

# Assignment of Rents: A Brief Overview

by Henry M. Karwowski

To a creditor's attorney, the expression assignment of rents signifies strength, a potentially lethal weapon. For a debtor's attorney, in contrast, it may precipitate unease, if not anxiety and dread. Whatever their feelings, both types of attorney are well advised to familiarize themselves on the law relating to the subject. In many cases, those involving single asset real estate in particular, it implicates the issue of whether rents constitute property of the estate, and concomitantly, the issue of whether a debtor may utilize rents as a means of implementing a plan of reorganization. Thus, at stake may be nothing less than survival of a bankruptcy case itself.

This article briefly examines: (1) early interpretations of assignment of rents in the context of bankruptcy, (2) *Jason Realty*, the seminal Third Circuit opinion on the issue, and (3) post-*Jason Realty* case law.

## EARLY INTERPRETATIONS

Generally, assignment of rents is an agreement or provision whereby a borrower assigns rents from a property to a lender.

Until the mid-1990s, New Jersey courts differed in their interpretation and application of assignment of rents clauses in the bankruptcy context. For instance, some courts found that the specific language of the operative clause determines the issue of whether rents have been assigned, and hence, whether they no longer constitute property of the estate.<sup>1</sup> Other courts found to the contrary, *i.e.*, that regardless of the language of

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an assignment clause, rents constitute property of the estate by virtue of the debtor's equity of redemption.<sup>2</sup> Meanwhile, still other courts limited their analysis to the issue of perfection of a security interest. These courts did not consider the possibility that a debtor could assign all of its rights in rents to a creditor.<sup>3</sup>

Further confusing matters was the presence of *Commerce Bank v. Mountain View Village, Inc.*<sup>4</sup> In that case the Third Circuit recognized that in a *title theory* state like Pennsylvania, property, including rent, is conveyed to a mortgagee pending repayment of the loan, and held that rents did not constitute property of the estate. Some New Jersey courts distinguished *Commerce Bank* on the basis that New Jersey is a *lien theory state, i.e.*, execution of a mortgage does not convey title to the mortgagee, but rather confers on the mortgagee only a lien on the property.<sup>5</sup>

## JASON REALTY

In 1995, the landscape irrevocably changed with the issuance of

the opinion in *First Fidelity Bank, N.A. v. Jason Realty, L.P. (In re Jason Realty, L.P.)*.<sup>6</sup> In that case, the Third Circuit held that an assignment of rents clause vested the creditor with title to rents and granted the debtor only a license to collect the rents until default.<sup>7</sup> Upon default, the Third Circuit held, the debtor's interest in the rents ceased, and hence, the rents did not constitute property of the estate.<sup>8</sup>

The facts were straightforward. The debtor owned commercial real estate in Aberdeen.<sup>9</sup> Prior to its petition filing, it executed a note, mortgage, and assignment of leases relating to the property.<sup>10</sup> The assignment provided in relevant part that "[the debtor] hereby grants, transfers and assigns to [the creditor] the entire lessor's interest in and to ... certain leases ... TOGETHER with all rents, income and profits arising from said leases."<sup>11</sup> Meanwhile, the mortgage provided in relevant part that "[s]o long as there exists no default ... [the debtor] shall have the privilege to collect ... all rents, income, and profits arising under [the] leases."<sup>12</sup>

The debtor ultimately defaulted on the note.<sup>13</sup> As a result, the creditor sent notices to the tenants of the mortgaged property demanding they pay rent to the creditor.<sup>14</sup> It also instituted a foreclosure action and filed an application for appointment of a receiver.<sup>15</sup> Soon thereafter, the debtor filed its petition.<sup>16</sup>

The bankruptcy court held that the rents constituted cash collateral, and entered an order authorizing their use.<sup>17</sup> The district court reversed the order on appeal.<sup>18</sup> The debtor appealed this determination, as well as an order granting the creditor relief from the automatic stay.<sup>19</sup>

The debtor argued that "the estate held an interest in the rents, because the assignment merely pledged the rents as security," and that "[it] retained title to the rents and that the rents [were] now 'cash collateral,'" the use of which could be authorized by the bankruptcy court.<sup>20</sup> In support of its proposition that the assignment constituted mere collateral, it cited several factors, including: (1) "the assignment was part of a financing transaction," (2) "the mortgage acknowledged that the assignment was given as 'additional security,'" and (3) "rights and liabilities were set forth in the event that [the creditor] acquired title (indicating a future event)."<sup>21</sup>

The Third Circuit rejected these arguments on a number of grounds. First, it invoked New Jersey law for the purpose of determining the debtor's interest in the rents.<sup>22</sup> "It is well settled in New Jersey," the Third Circuit observed, "that an assignment of rents passes title to the assignee."<sup>23</sup> It also recognized that an absolute assignment transfers title to the assignee upon its execution,<sup>24</sup> and that an assignment is absolute if its language demonstrates an intent to transfer immediately the assignor's rights and title to the rents.<sup>25</sup>

Applying this law, the Third Circuit held that "[t]he instant assignment was quintessentially absolute, because it was a total assignment in *per verba de praesenti*."<sup>26</sup> "These parties mutually agreed in words of

the present to transfer full title to the rents," the Third Circuit found.<sup>27</sup> "This exchange inescapably and unambiguously expressed an agreement to assign present title."<sup>28</sup>

Second, the Third Circuit disregarded the assignment's role as "part of a financing transaction" and "additional security for repayment of the note."<sup>29</sup> It recognized that an assignment clause within a mortgage may be independent of the mortgage security.<sup>30</sup> Further, it was "impressed" that the assignment was contained in an agreement separate from the mortgage.<sup>31</sup>

[The creditor] proceeded here as an assignee of rents under rights conferred on a special instrument bearing the title 'Assignment of Lease or Leases,' and not in its capacity as a mortgagee enforcing rights contained in the instrument bearing the title 'mortgage.'<sup>32</sup>

Third, the Third Circuit also brushed aside the conditional nature of the assignment. It noted that, under New Jersey law, an absolute assignment may have conditions,<sup>33</sup> and that "[t]he fact that a right is conditional on the performance of a return promise or is otherwise conditional does not prevent its assignment before the condition occurs."<sup>34</sup> It also noted that under New Jersey law, an assignment may be conditioned upon default.<sup>35</sup>

Finally, the Third Circuit found that any reliance on or reference to its decision in *Commerce Bank* was misplaced.

There is often a failure to recognize, the differences between those cases where the mortgagee attempts to collect rents solely on the strength of the mortgage instruments, and instances where the creditor proceeds solely, as here, as an assignee under an assignment of rents clause.<sup>36</sup>

As a consequence, it cautioned against confusing "assignee apples" with "mortgage oranges."<sup>37</sup>

While it sympathized with "the perennial problem facing bankruptcy judges ... to strike a proper

balance between rights of the creditor and debtor,"<sup>38</sup> the Third Circuit held that "[i]t is important in interpreting New Jersey law that the otherwise worthy desire for achieving a reorganization under Chapter 11 should not trump the rights of an assignee of a lease under a prepetition assignment."<sup>39</sup>

With respect to the automatic stay motion, the Third Circuit noted that the debtor proposed the use of rents as a basis for funding its plan.<sup>40</sup> After recognizing that "when rents are not property of the debtor's estate, they may not be used to fund a plan of reorganization,"<sup>41</sup> the Third Circuit held that the debtor could not demonstrate a reasonable possibility of a successful reorganization within a reasonable time under section 362(d) (2).<sup>42</sup> The debtor also lacked equity in the property.<sup>43</sup> Accordingly, the Third Circuit affirmed the determination granting relief from the automatic stay.<sup>44</sup>

#### POST-JASON REALTY

*Jason Realty* has cast a long shadow over assignment of rents cases. In fact, in every published opinion since *Jason Realty*, New Jersey district courts, in addressing a rent assignment-type issue, have ruled in favor of the creditor, and in only one published opinion has a New Jersey federal court ruled otherwise.

For instance, in *In re Carretta*,<sup>45</sup> a district court, invoking *Jason Realty* found an assignment absolute on the following grounds: (1) the applicable mortgage assignment provision had been written in the present tense, and it contained the terms "absolutely" and "unconditionally," (2) the title of the mortgage document contained the expression "Absolute Assignment of Leases and Rents," indicating that "both parties were at least aware of the potential effect of executing the Mortgage Document," (3) the mortgage document provided for a separate security interest in rents, and (4) the mortgage document provided that "the rights and remedies of Mortgagee shall be cumulative and

not exclusive one of the other," indicating that the mortgage unambiguously provided for both a security interest in rents and an absolute assignment of them.

Likewise, in *MacArthur Executive Assocs. v. State Farm Life Ins.*,<sup>46</sup> a district court, citing *Jason Realty*, found that the presence of conditions in the operative document did not preclude a finding of absolute assignment.

*Jason Realty* has also influenced district courts in the non-bankruptcy context.<sup>47</sup>

Meanwhile, *In re Bridgepoint Nurseries, Inc.*<sup>48</sup> is the lone case in which a court addressing a rent assignment issue found in favor of the debtor. The mortgage in that case provided: "Borrower does hereby mortgage, grant and convey to Lender the following described property ... Together With ... all ... rents ... now or hereafter a part of the property."<sup>49</sup> The bankruptcy court held that this provision gave rise to a mere pledge of rents as additional security.<sup>50</sup> The following factors formed the basis for the holding: (1) "[n]owhere in the mortgage is the word 'assignment' used," (2) "[t]here is no separate section or paragraph indicating that an assignment of rents had occurred or was intended," (3) "[t]here is ... no separate document purporting to be an assignment of rents," and (4) "[t]he only place in the entire mortgage or any of the submitted documents where the word 'rents' appears is in the description of the loan collateral."<sup>51</sup>

#### CONCLUSION

A review of *Jason Realty* and subsequent cases reveals a number of features common to absolute assignment provisions. These include: (1) the expression "assignment of rents" or similar language appears in the title of the mortgage document or in the text of the applicable provision, (2) the applicable document or provision is written in the present tense, (3) the applicable document or provision contains words such as "absolute"

or "unconditional," (4) the assignment is contained in an agreement separate from the mortgage, or in a separate section or paragraph in the mortgage, (5) the mortgage provides for a separate security interest in rents, and (6) the mortgage provides for cumulative, nonexclusive rights and remedies to the creditor.

Creditors are advised to incorporate these features into mortgage and/or assignment documents. Likewise, in the event litigation arises with respect to a previously executed mortgage or assignment, creditors should emphasize the presence of these features. Debtors, in contrast, should emphasize their absence. ■

#### ENDNOTES

1. See, e.g., *In re Glen Properties*, 168 B.R. 537, 541 (D.N.J. 1993); *In re Donato*, 170 B.R. 247, 253 (Bankr. D.N.J. 1994).
2. See, e.g., *In re Mocco*, 176 B.R. 335, 345 (Bankr. D.N.J. 1995). See also *In re Princeton Overlook Joint Venture*, 143 B.R. 625, 633 (Bankr. D.N.J. 1992) (noting the debtor's "collection interest" in rents).
3. See, e.g., *Midlantic Nat'l Bank v. Sourlis*, 141 B.R. 826, 834 (D.N.J. 1992).
4. 5 F.3d 34, 37-38 (3d Cir. 1993).
5. See, e.g., *Mocco*, 176 B.R. at 342; *Donato*, 170 B.R. at 252.
6. 59 F.3d 423 (3d Cir. 1995).
7. *Id.* at 425.
8. *Id.*
9. *Id.* at 426.
10. *Id.*
11. *Id.*
12. *Id.*
13. *Id.*
14. *Id.*
15. *Id.*
16. *Id.*
17. *Id.*
18. *Id.*
19. *Id.*
20. *Id.* at 427.
21. *Id.* at 428.
22. *Id.* at 427.
23. *Id.* (citing *Paramount Bldg. & Loan Ass'n of City of Newark v. Sacks*, 152 A. 457 (N.J. Ch. 1930)).
24. *Id.* (citing *New Jersey Nat'l Bank & Trust Co. v. Wolf*, 155 A. 372 (N.J. Ch. 1931)).
25. *Id.* (citing *In re Winslow Center Assocs.*, 50 B.R. 679, 681 (Bankr. E.D. Pa. 1985)).
26. *Id.* (citing expression "hereby ... assigns" in assignment of rents).
27. *Id.*
28. *Id.*
29. *Id.* at 428.
30. *Id.* (citing *New Jersey Nat'l Bank*, 155 A. at 373).
31. *Id.*
32. *Id.*
33. *Id.* (citing *Stanton v. Metro. Lumber Co.*, 152 A. 653, 654-55 (Ch. 1930)).
34. *Id.* (citing Restatement (Second) of Contracts, §§ 320 and 331).
35. *Id.* (citing *Stanton*, 155 A. at 654).
36. *Id.* at 429-30 (citations omitted).
37. *Id.* at 429.
38. *Id.*
39. *Id.* at 430.
40. *Id.*
41. *Id.* (quoting *Commerce Bank*, 5 F.3d at 38).
42. See *id.* at 430-31.
43. *Id.* at 430.
44. *Id.* at 431.
45. 220 B.R. 203, 211-12 (D.N.J. 1998).
46. 190 B.R. 189, 195 (D.N.J. 1995).
47. See, e.g., *Fed. Home Loan Mortgage Corp. v. B & C Inv. Assocs.*, No. CIV.A. 97-1913 (JEI), 1998 WL 467105, at \*1 (D.N.J. Aug. 11, 1998) (finding that "[it] simply [did] not see how [the mortgagor could] deny that assignment of rents ... [had been] created," where the mortgage provided for an "absolute" and "unconditional" assignment and transfer of all rents and revenues of the mortgaged property to the mortgagee); *Woods Corporate Assocs. v. Signet Star Holdings, Inc.*, 910 F. Supp. 1019, 1029-30 (D.N.J. 1995) (finding absolute assignment where the operative document provided that "[a]ssignor hereby conveys, transfers, assigns and sets over unto Assignee all of Assignor's rights, titles, interests and privileges in, to and under all leases now or hereafter in existence with respect to the Property or any portion thereof").
48. 190 B.R. 215 (Bankr. D.N.J. 1996).
49. *Bridgepoint*, 190 B.R. at 220 (emphasis omitted).
50. *Id.*
51. *Id.*

**Henry M. Karwowski** is an associate with the law firm of Rabinowitz, Trenk, Lubetkin & Tully, P.C.