

BANKRUPTCY LAW

Absolute Assignment of Leases and Rents in 3d Cir Bankruptcy Law

By Joseph McCarthy

It has become standard in commercial loan transactions for commercial lenders to require a borrower to execute an absolute assignment of leases and rents as additional security for the repayment of a loan. Unlike a mortgage, which serves as a lien or encumbrance on real estate, an absolute assignment of leases and rents conveys present and immediate ownership of the leases and rental income to the lender under New Jersey law. Generally, most absolute assignments of leases and rents confer a revocable license to the borrower to collect and use the rental stream until an event of default. Upon a default, the lender is authorized to demand possession of the rental income from the borrower and tenants and to use the proceeds to pay-down the debt and fund the carrying costs associated with the property.

In the bankruptcy context, an absolute assignment of leases safeguards the lender's rights and remedies to collect and use the rents generated from

a mortgaged property both before and after bankruptcy action is commenced. Under the Bankruptcy Code, property of the bankruptcy estate consists of all property in which a debtor holds an interest upon the commencement of the case. Section 541(a)(1), (6). However, because New Jersey law provides that an absolute and unconditional assignment of rents transfers legal title to the rents to the lender, the Third Circuit Court of Appeals held in *Jason Realty LP*, 59 F.3d 423 (3d Cir. 1995), that a debtor retains no interest in the rents, and the rents are not property of the bankruptcy estate within the meaning of Section 541.

Under New Jersey law, an assignment is "absolute" if its language demonstrates an intent to immediately transfer the assignor's rights, title and interest in and to the rents. However, where the language of the assignment does not convey an absolute and present transfer of ownership of the rents to the lender, but rather a security interest in the rents as collateral for the loan, New Jersey bankruptcy courts will decline to treat the assignment of rents as "absolute." An assignment of rents contained in a Chapter 7 debtor's mortgage which "absolutely and



unconditionally" transferred immediate ownership of all rents and revenues from debtor to lender, was found to be "absolute" by the United States District Court for the District of New Jersey in *In Re Cordova*, 500 B.R.701 (D.N.J. 2013). Thus, courts carefully consider the language in the assignment in determining whether the assignment was intended to be an absolute and present transfer of ownership of the rents to the lender.

Since the rents subject to an absolute assignment of leases and rents is not part of the debtor's bankruptcy estate under Section 541 of the Code, the rents may not be used to fund the debtor's Chapter 13 or Chapter 11 plan of reorganization. The U.S. Bankruptcy Court for the District of New Jersey in *In Re Surma*, 504 B.R. 770 (Bankr. D. N.J. 2014), held that an absolute and

McCarthy is a partner with Meyner and Landis in Newark. He represents clients in both state and federal courts in bankruptcy, insolvency and other creditors' rights matters.

unconditional assignment of rents in a Chapter 11 debtor's mortgage prevented the rents from becoming part of the debtor's Chapter 11 bankruptcy estate. Accordingly, the court ruled that the debtor could not use the rental income to pay the secured portion of the lender's bifurcated claim under debtor's proposed Chapter 11 plan.

Although *Jason Realty* settled any dispute over whether rents subject to an absolute assignment are part of a debtor's bankruptcy estate and whether they may be used to fund a debtor's plan of reorganization, it did not resolve all of the legal issues surrounding assignments of leases and rents in the Third Circuit.

For example, one of the unsettled issues in the Third Circuit is the effect of the merger doctrine on a lender's rights and remedies under an absolute assignment of leases and rents after the lender obtains a final judgment of foreclosure. Under New Jersey law, the merger doctrine provides that upon entry of final judgment of foreclosure, the promissory note, the mortgage, and the assignment of leases and rents merge into the foreclosure judgment. As a result, all of the lender's contractual rights under the loan documents are extinguished and the only thing remaining is the foreclosure judgment itself.

The effect of the merger doctrine on a lender's rights under an assignment of rents after entry of final judgment was considered by the U.S. Bankruptcy Court for the District of New Jersey in *In re Bridgepoint Nurseries*, 190 B.R. 215 (Bankr. D. N.J. 1996). There, the court concluded

that the lender's interest in rents, pursuant to a pledge of rents contained in a mortgage executed by the Chapter 7 debtor's landlord, merged into the final judgment of foreclosure, and therefore the lender did not have rights to collect and use the rents until after it acquired possession of the property through a foreclosure sale. It is important to recognize that the mortgage in question did not contain an absolute assignment of rents but rather a collateral pledge of the rents. The outcome may have been different had the lender's mortgage contained an "absolute" assignment of the rents as opposed to a collateral pledge of the rents. The Third Circuit Court of Appeals has yet to consider the legal effect of the merger doctrine on an absolute assignment of rents.

Another issue that remains open for interpretation is the extent to which the appointment of a rent receiver for the mortgaged premises eradicates an absolute assignment of rents. In *Wells Fargo Bank v. Ashley Business Park*, the Third Circuit Court of Appeals rejected the lender's claim that post-petition rents collected by the receiver belonged to lender under an absolute assignment of rents and could not be used to pay a brokerage commission. In that case, the debtor entered into a pre-petition brokerage agreement with a leasing agent prior to the appointment of the rent receiver. In affirming the district court's ruling, the court explained that once the receivership order was entered, the receiver acquired "complete possession" of the rental income generated by the receivership estate and was

authorized to pay the "current and actual operating expenses" of the mortgaged premises. The court went on to explain that the district court had the authority, by virtue of the receivership order, to determine the appropriate use of the rent money, regardless of which party had title ownership to the rents.

In sum, a commercial lender seeking to protect and preserve its rights to the rental income generated by the mortgaged premises, should retain experienced counsel who is well versed in this area of law and who understands what language is required in loan documents to make an assignment of leases and rents "absolute." Furthermore, upon an event of default, the lender's counsel should carefully consider how the lender's exercise of its rights and remedies will impact the lender's absolute assignment. The lender's counsel should come up with a strategic plan as to the timing and the sequence of the lender's election of its rights and remedies. Thought should be given by lender's counsel as to the impact of the appointment of a rent receiver and the language used in the receivership order. While the fundamental holding of *Jason Realty* is hailed as a tremendous victory for lenders in the Third Circuit, there are many issues and nuances that remain unresolved which will be litigated for many years to come. However, knowledge of these issues and careful planning and preparation in advance of litigation will place the lender in the best position to protect its rights and remedies. ■