender's security interest.

continued on page 6

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Receiverships

continued from page 5

Check for Errors

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.

In the Spotlight

continued from page 1

draw a lot of heated dispute between the property owner and the contractor, often because neither side really understands what is at stake. The contractor insists on a limited express warranty provision, which is then followed by a provision stating that the owner waives all "implied" warranties. In response, the owner insists that the express warranties be in addition to any implied warranties. However, lost somewhere in the stalemate is an expression of what specific implied warranties are being offered or given up. This article helps explain the implied warranties that arise in a construction project as well as the impact of contract clauses addressing such implied warranties.

The Two Big Implied Warranties

Generally, the two implied warranties that arise out of a construction project are: 1) the implied warranty of habitability; and 2) the implied warranty that the work will be performed in a workmanlike manner. When a contractor asks an owner to waive all implied warranties, the contractor will be targeting these two warranties in hopes of limiting the owner to the express warranties and the specific standards of performance set forth in the contract. Even when the parties agree to a waiver of these two implied warranties in the construction agreement, several factors will determine whether or not the waiver actually bars claims under such theories.

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Two other implied warranties, the implied warranty of merchantability and the implied warranty of fitness for a particular purpose, arise out of a construction project on very rare occasions. The courts have consistently held that the implied warranties of merchantability and fitness for a particular purpose do not apply to construction projects since the work involves the sale of a service as opposed to the sale of goods. *Nitrin, Inc. v. Bethlehem Steel Corp.,* 35 Ill.App.3d 577, 342 N.E.2d 65 (1st Dist. 1976). An exception may exist where the owner actually purchases the materials (*e.g.*, windows) from a manufacturer, which in turn sends out a contractor to install the materials. In this case, the implied warranty of merchantability and the implied warranty of fitness for a particular purpose may come back into play.

The Implied Warranty of Habitability

The implied warranty of habitability was created "to protect purchasers of new homes upon discovery of latent defects in their homes." *Redarowicz v. Ohlendorf*, 92 Ill.2d 171, 183, 441 N.E.2d 324 (1982). The public policy justifications for the theory are that purchasers of new homes generally do not have the ability to detect latent defects, such purchasers are usually making the largest investment of their lives, and the costs for such repairs should be borne by the responsible builder-vendor. *1324 W. Pratt Condominium Association v. Platt Construction Group, Inc.*, 2012 IL App 111474, 974 N.E.2d 279, 285 (1st Dist. 2012).

With this background, it is important to note that the implied warranty of habitability does not arise out of every construction project. In fact, the doctrine's application is significantly limited by two essential requirements for stating a claim under the theory. First, it only applies to the purchase or the renovation of residential properties. Second, it only allows recovery against vendor-builders and general contractors, as opposed to subcontractors and suppliers, except in limited circumstances, discussed below.

Thus, in a commercial, non-residential context, it may not be worthwhile for either side to get hung up in negotiations over the waiver or inclusion of an implied warranty of habitability provision. Illinois courts have repeatedly held that the implied warranty of habitability has no bearing on non-residential projects. *See Hopkins v. Hartman*, 101 Ill.App.3d 260, 427 N.E.2d 1337 (4th Dist. 1981); *Lowrie v. City of Evanston*, 50 Ill.App.3d 376, 365 N.E.2d 923 (1st Dist. 1977); *Board of Directors of Bloomfield Club Recreation Association v. Hoffman Group, Inc.*, 295 Ill.App.3d 279, 692 N.E.2d 825 (2nd Dist. 1998); *J.B. Stein & Co.*

continued on page 7

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