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Problems That Arise When Assigning Rents for Real Property In Bankruptcy

By William E. Ireland

Today's real estate market and business environment continues to challenge and confound landlords, property owners, lenders and tenants. For instance, when a residential building owner defaults on his mortgage, it leads to an all-too-common set of problems. When lenders give out commercial loans, they do so in exchange for not just security in the real property but more importantly, to obtain a security interest in the rents of the property. In a 100+ unit residential complex this can be a significant amount of money that is generated by the property on a monthly basis. In these challenging times, where several borrowers are seeking bankruptcy protection, lenders should be more wary than ever of protecting the full scope of their collateral which includes the rents. How can lenders best protect their security issue in the rent notwithstanding the potential that a borrower may file for bankruptcy protection?

The debtor, of course, seeks to discharge his entire debt, to retain as many assets as possible, and to accomplish these goals at a minimal cost. The most obvious source of continued income -- rent proceeds -- can be used to fund a reorganization. In most cases but not always, the tenant generally wants to remain in the rental property. And, it's only natural for a tenant to also want a landlord who is capable of making needed repairs and/or promised improvements.

Likewise, the mortgage holder wants to keep its security interest, receive payments and still be able to foreclose on the property, if necessary.

As a condition of financing, mortgage holders often require and receive an assignment of rents. *Civil Code* Section 2938 gives the lender the right to collect rent in the event of default. Just as there can be multiple lenders for the same property, there can be more than one assignment of rents for a single property. That can lead to a struggle for priority among the conflicting lenders. Priority is determined by the effective date, or in other words, the date the assignment is recorded. However, if there are two or more recorded assignments secured by the same property, the right to collect and receive rents depends on the date each assignee enforces his perfected lien. In other words, a junior assignee can enforce its assignment of rents by beating a senior assignee in collecting and retaining the rights to the property. However, that sort of priority is temporary. When the senior assignee enforces its rights, it then prevails over the junior assignee's rights. The senior assignee will be entitled to all the rents that are accrued and unpaid as of the date it enforces its senior assignment, and to any subsequent rents. However, according to *Civil Code* § 2938 subdivision (b), a senior assignee cannot recover rents that a junior assignee has already collected.

The assignment of rents creates other issues. Even though the lender is receiving rent payments under an assignment of rents, the other rights and responsibilities the owner/landlord has with respect to tenants remain unchanged. Conflicts arise when one party has obligations of ownership and yet another party has the right to collect rents. For example, the lender who is receiving rent is still not obligated to maintain the premises. The owner, who is not receiving rent, has little motivation or ability to maintain the premises.

Bankruptcy further complicates the situation. Most often, the lender acquires a true assignment of rents. In these cases, the lender does not have to perfect the lien because his interest is unconditional. If the property owner has filed for bankruptcy, that bankruptcy does not defeat the ability of the lender to benefit from the recorded assignment of rents. 11 U.S.C. § 552(b); *Matter of Charles D. Stapp of Nevada, Inc.*, 641 F.2d 737, 739-740 (9th Cir. 1981). However, in many cases, the lender obtains a lien on rents by an

assignment for additional security. If the lien is an assignment for additional security, the lien must then be perfected.

Under 11 USC Section 544(a), if the lien is not perfected, then the bankruptcy trustee's claim will prevail over the lien. If the bankruptcy case is filed before the lender perfects the lien, the lender cannot perfect it by the common means of appointing a receiver. Doing so is a violation of the automatic stay per 11 USC Section 362(a). However, Bankruptcy Code Section 546(b) and 362(b)(3) allow a creditor to perfect or continue perfection of a security interest by giving notice in lieu of enforcement, or by giving notice under state law. The lender can create very different results depending on subtle differences in its actions.

In one tricky example, a lender may have filed a pre-petition UCC financing statement in addition to a deed of trust. In this case, the lender can file UCC continuation statements, without seeking relief from stay to do so. A lender has choices in how it may go about providing the notice required by Section 546(b). If the lender is seeking relief from stay, it can ask that rents be sequestered as one element of its motion. Or if it does not want to concede that relief from stay is necessary, it can file a notice of perfection of lien on rents with the trustee for the bankrupt entity. However, this must be done quickly and must also be served on the debtor.

When a bankruptcy is filed, the appointment of a receiver gives rise to a different set of challenges. First, the receiver is prohibited from automatically distributing the debtor's property. In other words, the receiver cannot continue payments of rent that may have been going to the lender; nor can it pay out proceeds that have been received but not yet distributed to the lender. 11 USC 543(a)-(b). In a single asset bankruptcy, it is common for a secured lender with a perfected lien on rents to be paid post-bankruptcy rents net of operating expenses as a form of adequate protection. And, 11 USC Section 362(d)(3)(B)(i) expressly allows that relief. Accumulated rents become additional security for the lender's claim. Thus, the secured creditor's collateral equals the value of the real estate plus the accumulated rents. *Liberty Nat. Enters. v. Ambanc, et al.* 115 F3d 650(9th Cir. 1997).

The threshold issue that remains is whether the lender holds a presently effective absolute assignment of rents. If it does, the rent would not be property of the bankruptcy estate. *First Fid. Bank v. Jason Realty(In re Jason Realty)*, 59 F3d 423(3rd Cir. 1995). If the rent is not part of the estate, then the trustee cannot use any portion of it for the benefit of the bankruptcy estate. If the rent is part of the bankruptcy estate, then the parties must stipulate or litigate how the cash collateral will be used, a decision that requires court approval. Fed. R Bankr. 4001(d)(1).

Finally, lenders are always concerned about protecting their interest in the property as well as their right to receive rent. The California "one action rule," as defined by *Code of Civil Procedure* § 726, provides there can be only one form of action to recover any right secured by a mortgage or deed of trust. That remedy is foreclosure. *Alliance Mortgage Co. v. Rothwell*, 10 Cal.4th 1226, 1236 (1995). Obviously the question that arises is whether paying rents to the lender violates the one action rule. *In re Sunnymead Shopping Center Co.*, 178 B.R. 809 (BAP 9th Cir. 1995) found that it was not.

In short, assignment of rents and bankruptcy estates involving real property affected by the assignment of rents create complicated technical problems. As a result, a lender must carefully analyze its use of the available remedies to protect its interest in the rent proceeds, and to protect its rights in the underlying property. Given that property is often a major - or even the sole - asset in a bankruptcy estate, courts will require careful compliance.

For all these reasons, the lender needs to anticipate the possibility of bankruptcy from day one when the loan documents are being prepared, and take all necessary steps to protect its security interests in the rents as well as in the property, even if the property owner seeks bankruptcy protection.

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