

# **ASSIGNMENT OF RENTS TO A SECURED LENDER**

EFFECTS IN CHAPTER 11 BANKRUPTCY

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IN RE TOWN  
CENTER FLATS LLC

855 f.3d 721 (6<sup>th</sup> Cir. 2017).

# BACKGROUND



1. Town Center Flats, LLC built a 53 unit residential complex.
2. Financed with a \$5.3 million loan.
3. Secured by mortgage and an agreement to assign rents to the creditor.

# ASSIGNMENT OF RENTS

Town Center “irrevocably, absolutely and unconditionally [agreed to] transfer, sell, assign, pledge and convey to Assignee, its successors and assigns, all of the rights, title and interest of [Town Center] in . . . Income of every nature of and from the Project, including without limitation, minimum rents and additional rents. . . .”



## ASSIGNMENT CONT. . .

The agreement was a “present, absolute and executed grant of the powers herein granted to Assignee.”

Simultaneously, the creditor granted Town Center a **license to collect and retain rents** until an event of default, at which point the license would “automatically terminate without notice to [Town Center].”



# CHAPTER 11 BANKRUPTCY



1. December 2013 Town Center defaulted.
2. December 2014 creditor served notice of default and a request for all Town Center tenants to pay rent directly to creditor, following Michigan law.
3. January 2015 creditor filed state law breach of contract complaint.
  - Interim agreement to allow Town Center to continue collecting rents.
4. Shortly after, Town Center filed for Chapter 11 Bankruptcy.

## CHAPTER 11 PRIMER

Reorganization of business affairs, debts, and assets.

Debtor retains its assets and continues to operate its business. Generally, from the outside it appears to be business as usual.

Substantial oversight of the Bankruptcy Court.

Debtor proposes a plan.

- Reducing expenses
- Liquidating assets
- Renegotiating debts

To be confirmed by the Court, the plan must be feasible.

## PROCEDURAL HISTORY

Town Center's Chapter 11 plan proposed to use rent income to fund its reorganization.

Creditor filed a motion to prevent Town Center from using post-petition rents.

Town Center objected, arguing it would have no income to reorganize if not allowed to use rents.



# PROCEDURAL HISTORY

## Bankruptcy Court:

- Bankruptcy Code Section 541 (a) provides that all interest of a debtor, including rents from property of the estate, are included in the bankruptcy estate.
- Bankruptcy Court agreed with Town Center and held that the rents are property of the estate, categorized as cash collateral.
- The Bankruptcy Court held that, under Bankruptcy Code Sections 363(a), 362(c)(2) and 552(b)(2), Town Center was permitted to use the rents, but was required to provide “adequate protection” to the creditor.
- In essence, the Bankruptcy Court held that the creditor had a security interest in the rent payments generated by Town Center’s apartment complex.
- Creditor appealed.

# PROCEDURAL HISTORY

## District Court:

- Creditor argued the rent payments were not property of the bankruptcy estate, were not cash collateral, and could not be used by Town Center to make payments under its Chapter 11 plan.
- Applying Michigan law, the District Court held that an assignment of rents is a transfer of ownership, not a mere security interest.
- Because it had transferred them away, Town Center had no interest in the rent payments at the time it filed bankruptcy and, therefore, the rents were not property of the bankruptcy estate.
- Bankruptcy Court's decision was vacated by the District Court.
- Town Center appealed.

## 6<sup>TH</sup> CIRCUIT ISSUE

Did the agreement to assign the rents create a

**Security interest in the rents**

or

**Transfer of ownership of the rents?**

What do you think?

## 6<sup>TH</sup> CIRCUIT ANALYSIS

1. Property rights and, therefore, property of the bankruptcy estate are established by state law.
2. In Michigan, once the statutory requirements for perfecting an assignment of rents has been made, the assignment of rent is treated as a transfer of ownership.
3. Requirements for perfection of an assignment of rents:
  - Agreement to Assign Rents
  - Record the Agreement
  - Default

## 6<sup>TH</sup> CIRCUIT ANALYSIS

1. Agreement to Assign:

Town Center “irrevocably, absolutely and unconditionally [agreed to] transfer, sell, assign, pledge and convey to Assignee, its successors and assigns, all of the rights, title and interest of [Town Center] in . . . Income of every nature of and from the Project, including without limitation, minimum rents and additional rents. . . .”

2. Creditor Recorded the agreement with the mortgage.
3. Town Center defaulted on the loan.

Creditor’s interests in the rent was perfected on December 31, 2013, when Town Center defaulted.

## 6<sup>TH</sup> CIRCUIT CONCLUSION

Because Town Center had no interest in the rents when it filed its bankruptcy petition, the rents were not assets of the bankruptcy estate.

Town Center could not use the rents to make payments to creditors, as proposed by its plan.

# RESULT

Town Center had no income.

Town Center could not get a plan of reorganization confirmed.

Chapter 11 relief was unavailable to Town Center and its case was dismissed.

**Chapter 11 may be unavailable to Single Asset Real Estate entities, depending on the terms of the mortgage and/or security agreement.**

**ANYONE TAKE ISSUE WITH THE  
6<sup>TH</sup> CIRCUIT'S ANALYSIS OR  
CONCLUSION?**



Nearly all cases and statutes relied on by the 6<sup>th</sup> Circuit speak to perfection. Perfection generally refers to the establishment of security interests, not transfers of ownership.

Here, the 6<sup>th</sup> Circuit analyzed the statutory and common law requirements for perfection and proceeded to conclude that, because the requirements were met, ownership of the rents was transferred to the creditor.

The Michigan cases relied on by the Court, holding that ownership of rents were transferred, were, in essence, really holding that the creditor had an absolute right to collect the rents without interference by the owner of the real property or other creditors with subordinate rights.

The assignee is **TREATED AS** the owner of the rents.

# TITLE THEORY

Lender may have title to and exclusive ownership of rents depending on the terms of the assignment and the applicable state law.

- 3<sup>rd</sup> Circuit (New Jersey)
- 3<sup>rd</sup> Circuit (Pennsylvania)
- 9<sup>th</sup> Circuit (Washington)
- 9<sup>th</sup> Circuit (California)

When a court construes the assignment of rents to be absolute, neither the debtor nor a trustee will be able to use the rents. The rents belong exclusively to the lender.

# LIEN THEORY

A lender is not entitled to possession of rents. Mortgagee has title to land and rents from outset, until debt is satisfied or the lender forecloses. Assignment of rent is additional security.

- 6<sup>th</sup> Cir. BAP (Kentucky)
- District of D.C.
- S.D.N.Y. (Delaware)
  
- New York courts are split, coming down on both sides. Precise language in the contract is a huge factor.

# WHAT ABOUT HERE IN IDAHO?



# Under Idaho law, it's not clear.

1. Idaho does not have a statute regarding assignments of rent being either security or a transfer of ownership.
2. No Idaho cases have addressed the issue directly.
3. No Idaho Bankruptcy cases have discussed whether rents subject to an assignment are property of the bankruptcy estate.

# 9<sup>th</sup> Circuit

1. *In re Ventura-Louise Properties*, 490 F.2d 1141 (1974).
  - Under California case law, an absolute assignment of a right to rents operates to transfer of Mortgager's rights to the rents, rather than a security interest in such.
  - General contract principles. The parties' intents rule.
  
2. *In re Park at Dash Point, L.P.*, 985 F.2d 1008 (1993).
  - Under Washington law, the right to collect rents is deemed a form of real property.
    - Taken a step further, an assignment of rent can be considered a transfer of ownership in those rents.

# MY SPECULATION



I suspect that in Idaho, whether state court or bankruptcy court, the long revered right to contract would be upheld and a well-drafted assignment would be deemed a transfer of ownership in the rents.

Especially if both parties are sophisticated, such as a commercial lender and a sophisticated developer.

## Take Aways

1. There is marked difference between an assignment of rents and a pledge for security. Check the agreements your clients are entering into.
2. If creating agreements, make sure to assess whether an absolute assignment or security interest is in your client's best interests.
3. If you find the right case, there is an opportunity to help create clarity by pushing it to the Idaho Supreme Court or 9<sup>th</sup> Circuit.



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