As Developers Default, Receiverships Multiply

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This article was published in the January/February 2010 issue of *URBAN LAND Magazine*

Along with the increased volume of distressed properties going into receivership come changes in the scope of work receivers perform.

A partially constructed property development, frozen in time behind a chain-link fence, a site that has been empty of an operating business and lifeless for months. Who owns the property, why is it sitting there half-built, when is somebody going to do something with it?

With the economy continuing to get pummeled and real estate values falling, abandoned properties have become an all-too-familiar sight. The scenario usually goes something like this: back when times were flush, the property owner borrowed millions to build the project, pledging the property as collateral for the loan. All involved assumed there would be buyers on the back end willing to pay the then-going rate for whatever was on offer. Then came the crash, and most of those buyers disappeared, while those who remain are willing to pay only a fraction of what the project budget assumed. The owner–often bankrupt and/or defunct–runs out of money, and abandons a property that suddenly is worth far less than what is owed on the loan. Contractors, security providers, and other vendors get stiffed on their invoices and stop showing up. The lender is left to pick up the pieces with a devalued, partially developed piece of collateral, which is typically encumbered by numerous liens, out of compliance with various codes and regulations, and possibly presenting health and safety risks to the surrounding community. Now what?

For many lenders in the current recession, the answer has been to go to court and seek appointment of a receiver to take possession and control of the property. In California, for example, a court may appoint a receiver under a variety of circumstances, including, among others, when any party with an interest in the property shows that it is in danger of being lost, removed, or materially injured; when a secured lender seeking judicial foreclosure shows the aforementioned or that the condition of the deed of trust or mortgage has not been performed and that the property is probably insufficient to discharge that deed of trust or mortgage; and in "all other cases where necessary to preserve the property or rights of any party."

Not surprisingly, the demand for receivers has soared as the real estate market has crashed. "The receivership business has gone crazy," says attorney David Pasternak of the Los Angeles law firm of Pasternak, Pasternak & Patton, who over the course of almost 30 years has been appointed as a state and federal court receiver, a provisional director, a referee, a special master (i.e., an authority appointed by a judge to make sure that judicial orders are actually followed), and bankruptcy court custodian well over 100 times, and who has represented and advised receivers in hundreds of other cases. "Some receivers are turning away or [are] close to turning away work. Others, like me, have expanded staff to deal with the demand, and we are still working seven days a week," he adds.

In addition to this increased volume, Pasternak says he has witnessed changes in the scope of work that receivers perform. "During the last recession in the early to mid-1990s, judges in southern California usually did not permit receivers to make capital improvements to real estate, or to sell it," he explains. "But today, it is much more likely than not that receivers are completing construction and selling properties."

This broader mandate for receivers is attributable to two major causes. First, by completing construction and selling properties on a retail basis, receivers are often able to recoup more of what is owed the lender than would be realized through a note sale or bulk sale of the overall

project. Second, the use of a receiver allows a lender to avoid the liability that attaches to owners and developers.

The question of "lender-in-possession" liability is particularly relevant in California. Under California Senate Bill 800 (SB 800), passed in 2002, homeowners and homeowner associations in most cases have up to ten years from the date construction was completed to file an action for construction defects against any project "builder"–a term that is broadly defined to include the property owner, the general contractor, and certain subcontractors. Lenders can avoid liability for construction defects under California Civil Code Section 3434, which shields lenders from construction defect litigation, so long as the damage alleged does not result from "an act of the lender outside the scope of the activities of a lender of money." But when the lender takes ownership of the property by foreclosure or some other means, or becomes involved in property management issues outside the scope of its lending, the protections of Section 3434 evaporate and a decade of construction defect liability under SB 800 may be triggered.

Some 97 percent of homeowner associations in newly constructed properties sue for construction defects at least once during the ten-year period allowed under SB 800, many more than once, according to David Wald, founder of Los Angeles–based Wald Realty Advisors, which over the past 18 years has provided receivership and other real estate services to more than 200 clients, including lenders, investors, law firms, and public agencies. Where the developer has left the scene, and a note sale or a bulk sale is not feasible or economically sensible, a receivership allows for a neutral professional with fiduciary duties to the court and the parties to care for the property without exposing the lender to construction defect and other lender-in-possession liability.

Recognizing these realities, judges now permit receiverships to endure long enough to complete construction and sell off units on a retail basis. "Historically, the receiver's role was to protect the property and any cash flow until the four-month foreclosure process was complete, and judges did not want to wait 18 months while units got sold," notes Wald. "Now, judges are more comfortable with the longer time frame and will set aside a trial date to allow the receiver to complete the sales." The receivership business has been decidedly countercyclical during the economic downturn. The avalanche of defaults on construction loans, the absence of buyers willing to take notes and collateral off lenders' hands, lenders' concerns about assuming construction defect and other liability, and the increased length and complexity of receiverships today have all combined to create unprecedented demand for receivers. As a result, many professionals working in slower areas of the economy related to real estate have migrated over to the receivership field. "Lawyers, property managers, developers–everyone who needs the income is trying to be a receiver," says Wald.

Even as the economy shows signs of perking up, there is no slowdown in sight for receivers. Wald sees a coming wave of at least $150 billion in defaults on commercial property mortgages in coming years. Assuming on the high end an average of $15 million per loan, he says, that is approximately 10,000 commercial properties that will be subject to ownership change, and potentially a receivership.

Both Pasternak and Wald caution that any lenders seeking the appointment of a receiver should choose their candidate carefully. "Pick a receiver that matches the property or project. If it's something small, it may be okay to go with a less-experienced receiver, but for something large-scale, with legal issues involved, use someone who is experienced," advises Pasternak. "You get what you pay for," adds Wald. "Anyone considering receiver candidates should ask two questions: 'Has the candidate worked as a receiver for this specific type of project in the past?' and 'Is the candidate doing such work currently?' If both answers are not 'yes,' you will be paying for their education."

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