



Representing Special Servicers in “Cleaning Up” Defaulted CMBS Loans

A HERCULEAN BUT NOT IMPOSSIBLE TASK

By Patrick E. Mears and Mark R. Owens

“Another labor was the cleaning of the Augean stables. Augeas, King of Elis, had a herd of three thousand oxen, whose stalls had not been cleansed for thirty years. Hercules brought the rivers Alpheus and Peneus through them, and cleansed them thoroughly in one day.”

Thomas Bulfinch, *Bulfinch's Mythology: The Age of Fable* 119 (Modern Library n.d.) (1855).

It has been estimated that, of the \$296 billion in commercial real estate loans maturing in 2011, 49% of them have negative equity. In 2012, this percentage will increase to 63%. See Sibley Fleming & Matt Hudgins, *Lenders Face Costly Problem*, Nat'l Real Est. Investor, Jan. 2010, available at http://nreionline.com/finance/investors/real_estate_lenders_face_costly. Unless these loans are modified, refinanced, or satisfied, the holders will be forced to decide whether to commence mortgage foreclosure proceedings or take other actions to collect these matured debts. In light of the current scarcity of funds for financing in the commercial real estate sector and the limitations on certain pooled loans, foreclosure and other collection activity will likely

skyrocket in 2011 and possibly continue in the years that follow. The holders of these loans—portfolio lenders and securitization trusts—are bracing themselves for this onslaught of activity.

The focus of this article is the commercial mortgage-backed securities (CMBS) market, in which commercial mortgage loans in the United States are sold to securitization trusts. These trusts are administered by trustees for the benefit of investors that purchase interests in the trust. These interests are normally evidenced by bonds. These trusts also may designate a Master Servicer to handle the day-to-day administration of the performing loans. In theory, as monthly payments are received by the trustee or the Master Servicer, these receipts are distributed to the bondholders as a return on their investment. In the event of a borrower's default on a commercial mortgage loan bundled into the trust, a Special Servicer, usually previously appointed in a Pooling and Servicing Agreement (PSA), will replace the Master Servicer as administrator and take appropriate action to collect the mortgage indebtedness, such as restructuring the loan, foreclosing on the defaulted mortgage (including possibly seeking the appointment of a receiver), or selling the property. On appointment, the Special Servicer typically will retain legal counsel.

This article will explain the milieu in which Special Servicers act, their duties and activities under PSAs, and the role of legal counsel in representing Special

Servicers in performing their contractual obligations. Unlike portfolio lenders, the first contact that Special Servicers have with a defaulted CMBS loan will be after the borrower's default under the mortgage loan documents. As a result, the Special Servicer usually lacks institutional knowledge concerning the loan and, therefore, must rapidly ascend the learning curve to perform its obligations in a timely and proper fashion. Because no federal or uniform law governs commercial mortgage loan restructurings and commercial mortgage foreclosures, the law governing these actions will normally be the law of the state in which the real estate is located. As will be demonstrated below, the legal issues facing a Special Servicer and its counsel are often extremely complex, especially when the defaulted loan is secured by mortgages on real estate located in two or more states.

CMBS Loans and Their Administration

General

The transfer of CMBS loans to trusts presupposes the existence of a market for their securitization through the issuance of bonds to investors. During the 1990s and until the advent of the world financial crisis in late 2008, this market was robust. The aggregate amount of mortgaged-backed securities almost tripled to \$7.3 trillion between 1996 and 2007. Saul S. LeVine & Arthur M. Magaldi, *Mortgage Crisis, Derivatives and Economic Chaos*, 16 Proc. of Am. Soc'y of Bus. & Behav. Sci. 1 (2009), available at

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<http://asbbs.org/files/2009/PDF/M/MagaldiA2.pdf>. Many CMBS loans are now maturing in a market of declining commercial real estate values and in borrower-unfriendly refinancing milieu. The anticipated value and liquidity of the real estate that was once thought to be on the rise are no longer present, resulting in extremely high loan-to-value ratios or collateral deficiencies.

Normally, many individual mortgage loans of different sizes, property types, and locations are pooled and transferred to a securitized trust. In turn, the trust issues a series of bonds that often have different yields, durations, and payment priorities. This series of different types of payment obligations is generally known as the capital stack. When all pooled mortgages have been transferred to the trust, these different bond classes will be rated by rating agencies. These ratings can range from investment grade (AAA/Aaa through BBB-/Baa3), below investment grade (BB+/Ba1 through B-/B3), and an unrated class subordinate to the lowest-rated bond class. The ratings will determine the marketability of the bonds to be issued and their pricing. The most junior class of bondholders will bear the highest risk of a default and, because of that risk, this class, often referred to as the "B-piece Buyer," is the class that usually selects the Special Servicer in the PSA.

The Players Involved in CMBS Securitizations

The entities that are the primary participants in a CMBS loan securitization in default are the Special Servicer, the Directing Certificateholder/Controlling Class/B-Piece Buyer, and the trustee.

Special Servicer. The B-Piece Buyer usually appoints the Special Servicer in the PSA, and this Special Servicer succeeds to the Master Servicer's responsibilities on the borrower's default. The Special Servicer also will have additional responsibilities relating to maximizing recoveries on the defaulted loan for the benefit of the bondholders by foreclosing on the mortgage or pursuing other options as discussed in greater detail below.

Directing Certificateholder/Controlling Class/B-Piece Buyer. B-Piece Buyers in the real estate mortgage investment conduit (REMIC) are the most subordinate bond classes, namely, the B-rated classes, BB/Ba-rated bond classes, plus the unrated class. The most subordinate



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bond class is considered the Directing Certificateholder (or Controlling Class). These Directing Certificateholders normally pursue an active role in monitoring the Special Servicer's actions after a default.

Trustee. The trustee of the securitized trust is the holder of the mortgage loan documents. As such, the trustee will be the foreclosing mortgagee unless the documents have been assigned to a special purpose entity.

Sources and Nature of the Special Servicer's Powers and Duties

Special Servicers become involved when a default occurs under a CMBS loan. They also are involved with real estate owned by the lender (REO properties). A Special Servicer is usually appointed by the Directing Certificateholder (or majority member of the Controlling Class). Because the Directing Certificateholder's class is usually unsecured and retains the highest risk, this class is in control, and not the class of senior investors that are the most secured. This system prevents the senior investors from making self-serving decisions that could adversely affect the subordinate classes.

The Special Servicer for a particular

CMBS loan is usually identified in the PSA. Further, the PSA will set forth the servicing standard by which the Special Servicer is bound and any specific limitations placed on the Special Servicer. Generally, the Special Servicer is charged with servicing the defaulted loan and managing the property securing the loan for the benefit of *all* investors in the CMBS trust, not just the Directing Certificateholder or the senior investors. To accomplish this task, the Special Servicer is given certain broad powers and discretion. The Special Servicer can

- work out the loan with the borrower by extending the term, changing the interest rate, or otherwise modifying the loan so long as the REMIC provisions remain intact (for example, the REMIC structure does not allow a loan assumption after foreclosure);
- enter into a forbearance agreement with the borrower to delay liquidation or foreclosure, or possibly to obtain additional collateral, guarantees, releases, and waivers;
- institute a foreclosure action and sell the property at a sheriff's sale, receiver sale, or otherwise depending on applicable law;
- seek the appointment of a receiver to preserve, protect, manage, and operate the assets;
- accept a deed in lieu of foreclosure; and
- sell the loan.

The Special Servicer's role is to take the most prudent action(s) to maximize value and return to the CMBS trust investors. Many of the foregoing options, available to Special Servicers both in and out of court, are explained in detail below.

One of the challenges that Special Servicers face is the quantity, quality, and availability of data concerning the loan. As previously noted, the Special Servicer is usually identified in the PSA, but it is not involved in the origination of the loan. Between the time of origination and the borrower's default, the CMBS loan may have been sold

one or more times. Therefore, Special Servicers do not always receive all of the loan data when they first become involved. Accordingly, the Special Servicer may have difficulty providing initial reports concerning the assets securing the loan. This lack of information sometimes makes the Special Servicer's job difficult.

Advising the Special Servicer as Client

Lawyers who are retained as counsel to Special Servicers are best advised to quickly obtain a copy of the PSA that governs the defaulted loan and all mortgage loan documents. The counsel's role is to advise the Special Servicer of its responsibilities under the PSA, to analyze the loan documentation to determine the nature, extent, and priority of the mortgage and other liens securing the debt, and to advise the Special Servicer of its options in administering the defaulted loan either in or out of court. The Special Servicer's lawyer may need to contact the client's asset manager or its in-house counsel familiar with the PSA and assist with the Special Servicer's duties and responsibilities under the PSA.

PSA

The PSA is the primary document that dictates the Special Servicer's duties and obligations. The PSA is a highly confidential and complex document that sets forth the servicing standard the Special Servicer is bound by and any specific limitations placed on the Special Servicer. Most PSAs grant very broad powers to the Special Servicer to service, modify, and collect on the underlying defaulted loan. A situation in which the Special Servicer is limited to perform these tasks is unique. Approval will likely be required, however, under the PSA for any major loan modifications and the sale of the property or the note.

If any questions arise regarding whether a Special Servicer may take certain actions, the PSA must be consulted in connection with the underlying loan documents. For example, the Special Servicer may consider entering into a loan modification with the

borrowers, but the PSA may provide specific limitations and notice requirements (notice and consent may be required from subordinate lenders).

Therefore, if there is any doubt regarding whether or not a Special Servicer may proceed or not proceed on a specific matter, the PSA should be consulted to reach a decision.



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Mortgage Loan Documentation

One of the first tasks that a Special Servicer and its counsel must undertake on being referred a defaulted loan for servicing will be to make certain that all underlying loan documentation has been properly drafted, signed, and, where required, recorded. Once the loan files have been obtained, the servicer should examine them and segregate the following documents.

The Mortgage Note and Any Allonges.

The lender's possession of the mortgage note, assignments, and all allonges is critical to the effective enforcement of the mortgage lien through foreclosure or other proceedings. Many CMBS loans have been assigned to more than one trustee during the lives of the loans, and, for each transfer, there should be in the loan documentation assignments of or allonges to the original note and the original note itself. In the absence of the note and all assignments and allonges, it may be difficult to maintain foreclosure and other collection activities.

The Mortgage and Assignment of Rents. One critical document necessary for lien enforcement is the mortgage or deed of trust, which must contain language granting a lien to the original lender to secure the underlying loan. To be fully enforceable, the mortgage or deed of trust must have been signed by the owner of the real estate and recorded in the land records of the county or other jurisdiction where the real estate is located. It also must satisfy all other legal requirements of the state in which the realty is situated.

Mortgages and deeds of trust often contain provisions for an assignment of rents and leases to the mortgagee as security for repayment of the indebtedness or as an absolute transfer to the mortgagee. Sometimes, the mortgagor will have executed a separate assignment of rents and leases, which, like the mortgage, must be recorded in the proper real estate records. The states in which these assignments are recognized often have adopted statutes that prescribe the various steps that an assignee must take to enforce the assignment and collect the rents from tenants. It is always necessary for the Special Servicer to obtain a title search report for the mortgaged realty from a title company or other title abstractor to determine if the lien on the mortgage and any separate assignment of rents have been perfected under applicable state law and, if so, to ascertain the priority of the mortgage and rent assignment. In addition, the title search report will disclose any recorded, subsequent assignments of the mortgage and rent assignment.

Security Agreement and UCC Financing Statement. In certain cases, the original borrower may have possessed at the time the loan was closed tangible and intangible personal property that did not constitute fixtures in which the lender obtained a security interest. This granting of a security interest will normally be evidenced either by a separate security agreement signed by the borrower containing the required granting language or by granting language contained in the mortgage itself. If this personal property is not of a type in which a security interest

can be perfected by filing a Uniform Commercial Code (UCC) financing statement in the real estate records (for example, accounts, general intangibles, and inventory), then the lender must have filed such a financing statement with the central filing office specified in Article 9 of the UCC as adopted in that particular state. Normally, this office will be the Secretary of State of the state in which the borrower entity is organized. In examining the loan documentation files delivered to it, the Special Servicer needs to review the



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language of the security agreement to make certain that the collateral is properly described and to determine that the security agreement debtor had rights in the collateral at the time of the agreement's execution. In addition, the Special Servicer must obtain a UCC search from the appropriate filing office to make certain that a UCC financing statement properly describing this collateral was filed, has not been terminated, and, if applicable, has been properly assigned to subsequent holders of the mortgage note.

Existence of an Event of Default and Notice to Borrower. The Special Servicer and its counsel also must review the loan documentation to ascertain whether the borrower is in default under the terms of the loan documents and that, if required by those documents, has been sent a notice of default. This is especially important in situations in which the borrower has the ability to cure the default relied on by the Special Servicer

within a prescribed period (for example, 10 days) after the default notice is transmitted. The Special Servicer must take care to send the default notice to all entities that must be copied on that notice at their proper addresses. In so doing, the Special Servicer should not simply rely on the address stated in the loan documents, especially if these documents permit any party to change its notice address by giving all other parties to the loan transaction notice of a new address.

Review of Borrower Communications and Other Historical Documents. A Special Servicer is best advised to review all other documents in the loan and collateral files, especially correspondence and electronic mail traffic between the borrower and the lender/Master Servicer, to understand fully the history of the mortgage loan's genesis and the relationship of the borrower with the lender/Master Servicer after the loan closed. The Special Servicer should carefully examine any documents reflecting possible maladministration of the loan to be prepared for a possible lender liability claim being asserted in the context of foreclosure proceedings and other litigation. If the Special Servicer has any questions after this review, the servicer may wish to interview representatives of the lender and Master Servicer involved in the prior stages of the mortgage loan.

Out-of-Court Collection Strategies

Consensual Loan Restructurings

Acting on behalf of the mortgage holder, the Special Servicer may determine, after analyzing the mortgage loan and security documents and valuing the collateral, that the best strategy for maximizing recovery is to negotiate the restructuring of the mortgage loan and security documents. Many factors can favor a restructuring, such as:

- Significant deficiencies in the loan documentation exist that require correction. For example, the legal description of the mortgaged real estate in the documents may be either erroneous or incomplete. Unless these deficiencies are

corrected with the cooperation of the mortgagor, foreclosure of the mortgage lien will be problematic at best.

- The Special Servicer may desire to obtain credit enhancements such as additional collateral from either the mortgagor or guarantors of the mortgage debt or additional guarantees. This will require the execution of amended or new loan documentation by the mortgagor, mortgagee, and guarantors.
- The commercial real estate project involved may be a profitable enterprise that is experiencing short-term financial strains requiring temporary relief, such as a reduction in the interest rate payable under the promissory note or a payment moratorium for a prescribed period of time.

In negotiating and documenting a consensual loan workout, counsel to the Special Servicer must analyze the existing loan and security documents to determine whether and to what extent deficiencies exist in that paperwork. Counsel also must obtain an updated title search report on the mortgaged realty and, if security interests in personal property have been taken as collateral, Uniform Commercial Code search results under the appropriate debtors' names from the necessary filing offices. Counsel also can advise the Special Servicer that a forbearance agreement is advisable in these circumstances. For a detailed description of this workout/restructuring process, see Patrick E. Mears et al., *Strategies for Secured Creditors in Workouts and Foreclosures* (ALI-ABA 2004). Once the restructuring documents have been executed fully, the Special Servicer's counsel must ensure that all critical documents, for example, mortgages and UCC financing statements, are properly recorded in all filing offices.

Nonjudicial Mortgage Foreclosures

A number of states have enacted legislation permitting a mortgagee to foreclose on the pledged real estate without involving the courts. E.g.,

Mich. Comp. Laws § 600.3201 et seq.; Minn. Stat. § 580.01 et seq.; Neb. Rev. Stat. § 76-1007 et seq.; R.I. Gen. Laws § 34-11-22. Nonjudicial foreclosures are popular with Special Servicers because they are less expensive and faster than judicial mortgage foreclosures. If, however, a lien priority dispute exists between the mortgagee and the holder of a competing lien, the Special Servicer is best advised to commence a judicial foreclosure proceeding so that the court can determine lien priorities in its judgment of foreclosure. Absent such a judgment, the foreclosing mortgagee may not be able to obtain a title insurance policy without an exception for the competing lien.

Rent Assignments

Many states have enacted statutes permitting a mortgagor to assign rents generated by the mortgaged commercial realty to the mortgagee as additional security for the indebtedness. Del. Code Ann. tit. 25, § 2121; Mich. Comp. Laws §§ 554.212 et seq., 554.231 et seq.; Minn. Stat. § 559.17(2); S.C. Code Ann. § 29-3-100. These rent assignments, which are contained in the mortgage or in a separate document, or both, will be recorded at the loan closing in the land records of the county in which the affected real estate is situated. On default under the loan documents, the assignee/mortgagee can take actions, in some jurisdictions specified by state statute, to collect the rents from tenants coming due after all prerequisites to enforcement of the assignment have been completed. A number of these statutes require the assignee to record a notice of default under the rent assignment in the land records. Michigan and South Carolina require that the mortgagee serve the tenants with a demand for the turnover of rents. Courts are split on the proposition that, on the recording of the notice of default and its service on the debtor and tenants, the debtor's right, title, and interest in and to the rents is extinguished and becomes the sole property of the assignee. See *In re Mount Pleasant Ltd. P'ship*, 144 B.R. 727 (Bankr. W.D. Mich. 1992); cf. *In re PMG Properties*, 55 B.R. 864 (Bankr. E.D. Mich. 1985).

A Special Servicer can elect to exercise the mortgagee's rights under the rent assignment and collect the rents either concurrently with a mortgage foreclosure proceeding or independently of any other collection actions. On service of the tenants with the notice of default and a demand for turnover of all rents going forward, the cash flow of the project in most cases will promptly dissipate. The tenants either will pay rents to the assignee or will not pay anyone at all. This stoppage of the rental stream will not only place substantial economic pressure on the mortgagor to satisfy the assignee's demands but also will deprive the mortgagor of this income stream even when the mortgagor subsequently files a petition under Chapter 11 of the federal Bankruptcy Code. A number of bankruptcy courts have held that, in these circumstances, the mortgagor loses all of its interest in the rents and, therefore, those rents are not "cash collateral" subject to the mortgagor's use in the bankruptcy case. See, e.g., *In re Mount Pleasant Ltd. P'ship*, 144 B.R. at 727.

Deeds in Lieu of Foreclosure

Most jurisdictions recognize and enforce deeds in lieu of foreclosure as an extra-judicial method by which a mortgagee can obtain title to mortgaged real estate in the absence of any foreclosure proceedings. On default under the mortgage loan documents, the mortgagor and the mortgagee can agree that the mortgagor will convey title to the real estate to the mortgagee under a warranty or quitclaim deed "in lieu of" mortgage foreclosure proceedings. In these transactions, either the entire mortgage debt or a portion of the debt (usually the property's value) will be discharged on the delivery and recording of the deed. These transactions are normally memorialized in written agreements providing for delivery of the deed in lieu of foreclosure and defining the rights and duties of the parties after the transfer occurs.

Special Servicers often seek a deed in lieu of foreclosure when a loan is in default. This process is normally expeditious and results in the immediate transfer of title to and possession

of the realty to the mortgagee without costly and time-consuming foreclosure proceedings and without triggering a redemption period for the mortgagor's benefit. Nevertheless, counsel to a Special Servicer must be cognizant of the pitfalls of using deeds in lieu of foreclosure.

First, adequate consideration should be given by the mortgagee to the mortgagor in exchange for the deed. This consideration is normally provided when the mortgage debt is completely forgiven in return for delivery of the deed. *Zubrys v. Harbor Country Banking Co.*, No. 192822, 1997 WL 33330696, at *1 (Mich. Ct. App. Dec. 19, 1997). When not all of the indebtedness is forgiven, however, the transaction might be subject to challenge and possible rescission on the basis of a failure of consideration. In these circumstances, many title companies will not issue an owner's policy to a mortgagee receiving a deed in lieu without an exception for this litigation risk.

Second, if the value of the real estate exceeds the amount of the mortgage debt, the transfer can be subject to challenge as a fraudulent transfer, especially when the transferor is insolvent at the time of the transfer or is rendered insolvent by the conveyance. Ga. Code Ann. § 18-2-70 et seq.; 740 Ill. Comp. Stat. 160/1 et seq.; Ind. Code § 513.41 et seq.; Ohio Rev. Code Ann. § 1336.01 et seq. The legal basis for such a challenge, which could be made by the transferor's creditors or trustee in bankruptcy, would be that the mortgagee failed to give "reasonably equivalent value" or "fair consideration" in return for the deed.

Third, if there is another lien on the transferred real estate, the Special Servicer will take title to the property subject to that lien. For junior liens, most states will permit the transferee to foreclose on the lien that was the subject of the deed in lieu after the transfer, provided that the deed in lieu contains "nonmerger" language, namely, a provision in the deed stating that the transfer of the realty by the deed does not result in a merger of the mortgage into title to the property and that the mortgage will remain intact to permit

its subsequent foreclosure. Thus, counsel to the Special Servicer must make certain that the deed in lieu contains this nonmerger language to protect the transferee in these circumstances.

Fourth, a deed in lieu that is executed and held in escrow, but not delivered to the lender, can be considered an equitable mortgage and a cloud on the equitable right of redemption. Therefore, even after the deed is delivered to the lender, courts can treat it as a mortgage that must be foreclosed for a transfer to occur. E.g., *Hamud v. E.T. Hawthorne*, 338 P.2d 387 (Cal. 1959); *Brenneman Mech. & Elec., Inc. v. First Nat'l Bank of Logansport*, 495 N.E.2d 233, 239 (Ind. Ct. App. 1986).

In-Court Collection Strategies

Federal vs. State Foreclosure Actions and Receiverships

The first choice a Special Servicer will need to explore is whether the foreclosure action will be a federal or state action. Most foreclosure actions are filed in state courts for many reasons, usually logistics and lower cost. Federal receiverships may be preferable to state receiverships when real estate is located within different counties throughout a state or located in different states. The Special Servicer may not want to commence simultaneous foreclosure actions in different states when it can have one federal foreclosure action. One consideration for not proceeding in federal court, however, is that the fees for a U.S. marshal to sell the property are usually higher than the fees charged by a state sheriff.

Federal Foreclosure Action and Receivership. Before filing a federal foreclosure action, federal jurisdiction must be established. Because most foreclosure actions do not involve federal question jurisdiction, diversity jurisdiction will most likely need to be established. Most commercial real estate transactions involve one or more limited liability companies. Citizenship of a limited liability company is determined by the citizenship of its members. Therefore, if a limited liability company is a party to the foreclosure action, the members of the limited liability company and their citizenship will need to be identified to establish whether a federal court

will have diversity jurisdiction. The required information may not be public or readily available. The lawyer for the Special Servicer may be able to obtain this by carefully examining the loan documents, especially signature blocks, notary blocks, and the original intake and due diligence documents (loan applications, tax returns, corporate resolutions, and member certificates). One way to eliminate this difficulty is to obtain a list of all members and their citizenship as required information during the loan origination process and by adding a covenant in the loan documents that any changes must be promptly reported to the lender.

If jurisdiction is established, venue must be determined. The loan documents should be consulted to see if the parties have already consented to venue. If not, 28 U.S.C. § 1391 must be applied:

A civil action wherein jurisdiction is founded only on diversity of citizenship may, except as otherwise provided by law, be brought only in (1) a judicial district where any defendant resides, if all defendants reside in the same State, (2) a judicial district in which a substantial part of the events or omissions giving rise to the claim occurred, or a substantial part of the property that is the subject of the action is situated, or (3) a judicial district in which any defendant is subject to personal jurisdiction at the time the action is commenced, if there is no district in which the action may otherwise be brought.

Once federal jurisdiction and venue are established, the district court has ancillary jurisdiction to adjudicate the foreclosure action. See 28 U.S.C. § 1367. The Special Servicer also may seek to have a receiver appointed. The decision of whether a receiver should be appointed is made by federal standards and resolved by federal law. *Midwest Sav. Ass'n v. Riversbend Assocs. P'ship*, 724 F. Supp. 661, 662 (D. Minn. 1989); *Waag v. Hamm*, 10 F. Supp. 2d 1191, 1193 (D. Colo. 1998). The appointment of a federal receiver is "an extraordinary

remedy that should be employed with the utmost caution and granted only in cases of clear necessity to protect a plaintiff's interest in the property." *Midwest Sav. Ass'n*, 724 F. Supp. at 662. The court will typically look to the following factors in determining whether to appoint a receiver:

- the existence of a valid claim by the moving party;
- fraudulent conduct on the part of the defendant;
- imminent danger that the property would be lost, concealed, injured, diminished in value, or squandered;
- an inadequacy of the available legal remedies;
- the probability that harm to the plaintiff by denial of the appointment would be greater than the injury to the parties opposing appointment;
- plaintiff's probable success in the action; and
- the possibility of irreparable injury to plaintiff's interest in the property.

Waag, 10 F. Supp. 2d at 1193.

Once appointed by the court, the receiver operates the property according to the laws of the state where the property is located. 28 U.S.C. § 959(b); *Waag*, 10 F. Supp. 2d at 1193; *Midwest Sav. Ass'n*, 724 F. Supp. at 661–62; *Borock v. City of New York*, 268 F.2d 412, 415 (2d Cir. 1959). There are many provisions that either the Special Servicer or the receiver may want included in the receiver order. A number of these provisions are set forth below as part of the "State Foreclosure Action and Receivership" section of this article. Within 10 days of entry of the order appointing the receiver, the receiver must file a copy of the complaint and the order of appointment in each district in which property is located. See 28 U.S.C. § 754. Failure to file copies of the complaint and order in any district divests the receiver of jurisdiction and control over all property in that district.

Typically, the jurisdiction of courts appointing receivers under 28 U.S.C. § 754 is exclusive and no other courts

have authority to interfere with the property or control the receiver over the receiver's custody and operation of the property. If a bankruptcy proceeding is filed by the borrower, however, 11 U.S.C. § 543 will need to be consulted regarding the receiver's powers and duties, or lack thereof.

Under 28 U.S.C. § 958, "a person holding any civil or military office or employment under the United States or employed by any justice or judge of the United States shall not at the same time be appointed a receiver in any case in any court of the United States." In addition, under 28 U.S.C. § 957, "a clerk of a court or any of his deputies shall not be appointed a commissioner, master, referee, or receiver in any case, unless special reasons require such appointment, which are recited in the order of appointment."

State Foreclosure Action and Receivership. Generally, a foreclosure action must be filed in the jurisdiction where the real estate is located. If real estate is scattered throughout a particular state, however, the action may be able to be commenced in a court where the defendants are subject to jurisdiction, and then the sheriff of each particular county where the real estate is located will sell the real estate.

Depending on which state the proceeding is in, judicial foreclosure, nonjudicial foreclosure, or both may be available. For example, Delaware, Indiana, Illinois, and Ohio recognize only judicial foreclosures (a complaint must be filed and a court must enter a foreclosure order). States such as Michigan, Georgia, and Minnesota allow both judicial and nonjudicial foreclosures.

The Special Servicer also can seek the appointment of a receiver under state law. When a receiver is appointed, in many states a receivership estate is created for the benefit of all creditors, similar to an estate created in a bankruptcy. A receiver is an impartial and disinterested party that serves as an "arm of the court" that will take possession and control of the subject property to preserve, protect, maintain, and operate the property subject to applicable law and the receivership order. The powers of the receiver vary for each state.

In certain instances, and usually with court approval, a receiver can even sell the property, though sale limitations may exist. For example, in Indiana, the power to sell the receivership property free and clear of liens requires consent by the borrower and other lienholders and an appropriate waiver of redemption rights. In Illinois, the receiver does not have the statutory right to sell real estate, but in certain limited instances the court may grant such authority if the loan at issue is nonrecourse and the borrower consents. In Ohio a court can permit a receiver to sell property.

The requirements for the appointment of a receiver also are different in each state. For example, Michigan courts can require a strong showing of harm. In Illinois, appointment is presumed, subject to rebuttal for cause for nonresidential properties, if the loan documents provide for appointment and the mortgagee has demonstrated that the loan is in default. In Indiana and Minnesota, however, appointment is required in certain circumstances (if the loan documents provide) and is discretionary in other circumstances. The process to choose the receiver also varies. In Illinois, the mortgagee is entitled to select the receiver, but in Indiana, Ohio, Minnesota, and Georgia, the

mortgagee usually selects the receiver subject to court approval. In Michigan, the mortgagee normally nominates a person to act as the receiver but the court is not required to follow this recommendation and can appoint its own nominee. See, e.g., *Ypsilanti Fire Marshal v. Kircher*, 730 N.W.2d 481 (Mich. Ct. App. 2007).

The court also will need to be satisfied that the receiver is qualified to act as a receiver. This is certainly important because the receiver is an arm of the court. To establish a receiver's qualifications, it is usually a good idea, and sometimes a requirement, to file an affidavit signed and acknowledged by the receiver setting forth, among other things, the receiver's education, training, and experience. Courts in Chicago require that the proposed receiver show disinterestedness under local rule. Attaching a résumé and other materials is recommended. In some areas the proposed receiver also may need to be a resident within the court's jurisdiction.

Because a receiver's appointment is by order of the court, the wording of the order is very important and should outline the receiver's duties and powers in addition to those imposed by any applicable state statutes and state and local rules. A few of the various issues

for the Special Servicer to consider when preparing or reviewing a receivership order are:

- specifying the scope of receiver duties:
 - file receiver reports,
 - collect rents and other income,
 - negotiate and terminate/reject leases and contracts,
 - eject defaulting tenants/file litigation,
 - manage, preserve, and protect the receivership property,
 - operate any business related to the receivership property,
 - hire and fire employees, agents, real estate brokers, accountants, counsel, and other representatives to assist in the performance of receivership duties,
 - obtain/maintain insurance on the receivership property,
 - make repairs,
 - pay taxes and other assessments related to the receivership property and possibly file tax returns,
 - prosecute and defend suits related to the receivership property without leave of court,
 - establish bank accounts,
 - make capital and tenant improvements,
 - apply or release security deposits (for example, cannot return if not in receiver's possession);
- prohibiting paying pre-receivership amounts;
- limiting liability of receiver (for example, gross negligence and no environmental);
- stating compensation of receiver (for example, monthly, hourly, and brokerage);
- identifying when court and lender approval is required;
- including particular property issues (for example, liquor licenses, capital improvements);
- providing for formal appointment of the receiver and an identification of the property subject to the receivership;
- granting the receiver possession and control of the receivership property (not title);

- entering into or terminating contracts;
- obtaining a surety bond for amounts in bank accounts over FDIC insurance limits;
- providing for tenant attornment to the receiver;
- requiring the mortgagor and its agents and employees to immediately turn over to the receiver possession of the property and all monies (for example, bank accounts, security deposits, and collected rents) and documents relating to the property (for example, information relating to accounts receivable and payables, leases, books, and records, insurance policies, and other contracts);
- requiring the mortgagor and its agents and employees to turn over all keys, alarm codes, and access devices to the receiver;
- requiring the receiver to file reports with the court on a periodic basis and deliver copies of those reports to designated parties;
- requiring that the mortgagor cooperate with the receiver; and
- describing the receiver's fees and expenses.

If the receiver wishes to take action that is not addressed in the order of appointment, the receiver should file with the court a motion requesting permission to take such action.

Money Judgment Against Obligors (Borrowers and Guarantors)

When the judicial foreclosure process is complete, in many states the Special Servicer may have obtained an order establishing a money judgment against the borrower (and possibly guarantors) as well as a decree of foreclosure. The next step in those jurisdictions is to collect this money judgment by selling other real estate and any other collateral to satisfy all or part of the money judgment. To the extent the proceeds from the sale of the property do not satisfy the full amount of the debt, the Special Servicer will need to pursue a deficiency action against the borrower and any guarantors. The loan documents (including any guarantees), however,

will need to be carefully examined to confirm that recourse is available to collect the deficiency judgment. Many commercial real estate loans contain nonrecourse provisions. In other words, the lender may collect only against the real estate and other collateral and may not collect against any other assets of either the borrower or guarantors, unless special circumstances exist ("bad boy" provisions). More often than not guarantees in these types of transactions are nonrecourse and the guarantors are only liable if the "bad boy" provisions are triggered, as in the case of fraud, embezzlement, property neglect, failure to pay taxes, and so on. In addition, guarantees can be limited to a certain amount.

Under most circumstances, the first bid on the real estate and other collateral at the sheriff's sale will be a credit bid placed by the lender. In other words, the lender will bid all or part of the judgment amount. In some states, the lender's right to a credit bid should be expressed in the foreclosure order and judgment so there is no confusion at the sheriff's sale. Also, in many jurisdictions the order and judgment should be clear that the lender can collect any deficiency, notwithstanding a credit bid. The amount of the lender's credit bid is sometimes regulated. For example, in Ohio it must be at least two-thirds of the appraised value, as determined by three disinterested persons, as ordered by the court. The lender must be careful and realize that the amount of the credit bid will reduce the outstanding judgment amount and cannot be collected by other means. For example, if the full judgment amount is credit bid, no deficiency will exist, regardless of the actual fair market value of the real estate and other collateral.

Conclusion

CMBS loan defaults will continue to be with us, creating complex and sometimes messy situations that cry out for creative and effective remedies. A Special Servicer and its counsel are, like Hercules in Greek mythology, assigned to perform this labor, the result of which will depend on how much broad knowledge and careful preparation they bring to the task. A thoroughly prepared and well-counseled Special Servicer will have the tools necessary to render this task relatively painless and quick. ■