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DEBT FINANCE

Assignment of Rents: Substance Over Form and Meaning of 'Property of the Estate'

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At the beginning of a Chapter 11 single asset real estate case a debtor may encounter resistance from its secured lender over the debtor's postpetition use of rents which are subject to an assignment of rents agreement. Secured lenders may argue that rents subject to an assignment of rents are not property of the estate, and therefore, are not cash collateral available for use by the debtor. Secured lenders have had some success in argument that upon a debtor's default under the loan documents, title to the rents vests in the secured lender, eliminating any interest the debtor may have held in the rents. *See, e.g., In re Soho Retail, LLC*, Ch. 11 Case No. 10-15114, Adv. No. 11-1286, 2011 BL 85874 (Bankr. S.D.N.Y. Mar. 31, 2011); *In re Loco Realty Corp.*, No. 09-11785, 2009 BL 137139 (Bankr. S.D.N.Y. June 25, 2009). A recent decision by Judge Stong of the United States Bankruptcy Court for the Eastern District of New York suggests that single asset real estate debtors can successfully defeat these arguments if the bankruptcy court is either willing to look beyond the label of a document to the lender's post-default actions, or recognize a debtor's ''equitable'' interest in postpetition rents as sufficient to render the rents ''property of the estate.'' *See In re S. Side House, LLC*, 474 B.R. 391, 406 (Bankr. E.D.N.Y. 2012).

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Whether postpetition rental income subject to an assignment of rents is ''property of the estate,'' and therefore cash collateral, depends on whether, (1) under relevant state law the rental income would be considered property of the debtor's estate, and (2) the extent of the debtor's interest in postpetition rents meets the definition of ''property of the estate'' under Bankruptcy Code § 541(a)(6).[1]

Clear Language of the Bankruptcy Code. Although courts often look to applicable state law to determine a debtor's property interest in postpetition rents, debtors may argue that the language of Bankruptcy Code § 541(a)(6) is express and clear that postpetition rental income obtained from property of the estate, is property of the estate.[2] Notably, and arguably as a result of the Supreme Court decision in *Butner v. United States*, 440 U.S. 48 (1979), many courts hold that property rights in and to postpetition rents are governed by state law.[3]

[1] *See In re S. Side House, LLC*, 474 B.R. 391, 396 (Bankr. E.D.N.Y. 2012) (stating that in order to determine whether postpetition rental income is property of the estate and cash collateral, ''the Court must start with New York law, which defines the property interests of borrowers and lenders under assignments of rent, and then consider whether the [d]ebtor's prepetition property interests in the Rents meets the definition of property of the estate under Bankruptcy Code § 541(a)'').

[2] Bankruptcy Code § 541(a)(6) provides that property of the estate includes ''[p]roceeds, product, offspring, rents, or profits of or from property of the estate, except that such as are earnings from services performed by an individual debtor after the commencement of the case.'' 11 U.S.C. § 541(a)(6).

[3] It seems clear that if *Butner* had been decided under the Bankruptcy Code as it is written today, the Supreme Court would have applied Bankruptcy Code § 541(a)(6) to the issue

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There is an argument to be made that *Butner* was decided prior to the enactment of Bankruptcy Code § 541(a)(6) and should not control the question of whether postpetition rents which are subject to an assignment of rents, should be ''property of the estate.'' There is a counter-argument that ''[a]lthough Bankruptcy Code § 541 creates a bankruptcy estate as a matter of federal law, a large part of that estate is comprised of the debtor's non-bankruptcy property interests owned, for the most part, as of the date of the filing of the bankruptcy petition.'' KENNETH N. KLEE, BANKR. AND THE SUPREME COURT, 184-85 (LexisNexis ed., 2008) (clarifying ''[t]he determination whether an item constitutes 'property' is a federal question, but the scope, character, and other attributes of the debtor's property interest depends on nonbankruptcy (usually state) law'') (citations omitted). The correct interpretation of Supreme Court precedent does not require Bankruptcy Code § 541(a)(6), however, because Bankruptcy Code § 541(a)(1)'s broad reach includes within the definition of ''property of the estate'' all of the debtor's interests, legal and equitable. 11 U.S.C. § 541(a)(1). [4] In accordance with the Supreme Court's holding in *United States v. Whiting Pools, Inc.*, 462 U.S. 198 (1983), the concept of property of the estate is to be given a broad application. *See also In re Amaravathi Ltd. P'ship*, 416 B.R. 618, 633 (Bankr. S.D. Tex. 2009) (''*Whiting Pools* demonstrates how bankruptcy modifies the rights of . . . all secured creditors. It illustrates that the bankruptcy estate's broad reach includes property that is controlled – but not owned outright – by a secured creditor.'' (citing *U.S. v. Whiting Pools, Inc.*, 462 U.S. at 209)); KENNETH N. KLEE, BANKR. AND THE SUPREME COURT, 120 (LexisNexis, eds. 2008) (noting the broad reach of property of the estate in a reorganization (citing *U.S. v. Whiting Pools, Inc.*, 462 U.S. 198, 211-12 (1983))).[5]

Indeed, even if the language of the document appears to be ''absolute,'' courts in New York will look beyond the language to find that title to the rents was not actually transferred to the lender, but rather was merely given as additional security.

Debtor's Interest in Rents. Despite the express language of Bankruptcy Code § 541(a)(6), and perhaps recognizing the distinction made by Kenneth N. Klee, courts often focus on determining whether, as of the commencement of the case, a debtor had any legal or equitable interest in the rents under applicable state law. *See, e.g., Sovereign Bank v. Schwab*, 414 F.3d 450, 452 (3d Cir. 2005) (''[D]etermining whether the rents here are property of the bankruptcy estate requires an inquiry into whether the debtor had any legal or equitable interests in those rents as of the date of the bankruptcy petition.''); *In re Jason Realty, L.P.*, 59 F.3d 423, 426 (3d Cir. 1995) (''Property of the estate consists of all property in which the debtor holds an interest upon the commencement of bankruptcy.'' (citing 11 U.S.C. § 541(a)(6))). *See also, In re S. Side House, LLC*, 474 B.R. 391, 402 (Bankr. E.D.N.Y. 2012) (citing *Taub v. Taub (In re Taub)*, 427 B.R. 208, 219 (Bankr. E.D.N.Y. 2010) (stating ''[w]hether or not a debtor has an interest in property sufficient to bring it within the ambit of 'property of the estate' is determined by state law or other applicable nonbankruptcy law'').

The determination under state law of what relative rights a secured lender and debtor held prior to the commencement of the bankruptcy case, with respect to rents subject to an assignment of rents, depends (at first glance at least) on whether the assignment of rents ''was intended to be for 'collateral' or whether it was intended to be an absolute assignment.'' DAVID R. KUNEY & ALEX R. ROVIRA, THE SINGLE ASSET REAL ESTATE CASE: BASIC PRINCIPLES AND STRATEGIES, 60 (Joel M. Aresty, Am. Bankr. Instit. 2012). *Cf. In re S. Side House*, 474 B.R. 391, 403 (Bankr. E.D.N.Y. 2012) (''New York courts interpret rent assignment clauses to be additional security even when they contain terms such as 'absolute' and 'unconditional.' This is because courts look beyond the language used in rent assignment clauses . . . .'').

Understanding 'Collateral' Versus 'Absolute' Assignments. Although case law suggests that the label of an assignment of rents is not determinative, and therefore it is a difference without a distinction in the end, debtors and secured lenders should still understand how ''absolute'' assignments of rents differ from ''collateral'' assignments of rents. *See, e.g., Fin. Ctr. Assocs. of E. Meadow, L.P. v. TNE Funding Corp. (In re Fin. Ctr. Assocs. of E. Meadow, L.P.)*, 140 B.R. 829, 832 (Bankr.

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before it, and found that federal bankruptcy law trumped state law on the issue of property rights to postpetition rents. *See Butner v. United States*, 440 U.S. 48, 54 (1979) (''The constitutional authority of Congress to establish 'uniform Laws on the subject of Bankruptcies throughout the United States' would clearly encompass a federal statute defining the mortgagee's interest in the rents and profits earned by property in a bankrupt estate. But Congress has not chosen to exercise its power to fashion any such rule.'') (footnotes omitted); *see Amaravathi Ltd. P'ship*, 416 B.R. 618, 623 (Bankr. S.D. Tex. 2009) (''*Butner's* invitation that Congress could define such interests was accepted in Bankruptcy Code § 541(a)(6) . . . .'').

[4] Bankruptcy Code § 541(a)(1) provides, in relevant part, that: ''(a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all of the following property, wherever located and by whomever held: (1) . . . *all legal or equitable interest of the debtor in property as of the commencement of the case*.'' 11 U.S.C. § 541(a)(1) (emphasis added).

[5] ''Accordingly, all post-petition rents are property of the bankruptcy estate. *Whiting Pools* mandates this result: Until title has transferred, property controlled by a secured creditor, unless subject to an exception, must be turned over to the estate.'' *In re Amaravathi Ltd. P'ship*, 416 B.R. 618, 633 (Bankr. S.D. Tex. 2009).

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E.D.N.Y. 1992). ''[A]n absolute assignment of rents operates to transfer the right to [rents to the lender] automatically upon the happening of a specified condition, such as default.'' *In re Amaravathi Ltd. P'ship*, 416 B.R. 618, 630 (Bankr. S.D. Tex. 2009) (quoting *Taylor v. Brennan*, 621 S.W.2d 592, 293 (Tex. 1981)). Alternatively, a collateral assignment of rents ''occurs when the debtor pledges the property's rents to the mortgage lender as additional security for a loan,'' and then, after an event of default occurs, ''the lender may assert rights not only to the property subject to the mortgage but also to the rents generated by the mortgage property.'' *Id. See also, In re S. Side House, LLC*, 474 B.R. at 403 (''When an assignment is for additional security, the lender has a lien on the rents, but title to the rents remains with the borrower. But when an assignment is absolute, title to the rents vests in the lender upon execution of the agreement, and the borrower is granted a revocable license to collect the rents that may terminate immediately and permanently upon default.'').

The View of Assignments in New York. In New York, the majority view is that, regardless of the label, an assignment of rents is given as additional security for the loan, and therefore, title to the rents remains with the borrower until the lender takes affirmative steps to enforce its right to own and collect the rents. *See In re S. Side House, LLC*, 474 B.R. 391, 403 (Bankr. E.D.N.Y. 2012) (citing *Maspeth Fed. Sav. & Loan Ass'n v. 47-78 Douglass St., LLC (In re 47-78 Douglass St., LLC)*, No. 10-03478, 2011 BL 168695, at *2 (Bankr. S.D.N.Y. June 27, 2011)). Indeed, even if the language of the document appears to be ''absolute,'' courts in New York will look beyond the language to find that title to the rents was not actually transferred to the lender, but rather was merely given as additional security. *See, e.g., Dream Team Assocs., LLC v. Broadway City, LLC*, No. L&T 62346/03, slip op. at 6 (N.Y. Civ. Ct. May 7, 2003) (''Under New York Law, . . . the language used in the assignment instrument is not determinative of what rights are actually transferred.''). *See also, FDIC v. Int'l Prop. Mgmt., Inc.*, 929 F.2d 1033, 1035 (5th Cir. 1991) (noting ''[t]he concept of a present transfer of title to rents contingent upon default, as opposed to a security interest in the rents, is essentially a legal fiction.'').[6]

Some courts will not find that a debtor's residual interest in property is sufficient to render the rents property of the estate because, according to those courts, if under state law the debtor would not have the right to collect the rents, then in bankruptcy the debtor does not have any greater rights.

Although under New York state law, assignments of rents are generally given as additional security for the loan, and are not ''absolute,'' two recent decisions out of the United States Bankruptcy Court for the Southern District of New York in the Second Circuit held that postpetition rents are not property of the estate available as cash collateral because, even though the assignment of rents was ''collateral,'' the lender's efforts were sufficient to cut off the debtor's property interest in the rents prior to the commencement of the case, or because the language of the agreement made it clear that the assignment of rents was ''absolute.'' *See, e.g., In re Soho 25 Retail, LLC*, Ch. 11 Case No. 10-15114, Adv. No. 11-1286, 2011 BL 85874, at *7 (Bankr. S.D.N.Y. March 31, 2011) (finding no need to determine whether an ''absolute'' assignment of rents is permissible under New York law, because regardless, the lender had taken ''sufficient affirmative steps'' to make the assignment of rents effective). *See also, In re Loco Realty Corp.*, No. 09-11785, 2009 BL 137139, at *5-6 (Bankr. S.D.N.Y. June 25, 2009) (recognizing most courts in New York find assignments of rents to be collateral, finding assignment of rents agreement was ''absolute'' in light of clear language labeling it as such, but recognizing that ''an absolute assignment of rents prepetition does not necessarily mean that the estate has no interest in the rents for the purposes of § 541 analysis'').

Courts Look Beyond Labels. Despite these recent cases, generally, case law and secondary sources overwhelmingly suggest that even those assignments of rents labeled as ''absolute'' are really just grants of security interests, and courts will look beyond the label at the facts and circumstances of each case.[7] Accordingly, debtors should argue that even if the assignment of

[6] Other states apply the same method of looking beyond the label of an assignment of rents agreement to determine whether it is ''absolute'' or ''given as additional security.'' *See, e.g., In re Senior Hous. Alt., Inc.*, 444 B.R. 386, 392-93 (Bankr. E.D. Tenn. 2011) (holding under Tennessee state law that ''an assignment of rents absolute on its face will nevertheless be viewed as a security interest if given in connection with a mortgage loan and not in exchange for a present consideration . . . .'') (citations omitted); *In re Hrapchak*, No. 07-1668, 2008 BL 79636, at *5 (Bankr. N.D. W. Va. Apr. 16, 2008) (holding under West Virginia law that although assignment of rents agreement was labeled ''absolute,'' after examining the facts and circumstances, ''the right to collect rents is given as security and the rents themselves constitute property of the bankruptcy estate'').

[7] *See In re Foundry of Barrington P'ship*, 129 B.R. 550, 556-57 (Bankr. N.D. Ill. 1991) (''[The lender] can call this arrangement an 'absolute assignment' or, more appropriately, 'Mickey Mouse.' It's still a lien.''); *In re Bethesda Air Rights Ltd. P'ship*, 117 B.R. 202, 204-09 (Bankr. D. Md. 1990) (holding assignment of rents was given as additional security for the loan because ''[s]ubstance should prevail over form in this case''); RESTATEMENT (THIRD) PROPERTY (MORTGAGES) § 4.2 Reporter's Notes, cmt. a (1997) (''The use of 'absolute assignment' terminology . . . creates needless confusion . . . . ''); Julia Patterson Forrester, *Still Crazy After All These Years: The Absolute Assignment of Rents in Mortg. Loan Transactions*, 59 FLA. L. REV. 487, 513-14 (2007) (''The courts holding that an absolute assignment does in fact create a type of security interest

rents is labeled ''absolute,'' they are still entitled use the rents as cash collateral, because they maintain an equitable and residual interest in the rents, which renders them ''property of the estate'' under Bankruptcy Code § 541.[8] *See In re Loco Realty Corp.*, No. 09-11785, 2009 BL 137139, at *6 (Bankr. S.D.N.Y. June 25, 2009) (finding absolute assignment of rents to be ''absolute'' in New York, but recognizing ''an absolute assignment of rents prepetition does not necessarily mean that the estate has no interest in the rents for purposes of a § 541 analysis'') (citations omitted); *Amaravathi Ltd. P'ship*, 416 B.R. 618, 637 (Bankr. S.D. Tex. 2009) (concluding postpetition rents are property of the estate regardless of whether the assignment of rents was absolute or collateral because ''[t]he only difference between such assignments is the fact that the lender must take affirmative steps to 'activate the 'collateral' assignment. . . . [once the lender takes those affirmative steps], however, the lender's rights with respect to the debtor and the rents are identical under either type of assignment.''). *In re Constable Plaza Assocs., L.P.*, 125 B.R. 98, 102-03, 106 (Bankr. S.D.N.Y. 1991) (holding appointment of receiver prior to commencement of the case ''did not cut off all of the debtor's property interests in the future rents'' because ''the debtor continues to possess a residual interest in the rents which results in characterizing such rents as property of the estate within the meaning of 11 U.S.C. § 541''). Some courts will not find that a debtor's residual interest in property is sufficient to render the rents property of the estate because, according to those courts, if under state law the debtor would not have the right to collect the rents, then in bankruptcy the debtor does not have any greater rights. *In re S. Pointe Assocs.*, 161 B.R. 224, 227 (Bankr. E.D. Mo. 1993) (rejecting debtor's argument rents are property of the estate because of debtor's ''residual interest,'' where lender acted to activate its rights to collect the rents, and therefore, as of the commencement of the case, under Missouri state law, ''the [d]ebtor has no right to the immediate collection of the apartment rents''). It is obvious, but worth highlighting, that if a court finds an assignment of rents agreement is ''absolute'' and the debtor does not maintain a residual interest in the postpetition rents, then, absent some alternative financing, the debtor's Chapter 11 single asset real estate case cannot continue.

In sum, depending on the facts, an assignment of rents agreement may not be an impediment to a successful single-asset real estate case, or to using a lender's cash collateral. The debtor's chances for success seem to rest on the court's willingness either to look beyond the label of a document, or to recognize the breadth of ''property of the estate,'' including a debtor's ''residual'' interest in postpetition rents.

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are correct because of the true substance of the assignment of rents in the context of a mortgage loan.'').

[8] *See Travelers Indem. Co. v. Grant Assocs. (In re Grant Assocs.)*, No. M – 47 (S.D.N.Y. Feb. 5, 1991) (holding ''the finding that the assignment was absolute does not necessarily compel the conclusion . . . that the [lender] thereby holds more than a security interest in the rents or that [the d]ebtor retains no interest in the rents . . . .''); *In re Charles D. Stapp of Nev., Inc.*, 641 F.2d 737, 740 (S.D.N.Y. 1981) (concluding that notwithstanding an absolute assignment under Georgia law, the debtor retained a residual interest in the rents which were assigned); *In re Princeton Overlook Joint Venture*, 143 B.R. 625, 633 (Bankr. D.N.J. 1992) (concluding that the mortgagor retained a ''collection interest'' in the rents, and thus, the rents were part of the bankruptcy estate pursuant to Bankruptcy Code § 541).

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