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Town Center's Impact On Real Estate Lenders And Borrowers

By **Dov Kleiner**

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A recent Sixth Circuit decision holds that a mortgage lender that has taken appropriate steps to perfect an assignment of rents is protected if its borrower files a bankruptcy petition, as the rents are considered property of the lender and not property of the debtor's estate. In re Town Center Flats LLC (Case No. 16-1812)(6th Cir. May 2, 2017). This decision has been justly celebrated by real estate lenders who hope to rely on the full benefit of their bargained for assignment of rents as it prevents a borrower from using the rents to fund a bankruptcy case until title to the property is resolved. Unfortunately, the comfort provided by the Town Center case is not so universal. In that instance, the holding was dependent on the subject property being in a "title theory" state (Michigan, in the case). In other jurisdictions, which are "lien theory" states, lenders may be less well off.

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Town Center

The facts of the Town Center case were relatively simple. Debtor Town Center Flats LLC ("Town Center") owned a 53-unit residential complex in Michigan, which it financed with a $5.3 million loan held by ECP Commercial II LLC ("ECP"). The loan was secured with a mortgage and an assignment agreement relating to the rents. In the assignment agreement, Town Center "irrevocably, absolutely and unconditionally [agreed to] transfer, sell, assign, pledge and convey to [ECP], its successors and assigns, all of the right, title and interest of [Town Center] in income of every nature of and from the Project, including, without limitation, minimum rents [and] additional rents." The agreement purported to be a "present, absolute and executed grant of the powers herein granted to Assignee," while simultaneously granting a license to Town Center to collect and retain rents until an event of default, at which point the license would "automatically terminate without notice to [Town Center]." As is typical of this arrangement, Town Center had no source of income other than rents from the complex.

Town Center defaulted on its obligation to repay the loan and, eventually, ECP took several steps to enforce its rights. First, it sent a notice of default and a request for the payment of rents to all known tenants of the complex. The following day, ECP recorded the notice documents in Macomb County, Michigan, completing the last step required by the Michigan statute to make the assignment of rents binding against both Town Center and the tenants of the property. ECP then filed a complaint in the Michigan state court alleging breach of contract, initiating foreclosure on the mortgage, and requesting appointment of a receiver to take possession of the Town Center property.

Approximately one week after ECP filed its suit, Town Center responded by filing for Chapter 11 bankruptcy relief. While the parties had been working under a temporary agreement as to the use of the rents, ECP moved in the bankruptcy court to prohibit Town Center from using the rents to fund the case. Town Center objected, pointing out that it had no other source of funds other than the rents. The bankruptcy court agreed with the debtor and found that the rents were ECP's cash collateral but that Town Center could use them so long as it provided "adequate protection" under Section 363 of the Bankruptcy Code. On appeal, the district court reversed, agreeing with ECP and the case then went up on appeal to the Sixth Circuit.

The Sixth Circuit's reasoning in In re Town Center was straightforward. Looking to Michigan law to determine the relative rights in the rents of ECP and Town Center, the court found that once a creditor had properly perfected the assignment of rents under the applicable statute, in that case by the proper notice and recordation, then the assignor no longer had an interest in post-default rents. The Sixth Circuit also rejected Town Center's claim that, because it had a theoretical right to retain rents if it were to cure the defaults or repay the mortgage, it had a sufficient property interest in the rents for them to be the property of the estate. At best, the court found, the debtor might have an interest in those future post-cure or post-payoff rents, but it had no interest in the rents paid while the debt was outstanding and in default.

Title Theory vs. Lien Theory

While this decision is certainly encouraging to lenders seeking control of assigned rents in a bankruptcy case, it hinges on a particularity of Michigan law that is not applicable in all other jurisdictions. In particular, Michigan is a "title theory" state that treats collateral assignments as assignments or conditional assignments of title. The Town Center Court relied on Mich. Comp. Law. § 554.231, which provides that:

Hereafter, in or in connection with any mortgage on commercial or industrial *property ... it shall be lawful to assign the rents*, or any portion thereof, under any oral or written leases upon the mortgaged property to the mortgagee, as security in addition to the property described in such mortgage. *Such assignment of rents shall be binding upon such assignor only in the event of default* in the terms and conditions of said mortgage, *and shall operate against and be binding upon the occupiers of the premises from the date of filing by the mortgagee in the office of the register of deeds for the county in which the property is located of a notice of default in the terms and conditions of the mortgage and service of a copy of such notice upon the occupiers of the mortgaged premises*.

(emphasis added)

The Sixth Circuit, analyzing Michigan case law, concluded that once there was a default and the lender complied with the noticing provisions of the statute, the transfer of title was effective and the mortgagor/assignor no longer had any interest in the rents — "Michigan courts have generally treated the assignment of rents as a transfer of ownership once the agreement has been completed and recorded and a default has occurred." Town Center, at [__] But other states, New York and Florida among them, may treat assignments of rents differently — these are "lien theory" states, which treat assignments of rent as mere collateral assignments . Most notably, in In re South Side House LLC, 474 B.R. 391 (Bankr. E.D.N.Y. 2012), the last reported decision to address the issue under New York law, the Bankruptcy Court for the Eastern District of New York concluded that the language in an assignment of rents notwithstanding, under New York law, "a borrower retains an interest in rents even after a foreclosure proceeding is initiated and a receiver is appointed to collect the rents." South Side at 411. While the South Side court acknowledged that at least one bankruptcy court had applied New York law to find that a lender's remedial efforts after a default could be sufficient to keep the rents out of property of the estate, see Soho 25 Retail LLC, No. 10-15114 (SHL), Adv. Pro. No. 11-1286 (SHL) (Bankr. S.D.N.Y. March 31, 2011), it declined to follow that example. The South Side court held that, regardless of the language in the assignment, an assignment of rents is in the "nature of a pledge of additional security." South Side at 411. In other words, in a "lien theory" state like New York, regardless of the language written and recordation or remedial steps taken, until the moment of an actual foreclosure sale or other formal transfer of title, a lender's interest in the assigned rents may be treated as nothing more than a collateral interest, and rental income is property of a debtor's estate albeit property subject to a lien. So long as South Side remains the last word, New York assignments of rent cannot be relied on as absolute assignments, at least not in the bankruptcy context.

Like Michigan, Florida also has a rent-assignment statute. But unlike in Michigan, the Florida statutory language is explicit that "[i]f such an assignment is made, the mortgagee shall hold a lien on the rents, and the lien created by the assignment shall be perfected and effective against third parties upon recordation of the mortgage or separate instrument in the public records of the county in which the real property is located, according to law."(Fla. Stat. § 697.07(2)). Florida bankruptcy courts have interpreted that to mean that rents can be used by a debtor, subject to the lender's rights to adequate protection for the use of its cash collateral. See, e.g., In re One Fourth Street North Ltd., 103 B.R. 320 (Bankr. M.D. Fla. 1989)(Assigned rents are property of the debtor's estate, prepetition default and demand notwithstanding, but subject to

mortgagee's lien.). Nonetheless, if a creditor is diligent in pursuing its remedies, it may be successful in obtaining a prebankruptcy final judgment of foreclosure that transfers ownership of the rents, even before the actual foreclosure sale takes place and prevent the rents from becoming property of the debtor's estate. See In re Villamont-Oxford Assocs. Inc., 230 B.R. 445 (Bkrtcy. M.D. Fla. 1998); In re Venice-Oxford Assocs., Inc., 236 B.R. 791 (Bkrtcy. M.D. Fla. 1998).

Conclusion

While lenders concerned about a bankrupt borrower's ability to use rents to fund a case must therefore be mindful of the jurisdiction in which they lend, one thing remains clear. In order to have any likelihood of blocking a debtor's use of assigned rents, the lender must also aggressively and carefully exercise its remedial options after a default. Because a bankruptcy stay would likely prevent the lender from recording a default, filing a foreclosure action or taking other steps to enforce its rights, even if the lender is willing to enter into negotiations with a troubled lender, it should be cautious about delaying exercise of any of its remedial rights. Those include notice to lessees and recordation of default as required by any applicable statute as well as moving for the appointment of a receiver and/or foreclosing on the property. While this will not ensure that rents are kept out of a "lien theory" state debtor's bankruptcy estate if the borrower files for bankruptcy, it affords the lender the surest opportunity to protect its collateral interest.

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