Absolute Assignments of Rents Survive Filings

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A critical threshold question in commercial real estate bankruptcy cases is whether real property rents constitute property of the debtor's estate within the meaning of § 541 of the Bankruptcy Code. Based on the language in the assignment, bankruptcy and federal appellate courts have found assignments of rents to be absolute transfers rather than collateral transfers under the laws of various states, including Idaho,[1] Michigan,[2] Missouri,[3] New Jersey,[4] New York,[5] Pennsylvania,[6] Tennessee,[7] Texas,[8] Vermont[9] and Wisconsin.[10] Lenders have successfully prevented debtors owning properties in these states from using real property rents that were absolutely assigned prepetition to operate their properties postpetition or to fund reorganization plans because such rents were deemed *not* to be property of the debtors' respective bankruptcy estates.[11] Rents are usually the sole source of real estate debtors' income, and accordingly, such findings effectively block these debtors from confirming plans of reorganization without their lenders' consent.

Until recently, it has been generally understood that where a borrower has executed and delivered an absolute assignment of rents and leases that transfers title to the rents under applicable nonbankruptcy law before filing for bankruptcy, the rents are not property of the borrower's bankruptcy estate and may not be used to support its reorganization. A trio of recent decisions has cast doubt on this assumption.

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Cases Relying on § 541(a)(6)

Three courts recently held that postpetition rents constitute property of a debtor's estate by virtue of § 541(a)(6) despite the debtor's execution of an absolute assignment of rents.[12] In *Amaravathi Ltd. Partnership*, the Bankruptcy Court for the Southern District of Texas observed that the Supreme Court held in *Butner v. United States*,[13] a case decided under the Bankruptcy Act, that property rights in rents received after the property owner has filed for bankruptcy are generally determined by reference to state law.[14] However, the *Amaravathi* court noted that the *Butner* court left no doubt that Congress has the power to enact uniform bankruptcy laws that override state law pursuant to Art. I, § 8, cl. 4 of the U.S. Constitution. The *Butner* decision was issued in 1979 and did not involve application of § 541(a)(6), which was enacted after *Butner* and provides that a debtor's estate includes "[p]roceeds, product, offspring, rents or profits of or from property of the estate."

The *Amaravathi* court determined that in enacting § 541(a)(6), Congress decided to supersede state law so that debtors could use post-petition rents to operate and reorganize.[15] It reasoned that there was no doubt that: (1) the relevant real properties in that case were owned by the debtors and thus constitute property of their estates under § 541(a)(1); and (2) the rents at issue came directly from those properties.[16] Based on those propositions, that court concluded that, under the unambiguous language of § 541(a)(6), the rents generated by the debtors' properties are property of their bankruptcy estates.

In *Bryant Manor LLC*, a Kansas bankruptcy court followed the holding of *Amaravathi*. An Eastern District of Texas bankruptcy court also held in *Las Torres Development* that post-petition rents are property of a debtor's estate under § 541(a)(6), notwithstanding the debtor's pre-petition execution of an absolute assignment of rents.[17] The *Las Torres* court also stated that the fact that the debtor had retained physical possession of post-petition rents it had collected was a sufficient basis to conclude that the debtor owned at least some property interest in such rents sufficient to qualify them as property of the estate under § 541(a)(1).[18]

Problems with this Statutory Construction

At first blush, the reasoning adopted in these recent cases seems to be logical and practical: Rents generated by property of the estate are themselves property of the estate under § 541(a)(6). It is tempting for bankruptcy courts to identify methods to assist honest debtors in their reorganization efforts, especially during an economic downturn, but the plain-reading approach adopted in these cases should be rejected.

As the *Amaravathi* court acknowledged,[19] it is well-settled that courts do not follow the plain reading of a statute if doing so leads to absurd results. A "plain reading" of § 541(a)(1) and (a)(6) would do just that. For example, if a building owner leases space to a tenant who in turn subleases the space to a subtenant, no one could seriously argue that rents paid by the nondebtor subtenant to the nondebtor tenant would magically become property of the building owner's bankruptcy estate should it become a debtor under the Bankruptcy Code.

Similarly, under the plain-reading approach, a ground lessor who has entered into a 99-year ground lease with respect to a building could reap a huge windfall if it files for bankruptcy. Suppose the ground lessee obtains

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1 *In re Gould*, 78 B.R. 590, 593 (D. Id. 1987).
2 *In re Woodmere Investors Ltd. P'ship*, 178 B.R. 346 (1996) (Bankr. S.D.N.Y. 1995) (applying Michigan law).
3 *In re South Pointe Assocs.*, 161 B.R. 224, 227 (Bankr. E.D. Mo. 1993).
4 *In re Jason Realty Ltd. P'ship*, 59 F.3d 423, 427 (3d Cir. 1995); *In re Carreta*, 220 B.R. 203 (D. N.J. 1998).
5 *In re Brooklyn Properties Ltd. P'ship No. 2*, No. 193-15707-352, *slip op.* at 5-6 (Bankr. E.D.N.Y. March 21, 1994).
6 *Sovereign Bank v. Schwab*, 414 F.3d 450 (3d Cir. 2005); *Commerce Bank v. Mountain View Village Inc.*, 5 F.3d 34 (3d Cir. 1993).
7 *In re Lingham Rawlings LLC*, 2010 WL 3490204, at *7 (Bankr. E.D. Tenn. Sept. 1, 2010); *In re Kingsport Ventures Ltd. P'ship*, 251 B.R. 841, 847-49 (Bankr. E.D. Tenn. 2000).
8 *In re Four Bucks LLC*, 2009 WL 1857432, at *3 (Bankr. N.D. Tex. June 29, 2009).
9 *In re Galvin*, 120 B.R. 767, 771-72 (Bankr. D. Vt. 1990).
10 *In re Century Inv. Fund VIII Ltd. P'ship*, 937 F.2d 371, 375, 378-79 (7th Cir. 1991).
11 For example, the court in *In re Loco Realty Corp.*, 2009 WL 2883050, *6 (Bankr. S.D.N.Y. June 25, 2009), concluded that a debtor that has executed an absolute assignment of rents retains merely "an interest in the rents in the nature of an accounting for any rents beyond the amount of the mortgage debt," but "the cash flow from the rents itself until the mortgage is satisfied are not property of the estate and cannot be used by the Debtor to fund the plan."
12 *In re Bryant Manor LLC*, 422 B.R. 278 (Bankr. D. Kan. 2010); *In re Amaravathi Ltd. P'ship*, 416 B.R. 618 (Bankr. S.D. Tex. 2009); *In re Las Torres Dev. LLC*, 408 B.R. 876 (Bankr. S.D. Tex. 2009). These cases were discussed by Jeffrey J. Graham and Matthew S. Johns, "Post-Petition Rents as Property of the Estate," 6 *Am. Bankr. Inst. J.* 44 (July/August 2010).
13 440 U.S. 48, 55 (1979).
14 *Amaravathi*, 416 B.R. at 622.
15 *Id.* at 624-25.
16 *Id.* at 624.
17 408 B.R. at 885-86.
18 *Id.* at 887.
19 *Amaravathi*, 416 B.R. at 624.

secured financing and grants a leasehold mortgage and a pledge of rents to the mortgagee in order to improve the property and lease it to tenants. If the ground lessor subsequently files a bankruptcy petition, the bankruptcy court adopting a "plain reading" of § 541(a)(6) may declare that all rents due from tenants to the ground lessee constitute property of the ground lessor's estate and must be paid to the ground lessor. Deprived of the right to collect rents from its tenants, the ground lessee would likely default on its mortgage obligations, which would also harm the leasehold mortgagee holding a lien on the rents and provide an undeserved windfall to the ground lessor, who had only bargained for the right to collect ground rent, not the right to the rents due from the tenants as well. Such patently absurd results would threaten to wreak havoc on commercial relationships between tenants and subtenants, and between leasehold mortgagees and their borrowers. Ownership of real property is not tantamount to ownership of the rights to collect the rents paid by tenants at that property. Rents must be paid pursuant to leases, and if the borrower absolutely assigned all of its rights, titles and interest under all existing and future leases to a lender pre-petition, a bankruptcy filing should not negate that.

Moreover, the Supreme Court has explained that the plain meaning of legislation should be conclusive, except in rare cases in which the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters.[20] In such cases, the intention of the drafters controls.[21] The intent of Congress, memorialized in the legislative history to the Code, is that § 541 is not intended to expand a debtor's rights beyond those that exist at state law. Both the House of Representatives and Senate reports provide that § 541 "is not intended to expand the debtor's rights against others more than they exist at the commencement of the case."[22]

Courts nationwide have recognized the central precept of bankruptcy law that § 541 does not expand a debtor's rights beyond those that exist under state law.[23] A debtor in possession succeeds only to the title and rights in property that it had and takes the property subject to the same restrictions that existed at the time the debtor filed its bankruptcy petition.[24] A debtor cannot use the cover of bankruptcy to acquire greater property rights than it was entitled to prior to bankruptcy.[25]

Assignments of rents are interests in real property, and one must first examine state law to determine whether the debtor holds any ownership interest in the rents. If so, federal law dictates the extent to which the rents are property of the estate and may be utilized by the debtor.

Finally, the conclusion that Congress intended to preempt state law property rights in enacting § 541(a)(6) is also suspect. There is a strong presumption *against* inferring congressional pre-emption of state law property rights in the bankruptcy context.[26] When Congress intends to displace state nonbankruptcy law, it has done so clearly and explicitly, using the phrase "notwithstanding any other applicable nonbankruptcy law" or similar language, which appears in other Code provisions, such as §§ 1123(a), 541(c)(1), 728(b) and 363(l).[27] Neither the legislative history nor the text of § 541 reflects an intent to preempt state law property rights in rents absolutely assigned pre-petition. The distinction between § 541(c)(1), for example, which includes the phrases "becomes property of the estate...notwithstanding any provision... in...applicable nonbankruptcy law," and § 541(a)(6) (and § 541(a)(7)), which lack any similar language—is unmistakable. There is no indication of federal pre-emption in these latter sections.

Proper Methodology for Applying § 541

There is a well-established methodology employed to ascertain whether a particular asset is "property of the estate." "Although § 541 defines property of the estate, we must look to state law to determine if a property right exists and to stake out its dimensions."[28] Once that state law determination is made, we must still look to federal bankruptcy law to resolve the extent to which that interest is propert-y of the estate.[29] Assignments of rents are interests in real property,[30] and one must first examine state law to determine whether the debtor holds any ownership interest in the rents. If so, federal law dictates the extent to which the rents are property of the estate and may be utilized by the debtor.

Conclusion

In *Jason Realty Ltd. P'ship*,[31] the Third Circuit Court of Appeals succinctly described the impact of applicable state law upon assignments of rents, which bankruptcy courts are to enforce:

> A federal court in bankruptcy is not allowed to upend the property law of the state in which it sits, for to do so would encourage forum shopping and allow a party to receive "a windfall merely by reason of the happenstance of bankruptcy." *Butner*, 440 U.S. at 55, 99 S.Ct. at 918. Thus in determining whether the parties' assignment of rents transferred title or, instead, created a "security interest," our goal must be to ensure that [the lender] "is afforded in federal bankruptcy court the same protection [it] would have under state law if no bankruptcy had ensured." *Id.* at 56, 99 S.Ct. at 918. We thus turn to [state] law to classify the parties' interests in the rents.[32]

The otherwise worthy desire for achieving a chapter 11 reorganization does not trump the rights of the holder of an assignment of rents.[33] ■

20 *United States v. Ron Pair Enters.*, 489 U.S. 235 (1989).
21 *Id.* at 242.
22 *Moody v. Amoco Oil Co.*, 734 F.2d 1200, 1213 (7th Cir. 1984) (quoting House Report, H.R. Rep. No. 595, 95th Cong., 1st Sess., *reprinted in* 1978 U.S. Code Cong. & Ad. News 5787); *In re Vote*, 276 F.3d 1024, 1026 (8th Cir. 2002) (quoting Senate Report, S. Rep. No. 95-989, at 82 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5868).
23 *See, e.g., Weinman, Trustee v. Graves (In re Graves)*, 609 F.3d 1153, 1156 (10th Cir. 2010) (filing bankruptcy petition does not expand or change debtor's interest in asset); *In re Vote*, 276 F.3d 1024, 1026 (8th Cir. 2002) (Section 541 is not intended to expand debtor's rights against others more than they exist at commencement of case); *Gendreau v. Gendreau (In re Gendreau)*, 122 F.3d 815, 819 (9th Cir. 1997) (filing for bankruptcy cannot give debtor greater interest in asset than that which he owned pre-bankruptcy); *Matter of Sanders*, 969 F.2d 591, 593 (7th Cir. 1992) (bankruptcy trustee succeeds only to title and rights in property that debtor had); *Federal Aviation Admin. v. Gull Air Inc. (In re Gull Air Inc.)*, 890 F.2d 1255, 1261 (1st Cir. 1989) (Code does not create or enhance property rights of debtor); *Peterson v. Berg (In re Berg)*, 387 B.R. 524, 554 (Bankr. N.D. Ill. 2008) (any rights recognized in bankruptcy must have been found under nonbankruptcy law prior to filing of bankruptcy petition); *In the Matter of TTS Inc.*, 158 B.R. 583, 585 (D. Del. 1993) (to extent that interest is limited in hands of debtor, it is equally limited in hands of estate.).
24 *Demczyk v. Mutual Life Ins. Co. of NY (In re Graham Square)*, 126 F.3d 823, 831 (6th Cir. 1997).
25 *Old Stone Bank v. Tycon I Bldg. Ltd. P'ship*, 946 F.2d 271, 276 (4th Cir. 1991).
26 *See Integrated Solutions Inc. v. Service Support Specialties Inc.*, 124 F.3d 487, 493 (3d Cir. 1997).
27 *See id.*
28 *In re Nejberger*, 934 F.2d 1300, 1302 (3d Cir. 1991). *See also Wornick v. Gaffney*, 544 F.3d 486, 490 (2d Cir. 2008) ("Whether the debtor has a legal or equitable interest in property such that it becomes 'property of the estate' under section 541 is determined by applicable state law.") (citation omitted); *Trustee v. Ulz (In re Ulz)*, 388 B.R. 865, 868 (Bankr. N.D. Ill. 2008) ("Whether the debtor has an interest in property in the first place, however, is a matter of state law.").
29 *Bailey, Trustee v. Big Sky Motors Ltd. (In re Ogden)*, 314 F.3d 1190, 1197 (10th Cir. 2002) (citing *Rine & Rine Auctioneers Inc. v. Myers (In re Rine & Rine Auctioneers Inc.)*, 74 F.3d 854, 857 (8th Cir.1996)). *See also Two Trees v. Builders Transport Inc. (In re Builders Transport Inc.)*, 471 F.3d 1178, 1185 (11th Cir. 2006).
30 *Jason Realty*, 59 F.3d at 427.
31 *Jason Realty*, 59 F.3d at 427.
32 *Jason Realty*, 59 F.3d at 427.
33 *Id.* at 430.