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“The Great Unsettled Question”: Non-Consensual Third-Party Releases Deemed Impermissible in *In re Purdue Pharma, L.P.*

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In a 142-page opinion issued on December 16, 2021, Judge Colleen McMahon (S.D.N.Y.) ruled that non-consensual releases of creditors’ direct claims against non-debtor entities are not permitted under the Bankruptcy Code in *In re Purdue Pharma, L.P*.[1] As a result of the ruling, the order confirming the plan of reorganization in the bankruptcy cases of Purdue Pharmaceutical and its affiliated entities (collectively, “Purdue”) was vacated. Days after the issuance of the opinion, Purdue asked the bankruptcy court to maintain a two-year freeze on more than 2,600 opioid-related lawsuits against non-debtors while it appeals the decision to the Second Circuit Court of Appeals. Ultimately, given the deep circuit-split, this issue is likely destined for the United States Supreme Court.

I. Background

Purdue’s bankruptcy was occasioned by the opioid health crisis that has plagued the country for over two decades. This health crisis can largely be traced to over-prescription of highly addictive pain relief medications including, specifically and principally, Purdue’s proprietary, OxyContin. Between 1996 and 2019, Purdue had revenues of $34 billion, with 91% emanating from OxyContin. By 2001, OxyContin was “the most prescribed brand-name narcotic mediation” in the United States, and rates of opioid addition were skyrocketing through the country.[2] According to the Centers for Disease Control and Prevention, from 1999 to 2019, “nearly 247,000 people died in the United States from overdoses

[1] *In re Purdue Pharma, L.P.*, 2021 WL 5979108 (S.D.N.Y. Dec. 16, 2021).
[2] *Id.* at *16-17.

involving prescription opioids."[3] Judge McMahon devotes the first 70 pages of her opinion to detailing the history of Purdue and the significant role that it played in the opioid crisis.

Despite a 2007 plea agreement with the federal government, in which Purdue admitted that it had, among other misdeeds, falsely marketed OxyContin as non-addictive, Purdue's profits after 2007 were driven almost exclusively by its aggressive marketing of OxyContin. As a result, by 2019, Purdue was facing thousands of lawsuits brought by government entities and individuals who had become addicted to OxyContin, and by the estates of individuals who had overdosed – either on OxyContin itself or on the street drugs such as heroin and fentanyl for which OxyContin served as a feeder.

Engulfed in what Judge McMahon described as "a veritable tsunami of litigation,"[4] Purdue filed for relief under chapter 11 of the Bankruptcy Code[5] in September 2019. The intent of the bankruptcy filing was for a "*Manville*-style" bankruptcy that would resolve both existing and future claims against: (i) Purdue, and (ii) certain non-debtor affiliates of the company – principally members of the Sackler family that had founded and managed Purdue throughout its history.[6] Pending a resolution of the bankruptcy case, a court-ordered injunction halted litigation against the Sackler family and other non-debtors.

Over 614,000 creditors filed claims in Purdue's bankruptcy case. The damages asserted in such claims exceeded $2 trillion, or roughly 10% of the world's gross domestic product.[7] For two years, the key stakeholders in the bankruptcy case negotiated with Purdue and the Sackler family through mediation and otherwise. Those negotiations ultimately resulted in a proposed plan of reorganization

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[3] *Id.* at *18.
[4] *Id.* at *1.
[5] The Bankruptcy Code is set forth in 11 U.S.C. §§ 101 *et seq*. Specific sections of the Bankruptcy Code are identified herein as "section __."
[6] Judge McMahon notes that, "In large part due to the success of their pharmaceutical business, the Sackler family have long been ranked on Forbes' list of America's Richest Families, becoming one of the top twenty wealthiest families in America in 2015, with a reported net worth of $14 billion dollars." *In re Purdue Pharma, L.P.*, 2021 WL 5979108 at *5 (S.D.N.Y. Dec. 16, 2021).
[7] *Id.* at *47.

(the "Plan") that would, if implemented, afford billions of dollars for the resolution of claims, while funding opioid relief and education programs. Although the Plan contained several beneficial features (including a gradual dissolution of Purdue, a document repository where Purdue materials would be made available for public review, and support for various opioid overdose reversal and addiction treatment medications), the most salient feature of the Plan was a $4.325 billion contribution by the Sackler family.

The Plan was approved by over 95% of the 120,000 creditors who voted.[8] It was confirmed "with obvious reluctance" by a highly respected bankruptcy judge in September 2021 who, after applying the traditional standard for approving settlements in bankruptcy, concluded that there existed no other reasonably conceivable means to achieve the result that would be accomplished by the Plan.[9]

Eight states, the District of Columbia, the United States Trustee, the U.S. Attorney's Office and several individual personal injury claimants, among others, appealed confirmation of the Plan.[10] The appellants asserted that the Plan impermissibly provided for broad, non-consensual third-party releases of claims against members of the Sackler family and their affiliates, none of whom had subjected themselves to the bankruptcy process. Such claims included direct claims predicated on fraud (which claims could not be discharged pursuant to section 523(a) if the Sacklers themselves had sought bankruptcy relief), misrepresentation, and willful misconduct under various state consumer protection statutes.

In the face of such claims, the Sacklers allegedly had engaged in an aggressive scheme to fraudulently transfer their assets:

> As the opioid crisis continued and worsened in the wake of Purdue's 2007 Plea Agreement, the Sacklers … were well aware that they were exposed to personal liability

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[8] It is noteworthy that while 614,000 creditors filed claims, only 124,000 voted on the Plan.

[9] *Id.* at *34, 62. The bankruptcy court opinion confirming the Plan can be found at *In re Purdue Pharma, L.P.*, 2021 WL 4240974 (Bankr. S.D.N.Y. Sept. 17, 2021).

[10] Importantly, the parties agreed to stay implementation of the Plan thereby avoiding equitable mootness issues.

> over OxyContin. Concerned about how their personal financial situation might be affected, the family began what one member described as an "aggressive" program of withdrawing money from Purdue almost as soon as the ink was dry on the 2007 papers. The Sacklers upstream[ed] some $10.4 billion out of the company between 2008 and 2017, which, according to their own expert, substantially reduced Purdue's "solvency cushion." Over half of that money was either invested in offshore companies owned by the Sacklers or deposited into spendthrift trusts that could not be reached in bankruptcy and off-shore entities located in places like the Bailiwick of Jersey.
>
> When the family fortune was secure, the Sackler family members withdrew from Purdue's Board and management. Bankruptcy discussions commenced the following year. As part of those pre-filing discussions, the Sacklers offered to contribute toward a settlement, but if – and only if – every member of the family could "achieve global peace" from all civil (not criminal) litigation, including litigation by Purdue to claw back the money that had been taken out of the corporation.[11]

The appellants attacked the legality of the Plan's non-consensual release of third-party direct claims against non-debtors and asserted that the Plan constituted an abuse of the bankruptcy process. Conversely, Purdue and those who supported the Plan argued that the settlements contemplated therein were permissible under the Bankruptcy Code and maximized the distribution to creditors given the expense, delay and risk associated with litigating claims against the Sacklers.

Recognizing the importance of the issue, Judge McMahon stated:

> The great unsettled question in this case is whether the Bankruptcy Court – or any court – is statutorily authorized to grant such releases. This issue has split the federal Circuits for decades. While the Circuits that say no are united in their reasoning, the Circuits that say yes offer various justifications for their conclusions. And – crucially for this case – although the Second Circuit identified the question as open back in 2005, it has not yet had occasion to analyze the issue. Its only guidance to the lower courts, uttered in that 2005 opinion, is this: because statutory authority is questionable and such releases can be abused, they should be granted sparingly and only in "unique" cases.
>
> This will no longer do. Either statutory authority exists or it does not…. Moreover, the lower courts desperately need a clear answer. As one of my colleagues on the Bankruptcy Court recently noted, plans releasing non-debtors from third party claims are no rarity: "*…Almost every proposed Chapter 11 Plan that I receive includes proposed releases*." When every case is unique, none is unique. Given the frequency with which this issue arises, the time has come for a comprehensive analysis of whether authority for such releases can be found in the Bankruptcy Code – that "comprehensive scheme" devised by Congress for resolving debtor-creditor relations.

[11] *Id.* at *4-5.

* * *

> This opinion will not be the last word on the subject, nor should it be. This issue has hovered over bankruptcy law for thirty-five years – ever since Congress added §§ 524(g) and (h) to the Bankruptcy Code. It must be put to rest sometime; at least in this Circuit, it should be put to rest now.[12]

II. The Court's Ruling[13]

Judge McMahon held that the Bankruptcy Code does not authorize non-consensual third-party releases of direct claims against non-debtors: "not in its express text (which is conceded); not in its silence (which is disputed); and not in any section or sections of the Bankruptcy Code that, read singly or together, purport to confer generalized or "residual" powers on a court sitting in bankruptcy."[14] The court noted that: "There is a long-standing conflict among the Circuits that have ruled on the question, which gives rise to the anomaly that whether a bankruptcy court can bar third parties from asserting non-derivative claims against a non-debtor – a matter that surely ought to be uniform throughout the country – is entirely a function of where the debtor files for bankruptcy."[15]

In reaching its conclusion, the court looked to see if there was any authorization for non-consensual third-party releases in: (a) the statutory text, (b) the circuit case law, both in the Second Circuit and elsewhere, and (c) in any "residual authority" granted to bankruptcy courts.

a. Statutory Authority

Judge McMahon noted that the bankruptcy court had concluded that it was statutorily authorized to approve the releases of direct, third-party claims against non-debtors pursuant to sections 105(a), 524(e), 1123(a)(5) and 1129(a)(1). Judge McMahon disagreed, holding that none of the aforementioned

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[12] *Id.* at *6-8 (citing *In re Aegean Marine Petroleum Network Inc.,* 599 B.R. 717, 726 (S.D.N.Y. 2019) (emphasis in original).
[13] The opinion also contains an important discussion regarding a bankruptcy court's constitutional authority, post-*Stern v. Marshall*, to enter a final confirmation order granting third party releases. Judge McMahon concludes that bankruptcy courts lack such authority.
[14] *Id.* at *7.
[15] *Id.* at *92.

sections confer on bankruptcy courts the power to approve the release of direct third-party claims against non-debtors.

Judge McMahon found that "one and only one section of the Bankruptcy Code expressly authorizes a bankruptcy court to enjoin third party claims against non-debtors without the consent of those third parties."[16] That section, section 524(g), expressly provides for such an injunction in limited circumstances involving injuries arising from the manufacture and sale of asbestos. She explained the origins of section 524(g), noting that it was passed after the Second Circuit Court of Appeals had affirmed the entry of an unprecedented injunction barring claims against certain non-debtor insurers in connection with the bankruptcy of the nation's leading manufacturer of asbestos, the Johns Manville Corporation.[17] Despite the Second Circuit's affirmance of the *Manville* injunction, she explained, "questions continued to be raised about its legality."[18] Congress passed section 524(g) and (h) to remove any doubt that those injunctions were authorized in the limited context of asbestos cases.

The court found that the text of section 524(g) plainly indicates that Congress believed that it was creating an exception to what would otherwise be the applicable rule of law.[19] Moreover, she found, the legislative history clarifies that the "special rule" being devised for asbestos cases was not intended to alter any authority bankruptcy courts may already have in other contexts. The court found particularly persuasive the following text from the legislative history:

> The Committee has decided to provide explicit authority in the asbestos area because of the singular cumulative magnitude of the claims involved. *How the new statutory mechanism works in the asbestos area may help the Committee judge whether the concept should be extended into other areas*.[20]

Based on this language, the court reasoned, Congress left to itself, not the courts, the task of determining

[16] *Id.* at *96.
[17] *Id.* at *97 (discussing *MacArthur Co. v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 837 F.2d 89, 91 (2d Cir. 1988)).
[18] *Id.* at *98.
[19] *Id.* at *97 (discussing the text of section 524(g)).
[20] *Id.* at *100 (internal citations omitted) (emphasis added).

whether to extend a rule permitting non-debtor releases to other areas. Noting that Congress "has been deafeningly silent on this subject" for over 25 years, she concluded that Congress had elected not to expand the authority granted in section 524(g) outside of the asbestos context.[21]

Judge McMahon looked at the other sections of the Bankruptcy Code that are frequently cited as providing authorization for non-consensual third-party releases – section 1123(b)(6) (providing that a plan may "include any other appropriate provision not inconsistent with the applicable provisions of [the Bankruptcy Code]), section 1123(a)(5) (providing that a plan of reorganization must "provide adequate means for [its] implementation") and section 1129(a)(1) (providing that a bankruptcy court "shall confirm a plan only if … the plan complies with the applicable provisions of this title"). Each section, she found, like section 105(a), "confers on the Bankruptcy Court only the power to enter orders that carry out other, substantive provisions of the Bankruptcy Code."[22] None of them, she concluded, creates any substantive right to approve the proposed releases.

The district court then rejected the argument that bankruptcy courts must be authorized to approve such releases because no provision of the Bankruptcy Code expressly prohibits them. Judge McMahon reasoned: "The notion that statutory authority can be inferred from Congressional silence is counterintuitive when, as with the Bankruptcy Code, Congress put together a 'comprehensive scheme' designed to target 'specific problems with specific solutions.'"[23] Granting releases to non-debtors, she stated, "is so far outside the scope of the Bankruptcy Code and the purposes of bankruptcy that the 'silence does not necessarily mean consent' principle" must be rejected.[24] In fact, she concluded, "the silence that speaks volumes is the twenty-seven years of unbroken silence that have passed since Congress said, 'We are limiting this to asbestos for now, and maybe, when we see how it works in that

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[21] *Id.*
[22] *Id.* at *120.
[23] *Id.* at *127 (citing *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 566 U.S. 639, 645 (2012)).
[24] *Id.*

context, we will extend it later.'"[25]

b. The Split Among the Circuits

Judge McMahon also analyzed the case law, noting that the Supreme Court has never specifically considered whether non-consensual third-party releases can be approved in bankruptcy. Despite the Supreme Court's silence, she did find guidance for her analysis in several recent opinions from the Court. For example, she noted that the Supreme Court has held that the "traditional equitable power" of a bankruptcy court "can only be exercised within the confines of the Bankruptcy Code."[26] Additionally, she noted that in two recent cases, the Supreme Court has held that "a bankruptcy court lacks the power to award relief that varies or exceeds the protections contained in the Bankruptcy Code – not even in 'rare' cases, and not even when those orders would help facilitate a particular reorganization."[27]

With these holdings in mind, Judge McMahon surveyed the circuits, starting in the Second Circuit. After reviewing a number of Second Circuit decisions,[28] she concluded that "The only fair characterization of the law on the subject of statutory authority to release and enjoin the prosecution of third-party claims against non-debtors in a bankruptcy case is: unsettled, except in asbestos cases, where statutory authority is clear."[29] According to Judge McMahon, the only clear statement in terms of statutory authority in the Second Circuit is that section 105(a), standing alone, does not confer authority

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[25] *Id.* at *129-130.
[26] *Id.* at *101 (discussing *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988)).
[27] *Id.* at *101-103 (discussing *Law v. Siegel,* 571 U.S. 415 (2014) (holding that bankruptcy courts do not have "a general, equitable power") and *Czyzewski v. Jevic Holdings Corp.,* 137 S. Ct. 973 (2017) (holding that the protections explicitly afforded by the Bankruptcy Code could not be overridden in a "rare" case, even if doing so would carry out certain bankruptcy objectives)).
[28] The opinion includes a discussion of the following relevant Second Circuit opinions: *MacArthur Co. v. Johns-Manville Corp. (In re Johns-Manville Corp.)*, 837 F.2d 89, 91 (2d Cir. 1988); *In re Drexel Burnham Lambert Grp., Inc.*, 960 F.2d 285 (2d Cir. 1992); *New England Dairies, Inc. v. Dairy Mart Convenience Stores, Inc. (In re Dairy Mart Convenience Stores)*, 351 F.3d 86, 92 (2d Cir. 2003); and *Deutsche Bank A.G. v. Metromedia Fiber Network, Inc., (In re Metromedia Fiber Network, Inc.)*, 416 F. 3d 136, 141 (2d Cir. 2005).
[29] *In re Purdue Pharma, L.P.*, 2021 WL 5979108 at *117 (S.D.N.Y. Dec. 16, 2021).

to approve such releases.

Judge McMahon then surveyed the law in other circuits. She noted that the Fifth, Ninth and Tenth Circuit reject entirely the notion that a court can authorize non-consensual third-party releases outside the asbestos context.[30] Similarly, the Third Circuit has held that the Bankruptcy Code "does not explicitly authorize the release and permanent injunction of claims against non-debtors, except in [the asbestos context]."[31]

Conversely, the Fourth and Eleventh Circuit have concluded that section 105(a), without more, authorizes such releases.[32] The Sixth and Seventh Circuits, she noted, have concluded that sections 105(a) and 1123(b)(6), read together, codify something that they call "a bankruptcy court's 'residual authority,' and hold that a bankruptcy court can impose non-consensual releases of third-party claims against non-debtors in connection with a chapter 11 plan" in unique circumstances.[33]

Ultimately, she acknowledged, the circuits have reached conflicting results. She characterized this as "a most unfortunate circumstance when dealing with a supposedly uniform and comprehensive nationwide scheme to adjust debtor-creditor relations."[34]

c. Residual Authority

Finally, the court addressed the argument that bankruptcy courts have "residual authority" to approve non-consensual third-party releases. The bankruptcy court, she noted, had accepted the Plan proponents' argument that the Supreme Court had held, in a case called *In re Energy Resources Co.*,[35] that a bankruptcy court has "residual authority" to approve reorganization plans that include "necessary

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[30] *Id.* at *117-118 (citing *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009); *In re Lowenschuss,* 67 F.3d 1394 (9th Cir. 1995); *In re W. Real Estate Fund,* 922 F.2d 592, 600 (10th Cir. 1990)).
[31] *Id.* at *118 (discussing *In re Continental Airlines,* 203 F.3d 203, 211 (3d Cir. 2000)).
[32] *Id.* at *119 (discussing *Nat'l Heritage Found., Inc. v. Highbourne Found., Inc.*, 760 F.3d 344, 350 (4th Cir. 2014); *In re Seaside Eng'g & Surveying*, 780 F.3d 1070, 1076-79 (11th Cir. 2015)).
[33] *Id.* at 119 (referring to, but not citing, *In re Dow Corning*, 280 F.3d 648, 658 (6th Cir. 2002) and *Matter of Specialty Equip. Cos. Inc.*, 3 F.3d 1043, 1047 (7th Cir. 1993)).
[34] *Id.*
[35] *Id.* at *133 (discussing *In re Energy Resources Co.*, 495 U.S. 545 (1990)).

and appropriate" provisions, as long as those provisions are not inconsistent with the Bankruptcy Code.

Even if such power existed, she concluded, it "is of no help where, as here, it is being exercised in contravention of specific provisions of the Bankruptcy Code."[36] Stating that she was convinced that the non-consensual third-party releases contemplated in the Plan were in fact inconsistent with sections 524(g) and (h), section 523 and section 1141(d), she held that no residual power could authorize the releases.

III. Conclusion

Judge McMahon held that the releases contained in the Plan were impermissible due to the absence of statutory authority for such releases. Based on the foregoing, Judge McMahon vacated Purdue's confirmation order. Acknowledging the significance of her decision, Judge McMahon closed by stating:

> It is indeed unfortunate that that this decision comes very late in a process that, from its earliest days in 2019, has proceeded on the assumption that [the releases] would be authorized – this despite the language of the Bankruptcy Code and the lack of any clear ruling to that effect. I am sure that the last few years would have proceeded in a very different way if the parties had thought otherwise. But that is why the time to resolve this question for once and for all is now – for this bankruptcy, and for the sake of future bankruptcies. It should not be left to debtors and their creditors to guess whether such releases are statutorily authorized; and it most certainly should not be the case that their availability, or lack of same, should be a function of where a bankruptcy filing is made.
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> I also acknowledge that the invalidating of these releases will almost certainly lead to the undoing of a carefully crafted plan that would bring about many wonderful things, including especially the funding of desperately needed programs to counter opioid addiction. But just as, "A court's ability to provide finality to a third-party is defined by its jurisdiction, not its good intentions," so too its power to grant relief to a non-debtor from non-derivative third party claims "can only be exercised within the confines of the Bankruptcy Code."[37]

It is not an exaggeration to say that Judge McMahon's opinion is one of the most consequential bankruptcy opinions of our time. The ability of a chapter 11 debtor to confirm a plan of reorganization

[36] *Id.* at *132.
[37] *Id.* at *136-37 (internal citations omitted).

that provides for non-consensual third-party releases is perhaps the primary reason for the filing of a number of large mass tort chapter 11 filings in recent years, including the Boy Scouts' chapter 11 case that is pending in the District of Delaware. Judge McMahon's opinion persuasively holds that such releases are not permitted by the Bankruptcy Code. Clearly, the last word on Purdue's Plan has not been written. In the coming months, these critically important issues will need to be addressed by the Second Circuit Court of Appeals and, thereafter, potentially by the Supreme Court.

MICHIGAN'S NEW ASSIGNMENT OF RENTS ACT IMPROVES BORROWER—LENDER RELATIONSHIPS

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The Michigan Uniform Assignment of Rents Act (the "Act") went into effect on September 22, 2022.[i] The Act changes the borrower-lender relationship for the better, bringing greater certainty and clarity to lending relationships. Although the Act's passage was largely driven by recent bankruptcy court decisions, the Act also answers many legal and practical questions under Michigan state law. This article discusses some of the changes brought by the Act and how they will affect lenders, borrowers, and tenants.[ii]

Michigan Assignment of Rent Law Before and After the Act

An "assignment of rents" is a provision in a mortgage or similar document that grants a security interest in a property's revenue. If the borrower defaults on a loan secured by a mortgage, the mortgage typically allows the lender to foreclose on the mortgaged property. If there is also an assignment of rents, the lender might be able to collect rents instead of (or in addition to) foreclosing.

Before the Act, two statutes codified Michigan's assignment of rents law.[iii] Court decisions conflicted as to whether assignments under these statutes created a security interest in rents or whether they transferred ownership of rents to a lender outright upon the borrower's default. In May 2017, the Sixth Circuit Court of Appeals resolved this question in *Town Center Flats*,[iv] holding that ownership of a commercial property's rents transferred to a lender when (1) a commercial loan is secured by a recorded assignment of rents, (2) the borrower defaults, and (3) a lender follows Michigan's statutory

procedure to enforce the assignment of rents. A bankruptcy court subsequently held that tenants need not receive notice of the borrower's default for ownership to transfer.[v] If ownership transfers, rents are not thereafter part of the bankruptcy estate; and without rents as part of the bankruptcy estate, many borrowers cannot finance a bankruptcy proceeding.

The Act clarifies that an assignment of rents is a perfected security interest as soon as it is recorded. It changes the outcome in *Town Center Flats*, however, by confirming that an assignment of rents does not transfer ownership, no matter how the loan documents are worded. If a borrower now files for bankruptcy protection, the rents are property of the bankruptcy estate and may help pay for the bankruptcy case—if the borrower either obtains lender permission or demonstrates that the lender's security interest in the rents is adequately protected.

In addition to making clear how an assignment of rents functions, the Act harmonizes its treatment with Michigan redemption law, clarifies treatment of hotel revenues and operating expenses with respect to an assignment of rents, and spells out how tenants should act when an assignment of rents is enforced. It thus differs slightly from the model act proposed by the Uniform Law Commission. One other difference from the model act is worth mentioning. Under the model act proposed by the ULC, every commercial mortgage automatically creates an assignment of rents unless the mortgage states otherwise. Under the Act, an assignment of rents is only created if a mortgage or separate agreement specifically grants one.

The Act Harmonizes Assignments of Rent with Michigan's Redemption Provisions

Michigan's foreclosure redemption provisions are unusual. In brief, an owner has a period of time after a sheriff's sale – typically six months for commercial property – to pay the amount bid at the

sheriff's sale, plus interest and certain limited advances, to redeem the property. If the owner redeems, its title is restored free and clear of the mortgage, and junior interests are not extinguished.

Before the Act, cases conflicted about the effect of the sheriff's sale on an assignment of rents. Some suggested that a mortgage, including any assignment of rents it contained, was extinguished by a foreclosure sale. Common practice was to sidestep this by recording a separate assignment of rents instrument. But even this did not resolve the uncertainty because cases were also mixed on whether a successful redemption extinguished a separate assignment of rents, or if the assignment of rents was independent security that continued until the debt was paid in full. The Act clarifies that a foreclosure sale does not extinguish an assignment of rents. Instead, an assignment of rents automatically terminates when either (i) the redemption period expires, or (ii) an earlier redemption occurs. Moreover, if a third party submits the winning bid at a foreclosure sale, the assignment of rents vests in that third party "to the extent of the remaining secured obligation" by operation of law, regardless of what the foreclosure notice says.[vi] These fixes make it plain exactly how and when an assignment of rents terminates, and who benefits from it.

Hotel and Other Occupancy Revenues Are Rents Under the Act

Occupancy revenues, most commonly derived from hotels, were another source of confusion prior to the Act's adoption. The Act makes Michigan the first state with a Uniform Assignment of Rents Act that expands the definition of "rents" to include occupancy revenues.[vii] Perhaps surprising, this distinction is not clear in many states. Although lenders often act as though hotel receipts are rents, the majority of courts view room revenues as personal property, not rents.[viii] This classification affects whether a security interest in hotel revenues must be perfected by recording a mortgage or by filing a

UCC-1 financing statement. Under the Act, lodging lenders in Michigan will enjoy a level of certainty unavailable in many other states.

Flexibility for Operating Expenses

Secured lenders whose commercial loans are in default have decisions to make with respect to operating expenses. In many instances, they may wish to allow expenses to continue to be paid, as this can preserve value by maintaining the property's physical condition and encouraging tenants to remain. In other situations, a lender may view its borrower as untrustworthy and prefer that all rents be turned over. Complicating this decision, if a lender collects all rents and pays operating expenses directly before taking possession or having a receiver appointed, a court might decide it is a "mortgagee in possession," with an entire slate of ramifications.

The Act offers lenders flexibility and a shield. After a lender has taken the statutory steps to collect rents under the Act, the borrower must deliver all rent proceeds to the lender, "less any amount representing payment of expenses *authorized by the assignee*."[ix] In other words, although a lender can authorize a borrower to pay for specific operating expenses, it is not required to do so. Moreover, the Act confirms that a lender's enforcement does not make it a mortgagee in possession.[x] Thus, the Act allows lenders to authorize the payment of operating expenses where the borrower has proven trustworthy and the lender believes that payment is in its best interests, and deny such authorization otherwise.

Clarity for the Lender-Landlord-Tenant Relationship

Before the Act, lenders could enforce the assignment of rents on tenants directly. Tenant uncertainty over to whom the rent must be paid and whether it would be liable afterward led to mixed results on the ground, however. The Act addresses these issues.

When a landlord defaults on its loan, its lender may notify the tenants that rents must be paid to the lender instead of the landlord. The Act includes a form of notice for the lender to use.[xi] The lender can use a different form, though, so long as it provides the required information, including details on how and where the tenant must deliver rent payments and a notice that the tenant may consult with a lawyer about any questions.[xii] If the tenant complies with the lender's notice and delivers its rent to the lender instead of the landlord, this satisfies the tenant's obligation to pay rent under its lease. The tenant must continue paying rent to the lender until the tenant receives a court order directing it to pay rent in a different manner or an earlier signed document from the lender canceling its notice.[xiii] The Act also "freezes" the existing lease: once the lender delivers a notice to the tenant, modifications to the existing lease are not binding on the lender unless the lender consents in writing to them.[xiv] This "freeze" effectively extends a principle common in many commercial subordination, non-disturbance and attornment agreements to situations where no such agreement exists. Tenants who comply with the lender's notice avoid the risk that they may pay the landlord yet still be liable to the lender or vice versa.

To ensure tenants understand their rights and obligations, the Act provides time for tenants to review a lender's notice with counsel before having to make the next rent payment. Under the Act, a tenant will not be in default under its lease for rent payments coming due within 30 days after receipt of a lender's notice until the earlier of (a) the 10th day after the due date for the next regularly scheduled rent payment or (b) 30 days after receipt of the lender's notice.[xv] So, for example, if a tenant receives a

lender's notice on the 28th day of the month and rent is regularly due on the 1st, the tenant has at least until the 10th to review the notice and deliver rent to the correct party.

The Role of Receivers Is Clarified with Respect to an Assignment of Rents

Michigan law allows for a lender to foreclose non-judicially (termed "by advertisement"). To foreclose by advertisement, it is required that "[a]n action or proceeding has not been instituted, at law, to recover the debt secured by the mortgage…."[xvi] Through a companion bill to the Act, Michigan's foreclosure by advertisement statute was amended that a lawsuit to appoint a receiver to enforce the assignment of rents does not preclude foreclosure by advertisement.[xvii]

The Act clarifies that (1) a lender is entitled to a receiver if the borrower is in default and either (a) it agreed to the appointment in a signed document, (b) it appears likely that the property may not be sufficient to satisfy the secured obligation, or (c) the borrower has failed deliver to the lender rental proceeds to which the lender is entitled; and (2) a receiver is entitled to collect rents that have accrued but remain unpaid on the date the assignment of rents is enforced, as well as collect rents that later accrue.[xviii]

Conclusion: The Act Reduces Expense by Providing Certainty

The bottom line is that the Act alters the borrower/lender relationship for the better by providing clarity and certainty. With each party's rights spelled out, they should focus (and litigate) less on logistics and more on issues that matter: the loan default, the underlying asset, and how best to resolve the related distress. The authors hope that this article helps all parties understand how the Act may affect their business relationships and thus better plan for the future.

[i] M.C.L. § 554.1051 *et seq.*

[ii] One of the authors' partners, who has subsequently retired, served on the subcommittee of the Debtor-Creditor Rights Committee of the State Bar of Michigan that adapted the Uniform Assignment of Rents Act for application in Michigan and testified in favor of its adoption.

[iii] M.C.L. §§ 554.231, 554.232.

[iv] *Town Ctr. Flats, LLC v. ECP Commercial II, LLC (In re Town Ctr. Flats, LLC)*, 855 F.3d 721 (6th Cir. 2017).

[v] *In re Skymark Props. II, LLC*, 597 B.R. 363 (Bankr. E.D. Mich. 2019).

[vi] M.C.L. § 554.1054(4)(a).

[vii] M.C.L. § 554.1052(m)(vi). Nevada, New Mexico, Texas, Utah, and North Dakota have also implemented versions of the Uniform Assignment of Rents Act, but at most contain general "catch-all" language.

[viii] *See, e.g., In re Ocean Place Dev., LLC*, 447 B.R. 726, 732-33 (Bankr. D.N.J. 2011).

[ix] M.C.L. § 554.1064(2)(a) (emphasis added).

[x] M.C.L. § 554.1061(a).

[xi] M.C.L. § 554.1060.

[xii] M.C.L. § 554.1059(1).

[xiii] M.C.L. § 554.1059(3)(d).

[xiv] M.C.L. § 554.1059(3)(e).

[xv] M.C.L. § 554.1059(4)(a-b).

[xvi] M.C.L. § 600.3204(1)(b).

[xvii] M.C.L. § 600.3204(1)(b)(ii).

[xviii] M.C.L. § 554.1057(1).