By Ronald A. Spinner and Marc N. Swanson

Were Those Rents Assigned? Absolutely!

Ronald A. Spinner
Miller, Canfield, Paddock and Stone, PLC; Detroit

Marc N. Swanson
Miller, Canfield, Paddock and Stone, PLC; Detroit

Ronald Spinner is a senior associate and Marc Swanson is a principal with Miller, Canfield, Paddock and Stone, PLC in Detroit.

Mortgages have long contained assignment-of-rent clauses, which provide a lender with extra protection in case of default. In addition to pledging property to back a loan, an assignment of rents provides that any rents generated by the property will also secure the mortgage. Exactly what effect an assignment of rents should have in a bankruptcy context, however, has been long debated. Are the rents property of the estate, or have they been assigned? If they are estate property, can a debtor use them to fund its bankruptcy case? In many cases, the debtor has no other significant source of funds, so if the answer to either question is "no," the debtor will be unable to avail itself of bankruptcy protection.

Many courts had determined that rents subject to an assignment-of-rents clause in a mortgage are estate property and represent a lender's cash collateral. However, recent opinions suggest that some courts are taking a fresh look at this position. These courts are finding increasingly often that if state law divests the debtor of its rights in rents pre-petition, then the debtor will not reacquire these rights by filing a bankruptcy petition. This is an important trend that is worth following because it can seriously affect lending relationships and bankruptcy cases.

Security Interest vs. Absolute Assignment

Although many clauses are referred to as "assignment of rents" clauses, they can be phrased in various — often simple — ways. An example of such phrasing includes the following: "For valuable consideration, Grantor hereby assigns, grants a continuing security interest in, and conveys to Lender all of Grantor's right, title and interest in and to the Rents from the following described property...."[1] In other cases, lenders have tried to reword them to portray them as a conveyance of absolute title rather than a mere security interest. Some clauses will state that a borrower transfers all of its rights, title and interests in and to rents to a lender, which in turn grants a license back to the borrower to collect the rents, so long as the borrower is not in default of its obligations to the lender.[2] Why the difference?

In the first case, it is clear that the lender understands that it is getting a security interest, which it can enforce in the event of a default. In the second, the lender is trying to set up an argument that the rents already belong to it, the borrower merely held a revocable license to collect the rents and the rents are not estate property at all. In other words, the lender wants to assert that the rents were "absolutely" assigned to it. Were a court to agree with that interpretation, then in a bankruptcy setting, the rents would not be cash collateral; in fact, the debtor would have no interest in them at all.

Fortunately for debtors, bankruptcy courts focus less on the wording of an assignment of rents and more on the parties' intent as to what they meant to accomplish.[3] When an assignment of rents is included in a mortgage (as opposed to an outright sale or factoring of the rents), a court is likely to find that only a security interest was intended or conveyed.[4] Thus, the rents usually remain property of the estate and, so long as the debtor can provide adequate assurance that they will be protected, the debtor may use them to fund its case. In the case of a single-asset real estate debtor, that may still be impossible to do, as a simple replacement lien in the rents usually will not suffice.[5] However, if a debtor has unencumbered assets in which it can offer a lien, it likely will be able to use the rents to help it reorganize.

Enter state law. Some state laws, such as those in Michigan, provide that once certain conditions have been met, an assignment of rents converts from a security interest to an absolute assignment of rents.[6] Recently, Michigan bankruptcy courts have been leaning toward acknowledging this state law. They are finding that if state law transferred the right to the rents to the lender prior to a debtor's bankruptcy filing, then that transfer remains valid — even after filing. Lenders view this as a vast (and legally correct) improvement in their position, while debtors are understandably concerned.

The *Town Center Flats* Decision

The U.S. District Court for the Eastern District of Michigan recently weighed in on the issue in the

1 *In re Madison Heights Grp. LLC*, 506 B.R. 728, 729 (Bankr. E.D. Mich. 2013).

2 *In re Buttermilk Towne Ctr. LLC*, 442 B.R. 558, 560 (B.A.P. 6th Cir. 2010); *MacArthur Exec. Assocs. v. State Farm Ins. Co.*, 190 B.R. 189, 191 (D.N.J. 1995); *In re Carretta*, 220 B.R. 203, 206-07 (Bankr. D.N.J. 1998).

3 *See, e.g., In re MRI Beltline Indus. LP*, 476 B.R. 917, 919-20 (Bankr. N.D. Tex. 2012); *In re Senior Hous. Alts. Inc.*, 444 B.R. 386, 391-93 (Bankr. E.D. Tenn. 2011); *In re Village Green I GP*, 435 B.R. 525, 535-38 (Bankr. W.D. Tenn. 2010).

4 *Buttermilk Towne Ctr.*, 442 B.R. at 562-64.

5 *Id.* at 564-67; *In re Hari Ram Inc.*, 507 B.R. 114, 125 (Bankr. M.D. Pa. 2014); *Putnal v. Suntrust Bank*, 489 B.R. 285, 289-90 (M.D. Ga. 2013) (noting that "the replacement-lien theory has by now been generally discredited"); *Stearns Bldg. v. WHCBF Real Estate (In re Stearns Bldg.)*, 165 F.3d 28 (6th Cir. 1998) (table decision).

6 M.C.L. §§ 554.231 & 554.232.

Town Center Flats opinion.[7] By statute, Michigan provides that an assignment of rents converts from a security interest to an absolute assignment if, after the borrower defaults, the lender records a notice of the default with the appropriate register of deeds and then serves that notice upon the occupants of the mortgaged real estate.[8] This is fine in state courts, but how does it apply in the bankruptcy setting? Michigan case law has split on the question. At least one bankruptcy court has held that regardless of whether a lender has perfected its rights in accordance with the statute, the rents remain estate property and are merely the lender's cash collateral.[9] However, a growing number of bankruptcy courts now read the statute literally and find that if the lender has complied with the statute's requirements, then the estate lacks any interest in the rents.[10]

Town Center Flats LLC owned a residential townhouse and apartment complex.[11] It had borrowed money and granted its lender a mortgage in its real estate, complete with an assignment of rents.[12] A year after Town Center defaulted on its loan on Dec. 31, 2013, its lender exercised its rights under the assignment-of-rents clause, properly filing the notice of default in the land records and notifying the tenants.[13] However, Town Center refused to surrender rents that had been paid to it. One month later, the lender sued in Michigan state court.[14] Town Center promptly filed for bankruptcy protection.[15]

In bankruptcy court, the lender pointed to the growing body of Michigan bankruptcy court case law finding that once the assignment of rents was properly enforced under state law, the debtor lost its interest in the rents and a subsequent bankruptcy filing would not return the rents to the estate.[16] As luck would have it, however, Town Center had drawn the same judge that had issued the *Newberry Square* opinion, in which the court found that even compliance with the statute did not suffice to remove rents from the estate. Thus, it was not particularly surprising that the court found that "[a]lthough it has been 20 years since the Court decided *Newberry*, it still believes in its soundness and does not believe there are any subsequent events which might cause it to change its mind."[17] The court thus reaffirmed *Newberry* and held that the rents were estate property and cash collateral.[18]

What was surprising was that the lender appealed — and won a reversal. The district court started with a reminder that a debtor is afforded the same protection in bankruptcy as it would have been afforded under state law outside of bankruptcy.[19] The court then noted that Michigan state courts had long ago agreed with an early bankruptcy opinion that had held that the Michigan statute acted to cleave the rents from the debtor, and thus from the debtor's estate.[20] The Michigan Appellate Court also recently reaffirmed the correctness of that view.[21] Given that the Michigan state courts had seemingly made up their minds on the issue, and given the growing number of Michigan bankruptcy court opinions that had decided the question differently than the court in *Newberry* had, the district court had little difficulty in reversing the bankruptcy court.[22]

"Toto, I've a Feeling We're Not [Just] in [Michigan] Anymore"

You might be thinking, "Of course, this is all well and good for Michigan lenders and borrowers, but what does this have to do with me?" Plenty — or nothing at all — depending on where you practice. For example, Texas (like Michigan) has decided to commit its stance to statute. Unlike Michigan, the Texas legislature has made it clear that no matter how it is worded or what steps a lender might take, an assignment of rents is purely a security interest.[23] Conversely, those in Illinois or Pennsylvania may find that taking possession of the property will secure the rents as well, although many lenders do not seem to do so quickly enough to secure their rights for bankruptcy purposes.[24] Other courts have come to tortuous conclusions toward one side or the other.[25]

The point is this: if lenders (and debtors, of course) were keenly aware of their rights under state law, the filings of each, both in the records and in the state courts, might change substantially. For lenders in Michigan, Illinois, Pennsylvania and likely elsewhere,[26] imagine the difference if you were able to argue that under state law, your debtor had no right to the rents that it had collected after you had perfected possession of those rents. For debtors in those states, imagine the effect that it would have on your ability to retain counsel if all counsel in those states were aware that they might well have to refund any fees you paid to them if the payment came from rents generated by your property.[27] Regardless of which side of the "v." you may focus your practice, assuming a nationwide approach to assignment of rents clauses could prove devastatingly wrong.

7 *ECP Commercial II LLC v. Town Ctr. Flats LLC*, Case No. 15-41307, 2016 WL 1237662 (E.D. Mich. March 30, 2016).
8 *Id.* at *2; M.C.L. § 554.231; *Otis Elevator Co. v. Mid-Am. Realty Inv'rs*, 206 Mich. App. 710 (1994).
9 *In re Newberry Square Inc.*, 175 B.R. 910 (Bankr. E.D. Mich. 1994).
10 *In re Mount Pleasant Ltd. P'ship*, 144 B.R. 727 (Bankr. W.D. Mich. 1992); *In re Woodmere Inv'rs Ltd. P'ship*, 178 B.R. 346, 358-60 (Bankr. S.D.N.Y. 1995) (interpreting Michigan law); *Madison Heights Grp. LLC*, 506 B.R. at 724; *see also In re Coventry Commons Assocs.*, 143 B.R. 837 (E.D. Mich. 1992) (holding that strict compliance with Michigan statute is required for title to pass, but is not required for rents to be treated as cash collateral); *In re P.M.G. Props.*, 55 B.R. 864 (Bankr. E.D. Mich. 1985) (holding that title to rents passed to mortgagee on default, even though mortgagee had not fully complied with statutory requirements).
11 *In re Town Ctr. Flats LLC*, 531 B.R. 176, 177 (Bankr. E.D. Mich. 2015), *rev'd, by Town Ctr. Flats*, 2016 WL 1237662.
12 *Id.*
13 *Id.*
14 *Id.*
15 *Id.*
16 *Id.*
17 *Id.* at 179.
18 *Id.* at 182.
19 *Town Ctr. Flats*, 2016 WL 1237662 at *2 (citing *Butner v. United States*, 440 U.S. 48, 49 (1979)).
20 *Id.* (citing *Otis Elevator Co. v. Mid-Am. Realty Inv'rs*, 206 Mich. App. 710 (1994)).
21 *Id.* at *4-5 (citing *Ashley Livonia A&P LLC v. Great Atl. & Pac. Tea Co. Inc.*, Case No. 319288, 2015 WL 3757546 (Mich. Ct. App. June 16, 2015)).
22 *Id.* at *5.
23 *MRI Beltline Indus.*, 476 B.R. at 921-23.
24 *See Settlers Hous. Serv. Inc. v. Schaumburg Bank & Trust Co. (In re Settlers Hous. Serv. Inc.)*, 514 B.R. 258, 284 (Bankr. N.D. Ill. 2014); *Sovereign Bank v. Schwab*, 414 F.3d 450 (3d Cir. 2005) (interpreting Pennsylvania law); *Harim Ram*, 507 B.R. at 831-35 (same).
25 *Compare In re Augusta Ctr.*, 491 B.R. 298, 303-06 (Bankr. S.D. Ga. 2013) (finding that lender "had a present choate right to rents" but that debtor's reversionary interest in rents sufficed to draw them into estate), *with In re Bryant Manor LLC*, 422 B.R. 278, 283-89 (Bankr. D. Kan. 2010) (finding that although rents became property of lender while receiver was in place, they would revert to estate once receiver was removed by bankruptcy court and thus were estate property, but that it was in best interest of creditors to leave receiver in place, effectively mooting debtor's cash collateral motion).
26 For example, New Jersey, if the assignment is drafted as unambiguously absolute. *First Fid. Bank NA v. Jason Realty LP (In re Jason Realty LP)*, 59 F.3d 423, 427-30 (3d Cir. 1995); *MacArthur Exec. Assocs.*, 190 B.R. at 195-96; *Carretta*, 220 B.R. at 211-16. Also, possibly Florida, if sufficient steps are taken pre-petition. *In re Villamont-Oxford Assocs. Ltd. P'ship*, 230 B.R. 445 (Bankr. M.D. Fla. 1998) (reviewing and discussing Florida case law on subject).
27 *Stearns Bldg.*, 165 F.3d 28 at *6.

continued on page 58

from page 35

Conclusion

The takeaway is that both debtors and lenders need to pay attention to their state law environments. If you are a lender in a state that allows assignments of rents to be converted from security interests to absolute assignments, you need to understand exactly what is required to make that happen and perhaps take those steps earlier than you might otherwise. Conversely, debtors in states where this is the case need to be more sensitive to their defaults. If such a debtor defaults and takes too long to file for bankruptcy protection, it may entirely lose the practical ability to do so.

Lenders and debtors in states like Texas, where it seems clearer that nothing a lender does will boost an assignment of rents from a security interest to an absolute assignment, may get to be more relaxed when a debtor defaults, although this "relaxation" may come at the cost of higher interest rates charged to debtors for the privilege of doing business in those states. In any event, a "one-size-fits-all" approach to lending or borrowing in multiple states simply does not work anymore. Practitioners must remain aware of the law in each state in which they do business, and must plan accordingly in order to avoid unpleasant surprises down the road. abi