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Who owns the rents? Recent cases highlight uncertainty as to effect of mortgage rent assignments in New York bankruptcies

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Amid the recent proliferation of commercial mortgage defaults in New York, the question of whether property of a debtor's bankruptcy estate includes the rental income of real property subject to a mortgage's purportedly "absolute" assignment of rents has taken on great importance for both debtors and real property lenders.

Under the Bankruptcy Code, if such rents constitute property of the estate, a debtor-in-possession or trustee may have the right to use those funds as cash collateral during its bankruptcy case. On the other hand, if the rents are not estate property, the debtor cannot use those funds without the mortgagee's consent. The second scenario vastly improves the lender's strategic position in the bankruptcy, since rental income can often "make or break" a Chapter 11 reorganization, particularly in single asset real estate cases.

Three recent bankruptcy court decisions in New York single asset real estate cases focus on this issue and highlight significant uncertainty: In re South Side House LLC, No. 09-43576, 2012 WL 2254212 (Bankr. E.D.N.Y. June 15, 2012); In re Soho 25 Retail LLC, No. 10-15114, 2011 WL 1333084 (Bankr. S.D.N.Y. Mar. 31, 2011) and In re Loco Realty Corp., No. 09-11785, 2009 WL 2883050 (Bankr. S.D.N.Y. June 25, 2009). Each involved very similar facts, but the decisions gave divergent answers about purportedly assigned rents in a Chapter 11 case.

In all three cases, the courts recognized that New York law lacks clarity on the treatment of purportedly "absolute" rent assignments, but still ruled – based on differing theories – that the assignments under the mortgages were effective. As a consequence, all three courts also determined that the debtors held only a reversionary interest in the rents, available only upon repayment of the mortgagee's loan. However, the holdings diverge radically in deciding the effect of this reversion. While the Soho 25 and Loco Realty courts ruled that this revisionary interest did not bring the rents within the bankruptcy estate, the South Side court concluded that the rents were estate property.

The South Side decision should concern commercial real property lenders because, under its logic, rents seemingly would always be property of a bankruptcy estate – until the foreclosure sale of the property – regardless of the language used in the mortgage and any enforcement steps by the lender.

ABSOLUTE ASSIGNMENTS OF RENT UNDER NEW YORK LAW

New York mortgages typically include an "absolute and present assignment" of rents by the borrower in favor of the mortgagee, with a revocable license granted to the mortgagor for rent collection until a default occurs. Lenders seek to make the assignment of rents absolute, instead of only a collateral assignment, in part to have the best argument that the rents remain outside the borrower's estate in an eventual bankruptcy. However, New York law is unclear as to whether such assignments fully achieve the desired effect.

The majority of New York courts construe assignments of rents to be for purposes of security, regardless of the wording used. Courts adopting this view have reasoned that New York, as a lien theory state, should not recognize the effectiveness of an absolute rent assignment unless an event of default exists and the lender has taken certain affirmative enforcement steps. See, e.g., LT Propco LLC v. Carousel Ctr. Co. LP, 68 A.D.3d 1695, 1696 (N.Y. App. Div. 2009) ("Because New York operates under a lien theory as opposed to a title theory with respect to mortgages, the language used in the assignment instrument itself is not determinative of what rights are actually transferred.") (citations omitted); Dream Team Assoc. LLC v. Broadway City LLC, 2003 N.Y. Slip Op. 50894(U), 2003 WL 21203342, at *6 (N.Y. Civ. Ct. May 7, 2003); ("[N]o transfer of title to the leases is effectuated when an assignment is given as security for a mortgage loan regardless of the language used in the assignment.").

Yet, even among this majority view, courts differ on exactly which enforcement step triggers an assignment's effectiveness. Some courts require the lender to take possession of the property or, more frequently, to obtain an order for the appointment of a receiver or the sequestration of rents. See, e.g., 641 Ave. of Americas Ltd. P'ship v. 641 Assocs. Ltd. 189 B.R. 583, 590-91 (S.D.N.Y. 1995) (sufficient affirmative steps taken where lender sought and obtained stay relief after postpetition default, instituted adversary proceeding to obtain rents and instituted a foreclosure proceeding); In re Northport Marina Assocs. 136 B.R. 911, 916-17 (Bankr. E.D.N.Y. 1992) (assignment ineffective until receiver is appointed or lender takes possession of property). For other courts, just the request for appointment of a receiver will suffice. See, e.g., In re Flower City Nursing Home Inc., 38 B.R. 642, 645 (Bankr. W.D.N.Y. 1984). However, other courts find that a mere formal demand for possession of the property and rents is adequate. See, e.g., 1180 Anderson Ave. Realty Corp. v. Mina Equities Corp., 95 A.D.2d 169, 173-74 (N.Y. App. Div., 1st Dep't 1983).

A minority of courts interpreting New York law even have held that absolute and present assignments of rents are self-executing upon default and entitle a secured lender to all rental income from the date of default, without the need for the affirmative steps. See, e.g., Credit Lyonnais v. Getty Square Assocs., 876 F. Supp. 517, 521 (S.D.N.Y. 1995) (awarding rents from default, notwithstanding that demand for rent was not made until one month later: "where an assignment of rents is a present tense assignment . . . the mortgage lender is entitled to all rents"); Fed. Home Loan Mortg. Corp. v. Dutch Lane Assocs., 775 F. Supp. 133, 139-40 (S.D.N.Y. 1991) (upon notice of default, mortgagee was "immediately entitled to all rents without any further action required" or need to "take any affirmative steps").

Notably, the court in Dutch Lane found significant that language in the assignment provision expressly provided that the lender need not take affirmative enforcement steps for the assignment to be effective. Fed. Home Loan Mortgage Corp.v, Dutch Lane Assocs., 775 F. Supp. 139 (assignment provision providing for effectiveness "without the necessity of [lender] entering upon and taking and maintaining full control of the Property in person, by agent or by a court-appointed receiver"). One court has further recognized that parties can contract around the obligation to take enforcement steps. See Builders Bank v. Rockaway Equities LLC, No. CV 2008-3575, 2011 WL 4458851, at *10 (E.D.N.Y. Sept. 23, 2011) ("In the absence of a contract provision to the contrary, after a default, the mortgagee must take some action to assert its rights in order to enforce its security interest in rent.") (emphasis added); but see In re South Side House LLC, 2012 WL 2254212, at *6, 16-17 (requiring affirmative steps despite language that assignment is effective "without the need for notice or demand . . . [and] whether or not Lender enters upon or takes control of the Property"). Accordingly, secured lenders would be well-advised to make express in their mortgage assignment of rents provisions that the assignment will be effective even in the absence of affirmative enforcement steps, though, South Side calls into question the efficacy of this language.

THE SPLIT: SOUTH SIDE, SOHO 25 AND LOCO REALTY

Due to this uncertainty, New York bankruptcy courts lack clear guidance on the effect of a purportedly absolute assignment of rents in bankruptcy. Indeed, while all three of these bankruptcy cases reached the same conclusion as to the effectiveness of the relevant assignment provisions, they took different approaches in doing so, leaving the confused state of New York law unchanged. Moreover, determining the effectiveness of an assignment provision is only half of the inquiry. Courts must still determine whether the debtor has any remaining interest in the rents and whether that interest is sufficient to bring the rents into the bankruptcy estate. All three courts agreed that the debtors maintained only reversionary interests in the rents after giving effect to the assignment provisions, but the courts disagreed as to whether that reversionary interest was sufficient to bring the rents into the estate.

In re South Side House LLC

In South Side, the debtor borrowed $29 million prepetition, secured by a mortgage on the debtor's primary asset, a mixed-use building in Brooklyn. The mortgage "absolutely and unconditionally" assigned to the mortgagee all current and future rents, specifying that the assignment constituted "a present, absolute assignment and not an assignment for additional security only." The assignment also granted to the debtor a license to collect the rents, which automatically revoked upon default under the mortgage. Upon revocation, the lender would be entitled "to possession of all [rents], whether or not [lender] enters upon or takes control of the Property."

Upon the debtor's prepetition default under the mortgage, the lender accelerated the debt and commenced a foreclosure action. The court in that action granted summary judgment in favor of the lender, entered an order appointing a receiver and scheduled a conference regarding the appointment of a referee. Before the foreclosure sale, however, the debtor filed for bankruptcy in the Eastern District of New York.

Typically, the issue of whether rents constitute estate property is decided at the outset of a bankruptcy case in connection with the debtor's request to use cash collateral or a secured lender's motion to dismiss the debtor's case or obtain stay relief. In South Side, however, the issue came to a head in connection with the lender's objection to plan confirmation, more than two years after the bankruptcy filing. The lender argued that the rents did not belong to the debtor and should be excluded from use to fund the debtor's plan.

Bankruptcy Judge Stong adopted the majority position under New York law that the purportedly "absolute" assignment of rents actually was "in the nature of a pledge for additional security only, and not an absolute assignment," and that the lender needed to take affirmative steps for the assignment to become effective. Judge Stong held that the lender took sufficient affirmative steps in the case by commencing a foreclosure action and obtaining the appointment of a receiver.

However, although the assignment of rents was held to be effective prior to the bankruptcy, Judge Stong also found that, under New York law, the "right to enforce an assignment or collect rents does not confer title." Rather, the debtor retained a "reversionary interest in the [rents] if the lender's claim is satisfied before the foreclosure sale, as well as a right to any excess rents that remain if the [lender's] claim is satisfied in full by a foreclosure sale." Noting that "the definition of property of the estate is broad and far-reaching," Judge Stong determined that this reversionary interest was adequate for the rents themselves to be estate property. In short, the debtor-in-possession could use the rental income to support its Chapter 11 plan, thanks to the state-law reversionary right.

In re Loco Realty Corp.

In Loco Realty, the debtor borrowed $3 million prepetition, secured by a mortgage on the debtor's property. The mortgage contained an assignment of rents provision that was substantially similar to that in South Side. The debtor then defaulted on the loan. The lender accelerated the loan, commenced a foreclosure action and obtained a receiver's appointment. The debtor filed for bankruptcy in the Southern District of New York before the foreclosure sale.

Shortly after the bankruptcy filing, the lender moved to dismiss or convert the debtor's case because the debtor had no interest in its real property rents and, thus, no income existed to support a reorganization. Bankruptcy Judge Gonzalez looked first to New York law, noting that it is "at best, unclear on the topic of whether an absolute assignment of rents transfers title to the rent upon execution of the instrument." However, unlike in the later-decided South Side, Judge Gonzalez ruled that the assignment of rents did constitute an absolute assignment of the rents, rather than a pledge of the rents as security, because the assignment evidenced the parties' intent to enter into a present assignment. The court further ruled that, even if the assignment of rents had been a mere pledge of security, the lender had taken sufficient affirmative steps to render the assignment effective.

Also contrary to Judge Stong's later ruling in South Side, Judge Gonzalez in Loco Realty held that the assignment transferred title in the rents to the lender. However, Judge Gonzalez also acknowledged that the debtor retained a reversionary interest in the rents "in the nature of an accounting for any rents beyond the amount of the mortgage

debt." Because the debtor only had "an interest in the rents to the extent the mortgage is ever satisfied," Judge Gonzalez ruled that "the cash flow from the rents itself until the mortgage is satisfied is not property of the estate[.]"

In re Soho 25 Retail LLC

In Soho 25, the debtor borrowed $8.5 million prepetition, secured by a mortgage on two commercial condominium units. The mortgage included an absolute assignment of rents provision similar to those in South Side and Loco Realty.

Upon the debtor's default, the lender sent the debtor a letter asserting its right to collect the rents. The lender subsequently sent letters to the debtor's tenants requesting that payments of rent be made directly to the lender, and the debtor joined in one of these letters.

The lender also filed a foreclosure action and obtained a judgment against the debtor pursuant to which a referee was appointed to sell the property. Before the sale could be consummated, however, the debtor filed for bankruptcy in the Southern District of New York. The issue of entitlement to rents arose shortly after the bankruptcy case commenced in connection with the filing of the lender's motion for stay relief and the debtor's complaint seeking a declaratory judgment that the rents were estate property.

Bankruptcy Judge Lane held that, under New York law, the assignment's language demonstrated the parties' intent to form an unconditional, absolute assignment, but recognized what the court considered a split under New York law as to whether language alone is enough to give the assignment effect. Ultimately, Judge Lane avoided this "murky legal question" and ruled that the lender took sufficient affirmative enforcement steps, including by commencing foreclosure proceedings, obtaining the appointment of a referee and moving for stay relief, to trigger the assignment in any case. As a result, the court held that the debtor had only a reversionary interest in the rents. Further, relying on Loco Realty, Judge Lane found the reversionary interest insufficient for the rents to constitute estate property. Thus, just like Loco Realty, but in stark contrast with South Side, Soho 25 denied the debtor-in-possession the use of rental income for its bankruptcy reorganization.

CONCLUSION

It is difficult to reconcile the decision in South Side with the decisions in Loco Realty and Soho 25. The facts are quite similar, but the holdings diverge. It is clear, however, that mortgagees should phrase their assignment provisions as present, absolute assignments, and should provide that no affirmative steps are necessary to give effect to the contemplated assignment. Moreover, regardless of the language used in an assignment provision, secured lenders should take affirmative enforcement steps, such as commencing a foreclosure proceeding, seeking the appointment of a receiver and seeking to collect the rents, as soon as possible after a default. These steps will increase the likelihood that a bankruptcy court will give effect to the assignment of rents under any interpretation of New York law.

However, mortgage lenders must remain mindful that, even if the assignment provision is given effect, the rents will remain estate property unless the bankruptcy court determines that the debtor's reversionary interest in the rents is too insubstantial to bring them into the debtor's estate. In light of South Side, lenders cannot assume that they will obtain such a ruling and should plan accordingly when underwriting mortgage loans.

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