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An Arizona Lender's Guide to Receiverships

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AN ARIZONA LENDER'S GUIDE TO RECEIVERSHIPS

What Is a Receivership and How Does It Differ from a Property Management Agreement?

A foreclosure receivership is not a property management agreement, and is not a means to allow a secured lender to manage property pending foreclosure. Its traditional purpose is to preserve and protect property for the parties having an interest in the property during the pendency of litigation between the parties (such as a judicial foreclosure action) affecting the property. In response to a controversial Arizona Court of Appeals decision, the Legislature amended the receivership statutes in 1993 to specifically allow a receiver to be appointed in connection with a trustee's sale or in other situations where no court action is pending or other claim for relief is requested from the court.

The court places the property in its constructive possession and control through the receiver, who acts as an officer of the court (not an agent of the lender) and must comply with court orders relating to the receivership. As a legal matter, the rights and obligations of the receiver are set forth by the court in the receivership order. However, as a practical matter, the lender's counsel generally prepares the receivership order in consultation with the receiver for the court's approval.

Why should a Lender Request a Receiver?

The Arizona statutes expressly recognize the right of a mortgagee to take possession of its collateral without the benefit of a receiver. However, a mortgagee in possession takes on certain "landowner" and "premises liability" responsibilities to third parties (for example, for injuries on the premises) that would normally remain with the property owner, and may become responsible for paying taxes and insuring the property. A mortgagee in possession must account for rents received and, if it fails to exercise reasonable diligence, may become liable for the fair rental value of the project. A mortgagee in possession may also become personally liable for transaction privilege taxes collected from tenants but not paid to the appropriate taxing authority. Obtaining the appointment of a receiver allows a lender to avoid mortgagee in possession liabilities.

Receiverships can also be used to insulate the lender from certain environmental and project management liabilities during the foreclosure process, and may be critical in projects such as hotels, restaurants and multi-tenant shopping centers and office buildings, which resemble the operation of a business more than the ownership of a parcel of real estate.

What Does a Lender Need to Show to Have a Receiver Appointed?

Prior to 1971, Arizona case law allowed a lender to obtain the appointment of a receiver only if waste was occurring or if the security was so inadequate that satisfaction of a deficiency judgment was unlikely. In 1971, the Legislature amended the Arizona statutes to allow the



appointment of a receiver without regard to the adequacy of the security or solvency of the trustor if the deed of trust contains an assignment of rents provision.

How Is a Receivership Created?

A secured lender generally files a complaint (a judicial foreclosure complaint or a complaint seeking the appointment of a receiver incident to a trustee's sale) asking the court to appoint a receiver. The court generally (but not always) requires the defendants to be served with notice of the application, issues an order to show cause (OSC) why a receiver should not be appointed and sets a hearing for about ten days to two weeks thereafter. The court generally does not consider evidence at the initial OSC hearing, but will appoint a receiver at the initial hearing if the receivership is uncontested or if the defendants stipulate to a receivership. If the defendants contest the receivership, the court will set the matter for an evidentiary hearing, generally within the following three or four weeks, depending on the judge's calendar.

Alternatively, a lender may seek to have a receiver appointed without notice to the defendants. The court will require a bond (in addition to the receiver's bond described below) to compensate the defendants for damage that they may suffer because of the receiver's seizure of the property. Some judges believe that appointing a receiver without notice is an unconstitutional due process violation and will not appoint a receiver without notice, even if the lender provides a bond.

The lender usually nominates a local property manager to serve as receiver. Generally, the receiver cannot be a party to the dispute, an officer or employee of a party, an attorney for a party or a person interested in the action. The receiver must provide a receiver's bond (commonly in an amount equal to a month's rents in contested proceedings, but often in much smaller amounts in uncontested proceedings) to ensure that the receiver will faithfully perform its duties. The clerk of the court will issue and deliver to the receiver a certificate of the receiver's appointment, which will serve as evidence to third parties that he is authorized to act as the receiver for the property. Courts generally allow receivers to exercise their sound business judgment, and do not hold receivers to higher standards of conduct than an ordinary landlord or property manager.

It is generally a wise practice for the lender to coordinate with the proposed receiver in preparing the receivership order so that the receiver obtains the powers it believes it needs to effectively manage and lease the project. For example, if the receivership order issued in connection with a multi-tenant project does not authorize the receiver to enter into leases or to employ counsel, the receiver will be faced with continually having to ask the parties or the court for instructions in the leasing and management of the project.

If the receiver receives conflicting demands from the parties, it may wish to apply for instructions from the court as to the appropriate course of action. It is generally a wise precaution for the receiver, as soon as practicable after its appointment, to inspect the property and to prepare and file with the court an initial report of the condition of the property and tenant



status. Such a report may later help the receiver to fend off claims that it mismanaged the property (bear in mind that the defendants who have been dispossessed from the property are the most likely parties to attempt or threaten to make a claim against the receiver's bond), and may help the lender to fend off claims by the borrower or guarantors that the amount of a deficiency judgment should be reduced by a loss that was allegedly caused by the receiver's mismanagement of the property.

What Costs Are Associated With a Receivership?

The receiver's fees (which are often negotiated in advance, based on the size and type of the project), the cost of the receiver's bond and the receiver's legal expenses are payable from the income produced by the property as administrative expenses of the receivership. If the property produces insufficient income to cover administrative expenses, including operating expenses, the lender may need to front those expenses as protective advances or receiver's certificates (IOUs issued by the receiver and secured, often in a first-priority position, by assets in the receiver's possession) may have to be issued. The *lender's* legal expenses are generally not an appropriate administrative expense of the receivership. The receiver's compensation should be specifically set forth in the receivership order; the court can later modify the receiver's compensation if circumstances warrant.

A receiver should exercise caution in paying from project income received during the receivership any unsecured trade obligation that was incurred prior to the receivership, unless the failure to pay the obligation will have a substantial adverse effect on the project (such as causing the utilities to be cut off or a lien to be created against receivership assets). Many receivers follow the practice of repaying security deposits to departing tenants only to the extent of income received from the tenant during the receivership (any deposit "refunds" made must generally be paid from receivership income, as project owners rarely keep security deposits in segregated accounts). For example, if a tenant had initially paid a \$10,000 security deposit to the owner, and the receiver received \$7,000 from the tenant during the receivership, the receiver would refund \$7,000 to the tenant and advise the tenant to look to the owner for the additional \$3,000. In longer term receiverships, a receiver may be considered to have "ratified" or "adopted" leases by accepting the benefits of the leases, and will also be charged with the owner's obligations under the leases. A receiver does not have the right to unilaterally change the terms of tenant leases, and a tenant will generally be able to reap the benefit of a below market lease until the lender actually forecloses on its prior lien.

What Happens to the Borrower/Owner's Property?

Conceptually, a receivership order creates a "receivership estate" and vests constructive possession and control of the receivership property in the receiver as of the date of appointment. However, title to real property remains in the owner, and the receiver may not have the right to sell that property without at least court approval (and perhaps the owner's consent). The receivership order should be drafted broadly enough to give the receiver control over any project bank accounts maintained by the owner.



What Are the Receiver's Powers?

The receiver's powers are set forth in the receivership order. Generally, those powers should be described as broadly as the lender feels comfortable in doing, to allow the receiver adequate room in which to operate and to avoid problems from an antagonistic defendant who may view an opportunity to disrupt the project or to second-guess the receiver as an opportunity to reduce or eliminate a deficiency judgment. The receiver is entitled at any time to ask the court for instructions in its property management activities, but must bear in mind that potential tenants may not wish to wait until court approval can be obtained and that the lender may become impatient with the delay and expense needed to obtain court instructions.

What Are the Receiver's Duties?

The receiver is responsible for protecting and preserving the property for the benefit of the litigants and performing the duties specified in the receivership order. The receiver generally files with the court a periodic income and expense report and, depending on the size of the project, may also have to file periodic reports regarding leasing and other operational information. The receiver may, if permitted by the receivership order or otherwise authorized by the court, engage counsel to assist it in preparing and filing reports, negotiating leases, evicting tenants or similar matters. The receiver is responsible for filing transaction privilege (sales) tax returns for the project, and might also be responsible for filing federal and state income tax returns.

How Is a Receivership Terminated?

Contrary to popular belief, a receivership is not terminated by the lender advising the receiver that its services are no longer needed, nor is it automatically terminated by the completion of a trustee's or sheriff's sale. As the receivership is created by the court, it must also be terminated by the court, and the receiver must be discharged and its receiver's bond exonerated. This is generally done by motion or stipulation shortly following the trustee's sale, expiration of the redemption period following a judicial foreclosure, or settlement of the case. The court will generally require that the receiver prepare and distribute to the parties a final accounting before it will exonerate the receiver's bond. If a party believes that it has been injured by the receiver's failure to perform its duties, it may be entitled to make a claim against the receiver's bond. Until the receiver is discharged, the receiver remains obligated to the court to remain in control of the property, and should not relinquish responsibility for leasing and property management to a successor owner.

Are There Less Costly Alternatives to a Receivership?

A receiver can insulate the lender from mortgagee-in-possession liabilities and enable the project to continue operating while a judicial foreclosure or trustee's sale is pending. However, receiverships can be relatively expensive, especially if obtained in connection with a trustee's sale that is of relatively short duration. For projects involving few tenants and relatively few ongoing leasing and property management responsibilities, a lender may consider making direct rent demands on the tenants and simultaneously entering into a "protective advance agreement"



with the borrower and other obligors. Such an agreement would allow the lender, in its discretion and upon specific request to the lender, to release the rents that it receives, either to the property manager or directly to project vendors, for payment of normal project operating expenses. Alternatively, the lender could allow the property manager to continue to collect the rents, and the protective advance agreement would irrevocably instruct the property manager to remit the rents (or the rents net of project operating expenses) directly to the lender. The lender may wish to require the owner to retain an independent property manager as a condition to any such arrangement. Neither of the above arrangements is equivalent to a bonded receiver; however, those less formal, less expensive measures may in appropriate circumstances allow the parties to minimize tenant disruption and prevent the borrower from “milking” the project.

The goal of the RC&A Arizona Lending Guides is to provide helpful substantive discussion and insights, based on the author’s 27 years of experience in Arizona commercial real estate lending, loan workouts and enforcement, regarding a number of general legal issues of concern to commercial real estate lenders. Opinions expressed in the RC&A Arizona Lending Guides are the author’s and do not constitute legal advice regarding any specific matter or situation. Legal advice can be given, and an attorney-client relationship can be formed, only on the basis of specific facts discussed between client and attorney pursuant to an engagement to perform legal services.

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