

Lender and Receiver Both May Pay For Mismanaged Foreclosure

Article by: John Waller

If you deal with receiverships, this case will be of interest to you. A lender, a borrower and a court-appointed receiver have been battling one another in an Indiana federal court in connection with a failed construction project. Problems arose when a partially-constructed apartment complex deteriorated so much during a foreclosure suit that a judge condemned the property and ordered it to be demolished, resulting in damages alleged by the borrower of \$4,167,881 (representing the purported value of the property pre-suit minus the value of the foundations of the buildings after demolition). In Judge Philip P. Simon's words, "assessing who is at fault for this mess is at the center of the action currently before the Court." In rulings filed September 18, 2006 and October 16, 2006, the Northern District's Judge Simon brought some order to the chaos in case no. 2:02cv368, *Four Winds v. American Express Tax and Consulting Services, et al.* The cite to the September Opinion, which relates to the borrower's claims against the receiver, is 2006 U.S. Dist. LEXIS 71349. The October Opinion, which addresses the receiver's cause of action against the lender, can be found at 2006 U.S. Dist. LEXIS 75581.

Lender spanked. The litigation began when the lender decided to foreclose. The borrower filed a counterclaim asserting wrongful foreclosure because there had been no default. The borrower convinced the court that no default occurred, so the court dismissed the foreclosure aspect of the case. The lender then settled with the borrower for a "hefty amount" on the counterclaims.

Receiver faces trial. The borrower also is pursuing the receiver for negligently failing to protect and preserve the project. An agreed order governed the receiver's conduct, and the issue is whether the receiver was grossly negligent. The receiver sought a dismissal of the claim by submitting evidence that it did not act with gross negligence. In fact, the receiver undertook at least some measures to protect the property. But Judge Simon ruled that the case must go to the jury to decide factual issues, including: (1) how the project would have fared had the receiver not undertaken the protective measures that it did, (2) how much damage would more extensive protective measures have prevented, (3) why the receiver did not apply to the court for permission to complete the project or for funding to implement more extensive measures, (4) how many times should the receiver have visited the project and (5) whether the receiver was grossly negligent in fulfilling its duties as the receiver. The case is set for a jury trial on February 20, 2007.

Receiver v. lender dismissed. The receiver, in turn, had its own negligence claim against the lender, which claim really was about seeking reimbursement for any damages the receiver might have to pay to the borrower. The receiver pointed the finger at the lender, arguing that the lender controlled the receiver's actions through the funding (or lack thereof) of the receivership. Judge Simon held there was no legal basis for the receiver's position, however, and dismissed the claim. If any negligence-based duties flowed between the parties, they flowed from the receiver to the lender, not vice versa. Thus the receiver, if found to be grossly negligent, cannot recoup any losses from the lender (although the receiver may be entitled to a credit/set-off for the money the lender paid to the borrower.)

Interestingly, the agreed order appointing the receiver required the receiver to preserve and protect the property with receivership funds, even though there were no "receivership funds" to do so because the property generated no income. That catch-22 may have been the property's downfall. The receiver was responsible for directing the preservation of the property, but on whose dime? Evidently there was an informal arrangement whereby the lender funded the receivership. That went okay at the beginning, but the problems and costs later seemed to snowball out of control. I gather that, if and to the extent the receiver was negligent, it was due in part to inadequate funding by the lender. The confidential "substantial" settlement the lender paid to the borrower supports my speculation.

Lessons. Even though the lender won its legal battle with the receiver, the lender had already lost when the project failed and the borrower forced the lender to settle. There are some lessons here for lenders (and receivers):

- Ensure there is a default before a foreclosure case is initiated
- Spell out in the receivership order exactly how the receivership will be funded
- Clarify in the order the duties of the receiver, and the borrower or lender as warranted
- If the lender agrees to fund the preservation of the property, it should take reasonable steps to do so and should not unreasonably permit a project to deteriorate substantially in value

But perhaps the greatest lesson is - in cases of construction loans where the collateral is being built - lenders should foreclose and appoint a receiver only as a last resort. John D. Waller is a partner at the Indianapolis law firm of Wooden & McLaughlin LLP (<http://www.woodmclaw.com>). He publishes the blog *Indiana Commercial Foreclosure Law* at <http://commercialforeclosureblog.typepad.com> John's phone number is 317-639-6151, and his e-mail address is jwaller@woodmclaw.com