Commercial Aspects of Foreclosure

Mortgage Foreclosure 2015

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I. Differences Between Residential And Commercial Real Estate

There exists a different psychology between residential and commercial mortgagors and mortgagees. The foreclosure process is different in the foreclosure of a commercial mortgage. Differences are found in the right of the mortgagee to possession, redemption and personal liability. A commercial mortgagor is likely to encounter a receiver. Guaranty liability is an issue.

II. Applicability of Supreme Court Rules 113 and 114.

Supreme Court Rules 113 regarding practice and procedure in mortgage foreclosure cases is applicable to commercial foreclosure cases. The cautious approach is to comply with Rule 114 regarding the loss mitigation affidavit. Rule 114(a) states that for all actions filed under the Illinois Mortgage Foreclosure Law, and where a mortgagor has appeared or filed an answer or other responsive pleading, Plaintiff must, prior to moving for a judgment of foreclosure, comply with the requirements of any loss mitigation program which applies to the subject mortgage loan. However, the Form Loss Mitigation Affidavit refers to the residential mortgage loan that is the subject of the pending foreclosure case. As a result of this inconsistency, I recommend compliance with Supreme Court Rule 114.

III. Possession

The Illinois Mortgage Foreclosure Law changed the rules regarding possession during foreclosure. The relevant statutory provisions begin with §15-1701(b), which provides:

> Prior to the entry of a judgment of foreclosure:
>
> In the case of residential real estate, the mortgagor shall be entitled to possession of the real estate except if (i) the mortgagee shall object and show good cause, (ii) the mortgagee is so authorized by the terms of the mortgage or other written instrument, and (iii) the court is satisfied that there is a reasonable probability that the mortgagee will prevail on a final hearing of the cause, the court shall upon request place the mortgagee in possession. If the residential real estate consists of more than one dwelling unit, then for the purpose of this part residential real estate shall mean only that dwelling unit or units occupied by persons described in clauses (i), (ii) and (iii) of Section 15-1219.
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> In all other cases, if (i) the mortgagee is so authorized by the terms of the mortgage or other written instrument, and (ii) the court is satisfied that there is a reasonable probability that the mortgagee will prevail on a final hearing of the cause, the mortgagee shall upon request be placed in possession of the real estate, except that if the mortgagor shall object and show good cause, the court shall allow the mortgagor to remain in possession.

Therefore, prior to judgment, the residential mortgagor is entitled to possession, but if the mortgagee shows good cause and is authorized by the mortgage, then the mortgagee can obtain possession. In all other cases, if the mortgagee is authorized by the mortgage and the court believes it likely to prevail, the mortgagee upon request is to be placed in possession; however, if the mortgagor objects and shows good cause, the mortgagor may remain in possession.

In *Travelers Insurance Co. v. LaSalle National Bank,* 200 Ill.App.3d 139, 558 N.E.2d 579, 146 Ill.Dec. 616 (2d Dist. 1990), the court entered an order placing the plaintiff mortgagee in possession of the mortgaged premises during foreclosure. The mortgaged premises were nonresidential real estate. The mortgagee alleged that the mortgage instrument expressly authorized the mortgagee to take possession and that there existed a probability that it would prevail on its foreclosure complaint. Along with its motion for possession, the plaintiff submitted a summary judgment motion and supporting affidavit that verified the allegations of the complaint and indicated the unpaid principal and interest owed by the defendants. The defendants alleged affirmative defenses based on theories of unclean hands and estoppel.

The *Travelers* court, in interpreting the IMFL, stated that the presumptive right to possession during foreclosure lies with the mortgagor of residential real estate and with the mortgagee of nonresidential real estate. In the case of nonresidential real estate, the mortgagee must show (a) that the mortgage documents authorize the mortgagee to be entitled to be placed in possession and (b) that "there is a reasonable probability that the mortgagee will prevail on a final hearing of the cause." 558 N.E.2d at 581.

The court noted that the sole issue on appeal was "whether defendants demonstrated good cause pursuant to §15-1701(b)(2)." 558 N.E.2d at 581. In making that determination, the court held that a nonresidential mortgagee had no obligation to allege misdeeds or omissions on the part of the mortgagors. Furthermore, whether the mortgagee was "adequately protected" was not a relevant consideration under IMFL. 558 N.E.2d at 580.

In ruling in favor of the mortgagee, the court considered that the answer and affirmative defenses were unverified, the denials went only to the amount of interest, and the affirmative defenses were conclusory. As a result, the answer and affirmative defenses did not overcome the mortgagee's affidavit. 558 N.E.2d at 581.

A more troubling case to borrowers is *Mellon Bank, N.A. v. Midwest Bank & Trust Co.,* 265 111.App.3d 859, 638 N.E.2d 640, 202 Ill.Dec. 772 (1st Dist. 1993), in which the court reversed an order denying the lender's request for a receiver to manage and conserve the mortgaged premises during the pendency of the foreclosure. The borrower filed a verified answer with affirmative defenses denying the existence of a default and objecting to the appointment of a receiver. The affirmative defenses were based on theories of lack of consideration, inequitable conduct, and estoppel based on acceptance of late payments. 638 N.E.2d 648.

The court held that once IMFL's requirements are met, a court does not have discretion in awarding possession. The court referred to two prior cases in which the courts had held that in Illinois a proven default establishes a reasonable probability of success in a mortgage foreclosure action. Whether a default exists will typically turn on the interpretation of documentary evidence. The court determined that the borrower's defenses in the case did not establish good cause and that the defenses were unpersuasive.

As a result of *Travelers, supra,* and *Mellon Bank, supra,* it is important for a borrower's attorney to:

> review the mortgage and related materials to see if the instruments entitle the mortgagee to possession *(see Asset Guaranty Reinsurance Co. v. American National Bank & Trust Company of Chicago,* 254 IlLApp.3d 713, 627 N.E.2d 179, 194 Ill.Dec. 63 (1st Dist. 1993));
>
> show by way of verified affirmative defenses and affidavit that no default exists;
>
> show by way of verified affirmative defenses and affidavit that the mortgage or loan documents are invalid;

The mortgagor's burden in defending the appointment of a receiver in the context of a commercial mortgage foreclosure was the subject of two recent Illinois cases: *Centerpoint Properties Trust v Olde Prairie Block Owner, LLC,* 398 Ill App 3d 388 (1st Dist 2010) and *Bank of America, N.A. v. 108 N. State Retail LLC.*, 401 Ill. App 3d 158 (1st Dist. 2010).

In both cases, the mortgagee met its statutory burden under Illinois law of showing that (1) the mortgage or other written instrument authorized the appointment of a receiver and the mortgagee's possession of the mortgaged property, and (2) there was a reasonable probability that the mortgagee would prevail upon a final hearing. Therefore, the courts in both cases held that the burden shifted to the mortgagor to establish good cause to retain possession.

In *Centerpoint*, the court rejected the defaulting mortgagor's contention that it had shown good cause to retain possession because the mortgagee failed to allege any fraud, mismanagement, waste or other dissipation of the mortgaged property. The court rejected this argument as attempting to shift the burden of making a good-cause showing to the mortgagee. The court also rejected the mortgagor's arguments that it could better manage the property and the harm caused by the appointment of a receiver outweighed any harm the mortgagor might incur if it were permitted to retain possession. Therefore, arguments that the appointment of a receiver makes it difficult to attract prospective tenants, promote projects to investors, and obtain financing in order to resolve the foreclosure action will not in themselves defeat the appointment of a receiver in Illinois.

But the court in Centerpoint did acknowledge it could conceive of circumstances in which a court could find that good cause to retain possession has been established, e.g., where the mortgagor presents evidence that it has a commitment from an investor to provide funds for development of the property or has obtained a loan from another lender to refinance, and that the appointment of a receiver would likely impede those transactions. However, the transaction must be imminent and not at some unknown time in the future.

In *Bank of America*, the mortgagor contested the court's holding that the mortgagee had a reasonable probability of succeeding in the underlying foreclosure and had established the absence of good cause for the mortgagor to retain possession. The mortgaged property was the high-profile property in downtown Chicago known as Block 37. The defaults asserted by the mortgagee were: (1) the loan was out of balance and; (2) the failure of the loan guarantors to hold unencumbered liquid assets of at least $5 million as required by the loan agreement. The mortgagor had acknowledged in at least 23 previous letter agreements that: (1) it was in default because the loan was not "in balance" (i.e., the amount of funds available under the loan did not equal or exceed the amount budgeted to complete the project); (2) the guarantors failed to maintain the required $5 million in liquid assets; and (3) it had no counterclaims, defenses, setoffs, or affirmative defenses.

The mortgagor asserted two good-cause arguments, namely: (1) it was in the best position to complete the project and protect the value of the collateral, particularly given the project's complexity and the fact that the project was in its final stages of construction; and (2) the proposed receiver was unprepared to take over the project and had disqualifying conflicts of interest. The alleged disqualifying conflicts were: (1) the receiver's employer, CB Richard Ellis ("CBRE") represented other properties in the immediate vicinity of the mortgaged real estate that were direct competitors for the limited pool of retail tenants seeking to lease space in downtown Chicago and (2) CBRE also represented several prospective Block 37 tenants, some of whom were involved in ongoing disputes with the mortgagor. The court held that the alleged qualifications of the mortgagor's current manager were insufficient to establish sufficient good cause to permit the mortgagor to retain possession and even though the mortgagor argued it was in a better position to complete the project, it had not presented a plan to obtain the additional funding required to complete the project, or indicate how it would be able to put the loan "in balance."

The court ruled that there was no indication that the proposed receiver was incompetent, inexperienced or incapable of managing the project and bringing it to completion. The court noted that CBRE was a large real-estate service company and that the individual proposed by CBRE to act as receiver for this property had acted as a receiver on twenty other large developments. Finally, the court ruled that the issue of an alleged conflict of interest would be appropriate for the trial court to decide.

If the mortgagee does take possession, the mortgagee is accountable to the mortgagor for all rents and profits reasonably expected to be received by the exercise of reasonable diligence minus a credit for expenses. *Rogers v. Barton,* 386 Ill. 244, 53

N.E.2d 862 (1944). Additionally, once a mortgagee has taken possession, the mortgagee is required to keep the property in necessary repair but not to make improvements. *McConnel v. Holobush,* 11 Ill. 61 (1849).

Section 2-415(c) of the Code of Civil Procedure provides that a court-appointed receiver "may be sued in respect of any act or transaction of the receiver in carrying on the business connected with the property, without previous leave of the court in which the receiver was appointed." The court in *Wolfe v. Illini Federal Savings & Loan Ass 'n,* 158 Ill.App.3d 321, 511 N.E.2d 828, 110 Ill.Dec. 651 (5th Dist. 1987), found that the express language of §2-415(c) permitted an original action against a receiver for its conduct in caring for property during the course of the receivership.

In *Wolfe,* the mortgagees' insurance coverage on the realty lapsed. The receiver did not secure coverage, and vandals damaged the structure. The mortgagees subsequently redeemed their ownership interest in the realty and sold it "below its market value." 511 N.E.2d at 829. The receiver's bond was insufficient to cover the vandalism damage to the realty. The court reversed the trial court's dismissal of the action against the receiver and remanded it back to the trial court. 511 N.E.2d at 831.

However, the court held that any objection to the manner in which the receiver was procured, such as the failure to post an adequate bond, cannot be collaterally attacked. The court made a distinction between the manner in which a receivership is procured and conduct in caring for property during the course of the receivership. 511 N.E.2d at 830.

In *Kelley/Lehr & Associates, Inc. v. O'Brien,* 194 Ill.App.3d 380, 551 N.E.2d 419, 141 Ill.Dec. 426 (2d Dist. 1990), the court held that a mortgagee in possession takes only those rights that the mortgagor had. Therefore, for example, the mortgagee in possession takes the rights of the mortgagor subject to tenants' rights of setoff for their prepayment of rent by performance of services. 551 N.E.2d at 426.

IMFL also provides that a subordinate lease is not terminated during the pendency of the foreclosure by the mortgagee's entry into possession pursuant to IMFL.

In *Fidelity Mutual Life Insurance Co. v. Harris Trust & Savings Bank,* 71 F.3d 1306 (7th Cir. 1995), the court stated that foreclosure and receiverships are costly remedies and there is no public interest in encouraging mortgagees to seek them at the first hint of default.

In *Comerica Bank-Illinois v. Harris Bank Hinsdale,* 284 Ill.App.3d 1030, 673 N.E.2d 380, 220 Ill.Dec. 468 (1st Dist. 1996), *appeal denied,* 171 111.2d 563 (1997), the court discussed collection of rents by a mortgagor under an assignment of rents. The court upheld the requirement of possession for the collection of rent. The court held that the mortgagee must take some affirmative action to gain possession of the property before it can collect rents from the property. The mere filing of a foreclosure action or

request for a receiver is not an affirmative action sufficient to trigger the mortgagee's rights to collect rents.

First American Bank, SSB v. Randall Plaza Center Associates, L.P. (In re Randall Plaza Center Associates L.P.), 326 B.R. 133 (Bankr. N.D.I11. 2005) concerned the right to collect unpaid rent on the prime space in the shopping center. The court found under the facts of that case that the lender was entitled to all rents upon properly enforcing its assignment of rents, including past due rents.

An interesting case is *United States Fidelity & Guaranty Co. v. Old Orchard Plaza Limited Partnership,* 284 Ill.App.3d 765, 672 N.E.2d 876, 220 Ill.Dec. 59 (1st Dist. 1996), in which the court granted a receiver the power of a corporate receiver to accept or reject leases.

IV. Receiverships

A. Standards for the Appointment of a Receiver – Differences Among Jurisdictions in Ease of Obtaining a Receiver

1. The appointment of a receiver is a branch of equity jurisdiction. It rests largely in the discretion of the appointing court when not dependent upon an enabling statute which permits receiverships.

2. The original receivership had its origins in the English court of chancery at an early date. It was incidental to and in aid of the jurisdiction of equity to enable it to accomplish, as far as practicable, complete justice among the parties before it, the object being to secure and preserve the property or thing in controversy for the benefit of all concerned pending the litigation, so that it might be subjected to such order or decree or judgment as the court might make or render. Chicago Title & Trust Co. v. Mack, 347 Ill. 480 (1932).

3. There are no coherent uniform standards for the appointment of a receiver. A federal district court may have the power to appoint a receiver in the event a party meets the requirements for federal jurisdiction.

4. Where federal jurisdiction does not exist, the appointment of a receiver is dependent upon the laws of a particular state. There exists a legal and practical difference regarding situations in which a receiver may be appointed, the standards for appointment, notice required to be given to adverse parties, the party who has the burden of proof in connection with the appointment of a receiver, the nature of evidence required for appointment of a receiver, and the amount of any required bond.

5. Among the various states appointment of a receiver may be based on the courts exercise of equity jurisdiction or an enabling statute that provides for receiverships in certain situations where certain criteria are met.

6. Circumstances in which a receiver may be appointed are dependent upon federal law or the law of a particular state. The situations may include:

   a. The foreclosure of a mortgage in order to collect the rents or profits, or manage, conserve, operate or possibly even sell the mortgaged real estate.

   b. Incomplete improvements or mechanics liens.

   c. The wind up of a dissolved corporation that is insolvent or in danger of insolvency or has forfeited its corporate rights.

   d. The wind up of a dissolved partnership.

   e. Winding up the affairs of limited liability company N.Y. Ltd. Liability Company Law.

   f. In aid of enforcing a final judgment or in connection with supplementary proceedings.

   g. In connection with fraudulent conveyances.

   h. To determine the existence, location, nature and magnitude of any hazardous substance into, onto, beneath or from the real property security.

B. Federal Receiverships

   1. A Federal Court must have subject matter jurisdiction to appoint a receiver.

      a. District courts shall have original jurisdiction of all civil actions where the matters in controversy exceed the value of $75,000, exclusive of interest.

      b. There must exist diversity of citizenship. 28 U.S.C. §1332(a).

   2. Problem of joinder of unidentified parties.

      a. Joinder of unknown owners and nonrecord claimants may destroy diversity. John Hancock Mutual Life Ins. Co. v. Central National Bank in Chicago, 555 F. Supp. 1026 (ND Ill. 1983); Banc Boston Mortgage Corp. v. Peroni, 765 F. Supp. 429 (ND Ill. 1991).

      b. Issue between lender and its title insurance company.

   3. Federal rules applicable to appointment of receivership.

C. Rule 66 was amended effective December 1, 2007 Fed. R Civ. P. 66. It provides:

the Federal Rules govern an action in which the appointment of a receiver sues or is sued;

the practice in administering an estate by a receiver or a similar court-appointed officer must accord with the historical practice in federal courts or with a local rule; and

an action in which a receiver has been appointed may be dismissed only by court order. Fed. R. Civ. P. 60.

1. Standards governing appointment of receiver:

   a. Appointment of a receiver is an extraordinary remedy and is granted only in cases of clear necessity to protect a party's interest in property. Commodity Futures Trading Commission v. Comvest Trading Corp., 481 F. Supp. 438, 440, 441 (D. Mass 1979). The appointment of a receiver should be granted cautiously to protect property and granted only when clearly necessary to preserve property pending its final disposition. Citibank, N.A. v. Nyland, Ltd., 839 F. 2d 93, 97 (2d Cir. C1988).

   b. Appointment of receiver is only available as "ancillary to some form of final relief which is appropriate for equity." Gordon v. Washington 295 U.S. 30, 38, 55 S Ct 584, 585 (1935)

   c. Factors to consider:

      i. The existence of a valid claim of the moving party.

      ii. Fraudulent conduct on the part of the defendant.

      iii. Imminent danger that property would be lost, concealed, injured, diminished in value or squandered.

      iv. Inadequacy of available legal remedies.

      v. The probability that the harm to the plaintiff by denial of the appointment would be greater to than the injury to the parties opposing appointment.

      vi. It's probable success in the action and

      vii. The possibility of irreparable injury to plaintiff's interest in the property. Wagg v. Haam, 10 F. Supp. 2d 1191, 1193 (D. Colo. 1998); Resolution Trust Corp. v. Fountain Circle Associates Ltd. Partnerships, 799 F. Supp. 48, 50-51 (N.D. Ohio 1992).