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Disagreement over Absolute Assignments of Rents Reappears

By Paul Rubin and Adam D. Wolper

During the real estate downturn of the early 1990s, courts in the Southern and Eastern Districts of New York disagreed over the impact under New York law of what appeared to be absolute assignments of rents, and whether Chapter 11 debtors could spend property rents to support their reorganization efforts despite such assignments. During the current downturn, two Southern District judges held that debtors are prevented from spending such rents because they had executed absolute assignments. *In re Loco Realty Corp.*, 2009 WL 2883050 (Bankr. S.D.N.Y. Jun. 25, 2009); *Soho 25 Retail, LLC v. Bank of America, N.A.* (*In re Soho 25 Retail, LLC*), 2011 WL 1333084 (Bankr. S.D.N.Y. Mar. 31, 2011). Those decisions seemed to signal a recent trend favoring lenders on this issue. But Judge Elizabeth S. Stong of the Eastern District recently reached the opposite conclusion in *In re South Side House, LLC*, 2012 WL 2254212 (Bankr. E.D.N.Y. Jun. 15, 2012). As the question remains unresolved, this article addresses arguments each side may wish to raise.

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Background

Mortgage lenders typically require their borrowers to execute absolute assignments of rents, which explicitly state that an absolute, unconditional and present assignment, and not an assignment as additional security, is intended. Under these assignments, the lender grants the borrower a license to collect property rents, which automatically terminates or is revocable upon the borrower's default. The assignments are contained either in the mortgage instrument or in a separate document denominated as an assignment of rents and leases. In theory, an absolute assignment conveys to the lender title to the rents immediately upon the borrower's execution of the assignment — but not all courts see it that way.

Non-Bankruptcy Courts

Outside of bankruptcy, New York courts disagree over the impact of an absolute assignment of rents. Most hold that even if an assignment is labeled "absolute," it grants the lender only a security interest in the rents. *Soho 25*, 2011 WL 1333084 at *6. *But See Sullivan v. Rosson*, 223 N.Y. 217, 226 (1918) (recognizing assignment clearly intended to be absolute and unqualified operated *in praesenti*). These courts view the context of the assignment — inclusion in security documents for mortgage loans — as indicative, regardless of their language, that they are only additional security and not true assignments. Additionally, they note that New York is a "lien theory" state, pursuant to which title to the mortgaged property remains with the borrower, and that a lender must take affirmative steps under New York law after an event of default in order to enforce their rights to the rents.

Conversely, other courts sitting in New York, including several federal district courts ruling in the context of foreclosure actions, have upheld the validity of absolute assignments of rents, concluding that title to the rents was transferred from the borrower to the lender immediately upon execution of the assignment. *See Credit Lyonnais v. Getty Square Assocs.*, 876 F. Supp. 517, 521 (S.D.N.Y. 1995); *Federal Home Loan Mortgage Corp v. Spark Tarrytown, Inc.*, 822 F. Supp. 137, 139-40 (S.D.N.Y. 1993); *Federal Home Loan Mortgage Corp. v. Dutch Lane Assocs.*, 775 F. Supp. 133, 139 (S.D.N.Y. 1991); *Federal Home Loan Mortgage Corp. v. Kopf*, 1991 WL 427816 at *2 (E.D.N.Y. Jan. 30, 1991). These courts rely on a textual analysis of the assignments, which expressly state that they are not meant as additional security only.

Courts agree that, even if a lender did not receive title under an absolute rent assignment at closing, the lender may nevertheless obtain the right to collect

the rents by taking certain steps, such as getting a rent receiver appointed in a mortgage foreclosure action or obtaining possession of the underlying real property. *Sullivan*, 223 N.Y. at 226. It is unclear, however, whether a lender's gaining the right to collect the rents is tantamount to obtaining ownership of them. *Compare Womans Hosp. in the State of N.Y. v. Sixty-Seventh St. Realty Co.*, 265 N.Y. 226, 233 (N.Y. 1934) (property owner is divested of title to rents upon appointment of receiver) with *Ganbaum v. Rockwood Realty Corp.*, 62 Misc.2d 391, 395-96 (N.Y. Sup. Ct. 1970) (assignment of rents cannot convey title to the rents, which are an incident of real property).

The Spectrum of Bankruptcy Opinions

Bankruptcy courts in the Eastern and Southern Districts of New York have issued a broad range of opinions on this and related subjects. At the debtor-friendly end of the spectrum is *In re Constable Plaza Associates, L.P.*, 125 B.R. 98 (Bankr. S.D.N.Y. 1991). That court held that the assignment clause before it was not absolute, and therefore the lender did not own the rents, but even if the clause were considered to be absolute, the rents would still be estate property because the debtor retained a residual interest in any rents beyond the amount of the debt. *Id*. at 101-03. Under the *Constable Plaza* reasoning, that residual interest is property of a debtor's estate sufficient to make the rents cash collateral, so whether the assignment is absolute or intended as a security interest is inconsequential.

In *In re Koula Enterprises, Ltd*, 197 B.R. 753 (Bankr. E.D.N.Y.1996), the court held that the assignment at issue was not absolute because, among other reasons: 1) it was contained in a mortgage and not a separate document; 2) it provided that the debtor could not assign the rents without the lender's consent (which was interpreted to mean that the debtor owned an assignable interest in the rents); and 3) it provided that, after payoff of the mortgagee, the remaining rents would be the debtor's absolute property. *Id*. at 756-58. This court held that, by having a receiver appointed pre-petition, the lender could at most obtain only possession of — not title to — the rents. Notably, the *Koula* court left open the possibility that it might have found the assignment to be absolute upon execution and barred the debtor from using the rents if the assignment had been contained in a document separate from the mortgage. *Id*. at 757.

In contrast, the court in *In re Brooklyn Props. Ltd. P'Ship No. 2*, No. 193-15707-352, slip op. at 5 (Bankr. E.D.N.Y. Mar. 21, 1994) found an assignment of rents to be absolute and unconditional, and therefore held that the Debtor had "no control over or entitlement to the rents produced by the Property."). *In re Woodmere Investors L.P.*, 178 B.R. 346, 359-60 (Bankr. S.D.N.Y. 1995), reached a similar result. That court found that, under Michigan law, the assignment at issue transferred title of the rents to the lender before the filing, and therefore the rents were not property of the debtor's estate. Also in 1995, the Third Circuit held that an assignment of rents was absolute under New Jersey law, and thus excluded the rents from the bankruptcy estate. *First Fidelity Bank, N.A. v. In re Jason Realty, L.P.* (*In re Jason Realty, L.P.*), 59 F.3d 423, 425. Though not binding in the Second Circuit, *Jason Realty's* repercussions were still widespread. In *First Fidelity Bank, N.A. v. Eleven Hundred Metroplex Associates*, 190 B.R. 510, 514-15 (S.D.N.Y. 1995), then-district-judge Sonia Sotomayor, relying on *Jason Realty*, found an assignment to be absolute under New Jersey law.

Notably, the holdings of these cases denying debtors the right to use rents because they were absolutely assigned explicitly or implicitly rejected the argument that a debtor retains a residual interest in rents sufficient to permit them to spend the rents as cash collateral.

In the first two opinions issued during the current economic crisis considering the impact of assignments of rents under New York law and the Bankruptcy Code, New York bankruptcy courts favored lenders. In *Loco*, Judge Arthur J. Gonzalez acknowledged that "New York law is, at best, unclear on the topic of whether an absolute assignment of rent transfers title to the rent upon execution of the instrument." *Loco*, 2009 WL 2883050 at *5. He nevertheless found an assignment to be absolute, and that title of the rents was transferred to the lender upon execution. Unlike *Constable Plaza*, Judge Gonzalez further held that the debtor's residual interest in the rents following execution of the assignment, which is in the nature of an accounting for any rents beyond the amount of the mortgage debt, was not sufficient to make the rents property of the bankruptcy estate. *Loco*, 2009 WL 2883050 at **5-7.

In *Sobo 25*, Judge Sean H. Lane sought to avoid the "murky legal question" of whether an assignment of rents is absolute upon execution. Instead, he held that the assignment whose language evinced an intent to be absolute was enforceable as an absolute assignment because the lender "took sufficient steps toward asserting its interest" under New York law. He identified, among other things, the lender's commencement of a foreclosure action and requesting appointment of a receiver as pre-petition enforcement making the assignment absolute. 2011 WL 1333084 at **7-8. Judge Lane agreed with Judge Gonzalez that a debtor's reversionary interest in the rents after payment of the loan was not

enough to make the rents property of the bankruptcy estate. *Id*. at **8-9.

South Side House Bucks Trend

In *South Side House*, Judge Stong reached the opposite conclusion. There, the debtor executed a mortgage containing an assignment of rents provision. It stated that the assignment was an absolute and unconditional assignment to the lender of all of the borrower's title to the rents, and that it was "intended by Borrower that this assignment constitutes a present, absolute assignment and not an assignment for additional security only." 2012 WL 2254212 at *17. The lender had also brought a prepetition foreclosure action in which a receiver was appointed.

The *South Side* court cited several New York state cases holding that an assignment absolute on its face may still be enforceable only as an assignment for additional security. *Id*. at *17 (citing, *inter alia, LT Propco, LLC v. Carousel Center Co*., 68 A.D.3d 1695, 1696 (4th Dep't 2009)). Judge Stong stated that under New York law, a court must look to the context of the agreement to determine the true nature of the assignment." *Id*. at *16. In that case, she cited the following as telltale signs that the assignment before her was only meant as additional security: 1) the assignment was contained in a mortgage securing a loan, and New York is a lien theory state; 2) the lender was not bound by the covenants and obligations in the leases (whereas in a true lease assignment, the assignee assumes the covenants and obligations of the assignor); and 3) upon taking possession of the rents, the lender could only use them to pay down the loan, and once the loan was paid off, the assignment was extinguished. *Id*. at *17.

Judge Stong declined to follow the holding of *Soho 25* that after a lender takes affirmative steps to enforce its rights under the assignment, it operates as an absolute assignment. Instead, she found that such steps may permit the lender to possess or collect rents, but the borrower still retains title to them. *Id*. at *17. Accordingly, she held that the rents were property of the debtor's bankruptcy estate that qualified as cash collateral and could be used by the debtor in its Chapter 11 case.

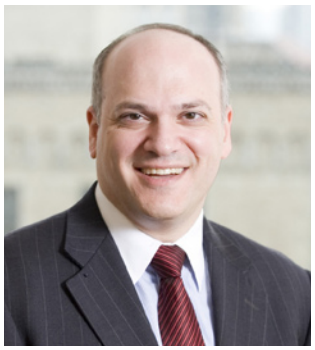
What Can Practitioners Do, Given the Uncertainty?

There is no clear consensus among bankruptcy courts whether what purports to be an absolute assignment of rents under New York law prevents a Chapter 11 debtor from using them to fund a reorganization plan. Most cases that found such assignments to be absolute involved an assignment of rents contained in a document separate from the mortgage. Taking a cue from *Koula*, those representing lenders should urge their clients to include assignments of rents in a separate document.

Lenders will also want to focus on language evidencing a present-tense, absolute and unconditional assignment that expressly states it is not a transfer intended as security. It is well-established that section 541 of the Bankruptcy Code, which delineates property of a debtor's estate, does not expand a debtor's rights beyond those that exist under state law. *Weinman, Trustee v. Graves* (*In re Graves*), 609 F.3d 1153, 1156 (10th Cir. 2010). Therefore, lenders could argue, a borrower who executed an absolute assignment of rents is left only with a right to an accounting in case the mortgage is someday paid off, and since the borrower was not permitted to collect or spend rents immediately before its bankruptcy filing, it should not have any greater right to the rents the day after the filing.

Aside from adopting the positions adopted by the courts in *Constable Plaza*, *Koula* and *South Side House*, counsel for real estate debtors should scrutinize the assignments executed by their clients. Even if the language indicates a present assignment, the document may require the lender to take affirmative steps after a default in order to revoke the borrower's license to collect the rents. If the lender did not revoke the license or take other affirmative steps to enforce its right to the rents before the bankruptcy filing, there may be room, even under *Soho 25*, for the debtor to argue that the assignment is not enforceable as an absolute assignment.

What is clear is that there is no discernable trend, and the issue is likely to remain unsettled absent a definitive ruling from the Second Circuit.



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