



## Real Estate Committee

### ABI Committee News

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### Absolute Assignment of Rents Does Not Always Bar Debtor's Use of Business Income for Reorganization Efforts

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Two recent decisions have provided guidance concerning the scope of a lender's right to collect "rents" generated by a debtor in possession, and the debtor's corresponding ability to use those "rents" in furtherance of its restructuring efforts: *In re Ocean Place Development LLC*<sup>[1]</sup> and *In re Soho 25 Retail LLC*.<sup>[2]</sup> The issue of whether certain post-petition income generated by a debtor constitutes property of the estate under § 541(a) of the Bankruptcy Code was at the forefront in these cases.

In both cases, the debtors granted security interests to their respective lenders, including pre-petition assignments of leases and rents,<sup>[3]</sup> in connection with certain financing transactions, pursuant to which the debtors made present assignments in favor of their lenders of the right to collect rents under secured leases. The debtors ultimately defaulted under their loans, and the lenders obtained judgments of foreclosure and scheduled foreclosure sales for the debtors' assets. However, before the foreclosure sales could take place, each debtor filed for relief under chapter 11.

Upon filing their respective petitions, each debtor sought to use its business income for ongoing operations and possible reorganization. The lenders opposed debtors'

requests, arguing that the use of such income was subject to the debtors' pre-petition assignment of leases and rents such that all rights, titles and interest in and to the "rents" purported to be covered thereby passed from the debtors to the lenders, and the debtors were barred from using such income to operate or fund their reorganization plans. Although the *Ocean Place*<sup>[4]</sup> and *Soho 25* courts reached opposite conclusions—the former holding that the income in question was property of the estate (and thus, capable of being used by the debtor as cash collateral), and the latter holding that such income fell outside the estate—the cases are not contradictory. The *Ocean Place* court examined the applicability of an assignment of leases and rents to personal property governed by the Uniform Commercial Code (UCC), whereas the *Soho 25* case considered an assignment of leases and rents as applied to interests in real property.

### ***Ocean Place***

The owners of Ocean Place, a beachfront resort property located on 17 acres along the New Jersey shoreline, filed for chapter 11 protection in mid-February 2011. Ocean Place operates a full-service hotel, including three restaurants, a bar/lounge, full-service spa and various other amenities, and realizes income from these operations. Prior to its filing, Ocean Place borrowed approximately \$52 million from a lender for its redevelopment and operating needs. In connection with this financing, Ocean Place executed a series of documents, including a mortgage, assignment of rents and leases, security agreement and lockbox agreement. In addition, the lender filed various UCC financing statements covering substantially all of Ocean Place's non-real estate assets. The debtor's income was primarily generated from charges relating to room occupancy, food and beverage sales, catering, gift shop purchases, spa and other hotel services. Even though Ocean Place's income was derived from sources other than traditional rents from leasehold interests in real property, the assignment of rents and leases and other loan documents broadly defined Ocean Place's various sources of income as "rents."

Upon filing a petition for chapter 11 relief, Ocean Place sought to use hotel revenues to operate post-petition, which was met with objection by its secured lender. The lender also filed a motion for relief from the automatic stay and a dismissal of the case. In its objection to Ocean Place's use of cash collateral, the lender argued that Ocean Place had no right to use its hotel revenues because that income was previously assigned to the lender pursuant to the assignment of leases and rents, and the debtor's license to collect those "rents" was revoked upon its default under the loan.

To resolve this dispute, the bankruptcy court needed to decide whether the lender

may avail itself of the holding of *In re Jason Realty LP*,<sup>[5]</sup> whereby the Third Circuit Court of Appeals ruled that rents that are subject to a pre-petition assignment of leases and rents agreement are not part of the estate and thus may not be used by a debtor post-petition without the lender's consent. Applying New Jersey law, the *Jason Realty* court treated the assignment of leases and rents as an absolute assignment, which transferred title to the assignee (lender) upon execution. Following such an assignment, the borrower no longer retained an interest in the rents collected, aside from a revocable license to collect and apply those rents until such time as there was a default under the loan. Such an assignment of rents, according to the *Jason Realty* court, is an assignment of an interest in real property insofar as it is derived from leasehold interests in real estate.

In ruling against the lender, the *Ocean Place* court distinguished *Jason Realty* on the grounds that the income claimed by the lender in *Ocean Place* to be subject to a prior assignment of leases and rents—the receipts realized by Ocean Place from hotel, spa and restaurant operations—was not, in fact, an assignment of an interest in real property, but was rather an assignment of receipts from non-real estate interests. The reviewing court disregarded the broad characterization of Ocean Place's hotel revenues as "rents" in the various loan documents and instead held that its revenues were "accounts" or "payments intangible" as defined in Article 9 of the UCC.<sup>[6]</sup> The court reasoned that the occupants of a hotel are not "tenants" who possess an interest in real property but are mere licensees who have only a personal contract with the hotel. As such, the lender's security interest in the income derived from hotel operations is an interest in personal property governed by Article 9 and is not capable of being absolutely assigned to the lender pre-petition like traditional "rents." Accordingly, the hotel revenues are part of the estate and are available cash collateral for debtor's use in operations and reorganization.

*Ocean Place* provides useful guidance by clarifying that the *Jason Realty* holding is limited to the assignment of interests in real property (*i.e.*, rents derived from leases of real estate), and will not otherwise extend to income earned from non-real estate interests, such as hotel revenues. Accordingly, lenders must be cognizant that they cannot, through the use of broadly defined terms, contract themselves out of the application of the UCC in order to avail themselves of more favorable rights governing interests in real property.

### ***Soho 25***

Like *Ocean Place*, *Soho 25* attempts to resolve the competing interests of a lender and debtor to post-petition income, which is arguably subject to a pre-petition assignment of leases and rents. The distinguishing fact, aside from its venue in New

York, is the fact that the revenues in question were comprised of income attributable to real property leases. Specifically, the “rents” at issue were generated by Soho 25’s leases of condominium units located in New York.

The debtor sought a determination that rents generated by its condominium units were property of the estate under § 541(a) and that its pre-petition assignment of rents to the lender was merely offered as additional security and should not be treated as an absolute, present assignment. As in *Ocean Place* and *Jason Realty*, the *Soho 25* court analyzed the substantive law of the jurisdiction in which the real property was located in order to determine the parties’ respective rights *vis-à-vis* the rents. The *Soho 25* court recognized that New York law is not clear as to whether an absolute assignment of rents automatically transfers title to the rent upon execution, though it noted that the majority view is that since New York operates under the lien theory (as opposed to title theory) concerning mortgages, such an absolute assignment is not permitted (regardless of language in the instrument suggesting to the contrary).

Following Soho 25’s loan default, the lender sent letters to property tenants requesting that they remit rent directly to the lender. The lender also commenced a foreclosure action that included a demand for the appointment of a rent receiver. A rent receiver was subsequently appointed, and a default judgment on the lender’s action was entered. As is often the case, before the lender could foreclose on the property, Soho 25 filed for protection under chapter 11 and sought to use its revenues to fund its plan of reorganization. As in *Ocean Place*, the interpretation and effect of the underlying assignment of leases and rents became the principal point of contention in *Soho 25*.

Soho 25 argued that under New York law, an assignment of rents is not recognized as being self-executing and does not become effective until a lender affirmatively asserts its rights to those rents, such as by obtaining the appointment of a receiver and gaining control over the rents. In addition, Soho 25 contended that the assignment was intended solely as additional security for the loan. In contrast, the lender argued that the assignment was absolute and self-executing, and that even if it were not, the lender nevertheless took sufficient steps to acquire ownership of the rents.

The *Soho 25* court ultimately avoided the question of whether New York recognizes absolute assignments of rents and concluded that it “does not need to resolve this murky legal question because the Lender here took sufficient affirmative steps to make the Assignment effective under New York law.” While the court recognized that

the most common factual situation in the case law on assignments involves the actual appointment of a receiver instead of a mere request for a receiver, the “sufficient affirmative steps” taken by Soho 25’s lender pre-petition were sufficient enough to perfect its superior interest in the rents. These steps included the commencement of a foreclosure action, request for an appointment of a receiver, obtaining a judgment in the foreclosure action, obtaining the appointment of a rent referee and scheduling of a foreclosure sale. In addition, the lender’s written demands that tenants remit rent directly to the lender was an additional factor convincing the court that the lender was diligent enough in securing its interests under the assignment agreement.

In addition to recognizing the lender’s pre-petition diligence in its pursuit of remedies against the debtor, the court was further persuaded by the lender’s actions after Soho 25 filed for bankruptcy protection. The lender’s efforts seeking relief from the automatic stay were, in the court’s view, further evidence of the lender’s intent to realize on its rights. Because the court found that the debtor had no rights to the rents by virtue of the pre-petition assignment of those rights to the lender, and thus could not use the rents to fund its reorganization plan, the court dismissed the debtor’s bankruptcy case.

### **Conclusion**

Lenders and debtors alike should take notice of the recent developments in assignment of rents and leases and its potential impact on the debtor’s ability to reorganize under the protections of the Code. Both parties must be cognizant that courts will scrutinize the underlying agreements to ascertain whether they comply with applicable law. Further, the *Ocean Place* decision made it clear that courts will not permit lenders to draft themselves out of the applicability of the UCC in order to get stricter controls over the debtor’s income stream. Simply put, hotel revenues constitute a UCC collateral, whereas “rents” only relate to realty income governed by non-UCC laws.

1. *In re Ocean Place Development LLC*, --B.R.--, 2011 WL 1195943 (Bankr. D. N.J. March 31, 2011) (MBK).

2. *In re Soho 25 Retail LLC*, 2011 WL 1333084 (Bankr. S.D.N.Y. March 31, 2011) (SHL).

3. The parties entered into other documents as well evidencing the lender’s security interest in the debtor’s assets.

4. Lowenstein Sandler PC was restructuring counsel for Ocean Place Development LLC.

5. *In re Jason Realty LP*, 59 F.3d 423 (3d Cir. 1995).

6. See UCC § 9-109(a). Recently, another bankruptcy court recognized that interests in receipts generated by a miniature golf course are not governed by real property law but by the UCC. *In re The Wright Group Inc.*, 443 B.R. 795 (Bankr. N.D. Ind. 2011).

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