

BANK USES STATE RECEIVERSHIP TO AVOID FORECLOSING ON PROBLEMATIC APARTMENT BUILDING

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Most lenders would prefer to avoid litigation in connection with foreclosing on income-producing property. Sometimes, however, it is the best approach when dealing with a litigious borrower and a troubled income-producing property that, if foreclosed upon, would require extensive renovation to correct building code violations in addition to dealing with local rent-control issues.

The workout scenario described in this article is based on a real-life situation encountered by a California lender that ultimately produced a successful result. The lender's loan was paid in full, and all attorneys' fees incurred by the lender in connection with the associated litigation were paid by the borrower.

Setting the Scene

The bank made a loan to a California borrower, the repayment of which

was secured by a multiunit apartment building in San Francisco that generated approximately \$100,000 a month in rents. The bank's promissory note was secured by a deed of trust that contained an assignment-of-rents provision granting the bank a first priority security interest. The building included several building code violations and rent-control law violations, which were the subject of numerous city enforcement proceedings.

The loan initially performed, but in its third year, the borrower failed to provide required reporting and was in breach of multiple financial covenants. In the interim, the city filed a lawsuit against the borrower, alleging breaches of various rent-control ordinances and contending

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that the borrower had engaged in retaliatory evictions, harassment of tenants, and related matters.

The city obtained a multimillion-dollar judgment against the borrower. To collect, the city filed a motion in its lawsuit seeking an assignment order requiring the borrower to turn over all rents generated from its building in partial satisfaction of the city's judgment. The bank, meanwhile, was not a party to the lawsuit filed by the city, so it could not oppose this motion.

The motion for an assignment order was granted, and the city took the necessary steps to collect the rents generated from the borrower's building, in derogation of the first priority security interest held by the bank in those rents pursuant to the assignment of the rents provision of its deed of trust. The assignment order was a breach of the bank's deed of trust, and the required payment of rents to the city pursuant to it caused a monetary default under the bank's loan documents. The bank, therefore, needed to take appropriate action to enforce the first priority security interest it held in the rents.

A Two-Fold Litigation Strategy

The bank needed to develop a legal strategy to address two things:

- The actions taken by the city in collecting the rents generated from the bank's real property collateral.
- Payment of its loan, preferably without foreclosing on the troubled building.

First, the bank filed a motion to intervene in the pending lawsuit by

the city against the borrower, which, if granted, would have allowed the bank to become a party to the suit. As such, the bank could have then asked the court to determine whether its security interest in the generated rents was senior in priority to the assignment order obtained by the city.

The bank's motion to intervene was successful. It then filed a motion requesting that the court determine that all rents generated from the borrower's building were the bank's collateral and could not be the subject of the city's assignment order. The court granted that motion as well, finding that the bank held a senior security interest in the rents because its deed of trust was recorded well before the city's assignment order. As a result, the city no longer collected the rent payments, which were turned over to the bank.

However, because it is not in the business of operating real property, the bank needed to develop a legal strategy to address the operation of the building and the collection of rents.

To do so, the bank filed a lawsuit seeking to have a receiver appointed over the building. The bank chose not to initiate California nonjudicial foreclosure proceedings, because it did not want to take title to the building for the reasons discussed earlier. Because of multiple defaults which then existed in its loan, the bank succeeded in having a receiver appointed over its real property collateral.

With its collateral protected and rents being collected by the receiver, the bank next needed to develop a strategy to obtain payment of its loan, preferably without having to foreclose on the building. Among the stipulations in the order appointing the

receiver was an injunction provision that prohibited the borrower from interfering with the receiver's operation of the bank's real property collateral, or transferring or further encumbering the real property collateral.

The bank then filed a motion to authorize the receiver to sell the building and develop the procedures required to do so. These included authorizing the receiver to retain a broker, enter into a purchase and sale agreement for the sale of building, and conduct a live overbid hearing in court to see if any other potential buyers were interested in purchasing the collateral for more than the offer in any purchase and sale agreement obtained by the receiver.

The receiver succeeded in entering into a purchase and sale agreement for more than \$4.67 million, an amount that would pay the bank in full, including all principal, interest, late charges, default interest, and legal fees. The bank then filed a motion seeking to have the court instruct the receiver to approve the purchase and sale agreement and schedule an overbid hearing. At the hearing on the motion, multiple alternative buyers participated in a vigorous auction process, during which the original buyer increased its offer by several hundred thousand dollars to become the successful bidder. The court then entered an order authorizing the receiver to close the sale of the building to the successful bidder.

The Borrower's Last Stand

Prior to the closing of the sale, however, the borrower encumbered the bank's collateral with a junior lien to disrupt the court-ordered sale and prevent the receiver from closing it. In response, the receiver filed an

emergency application with the court to permit the sale to close without payment of the unauthorized junior lien recorded by the borrower. The court issued an order to that effect.

The borrower appealed the order authorizing the receiver to sell the building, arguing that the filing of the appeal prevented the receiver from closing a sale. Both the receiver and the bank filed opposition to the borrower's motion, which was denied. The borrower then filed an emergency petition with the court of appeals to try once again to stay the sale of the bank's real property collateral. That petition, too, was denied.

After approximately a year of litigation, the receiver closed the sale of the building to the successful buyer. The bank's loan was paid in full when the sale closed, including all principal, interest, default interest, and late charges. The successful overbid to purchase the building also enabled the bank to recover all attorney fees incurred in dealing with the litigation tactics of the borrower.



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Lessons Learned

Despite multiple roadblocks created by the borrower, the bank diligently pursued its original decision to use the litigation process to achieve a receiver sale, allowing it to avoid taking title to the real property collateral and dealing with multiple issues that would have arisen if the bank became the owner of the building after foreclosure. The borrower's litigation tactics involved taking 10

different appeals from court orders and attacking the ethics of the receiver and the bank, not only in court pleadings but also in online news articles.

The lesson to be learned from this case is that, once the decision is made to engage in litigation to obtain payment of a real property secured loan based on the foregoing circumstances, it is best to stay the course and not be deterred by delaying tactics of the borrower. ■

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