

Chapman Client Alert

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Current Issues Relevant to Our Clients

Sixth Circuit Holds That a Perfected Assignment of Rents Precludes a Debtor's Use of Rents as Cash Collateral

In *In re Town Center Flats, LLC*,¹ the Sixth Circuit held that under Michigan law a properly perfected assignment of rents bars a debtor from using the rents to fund its operations in a Chapter 11 reorganization. Debtor Town Center Flats, LLC (“Town Center”) received a loan from ECP Commercial II LLC (“ECP”), which Town Center secured with a mortgage and an agreement to assign rents to ECP in the event of default. Town Center later defaulted on its obligation to repay the loan, and ECP filed a complaint for breach of contract and foreclosure of mortgage in Michigan state court. Shortly thereafter, Town Center filed a Chapter 11 bankruptcy petition. ECP moved to prohibit Town Center from using rents collected after the petition was filed. Town Center responded that it would have no income to fund a Chapter 11 reorganization if the rents were not included as part of the bankruptcy estate. The bankruptcy court agreed with Town Center and denied ECP’s motion. After ECP appealed to the district court, which vacated the bankruptcy court’s decision, Town Center appealed to the Sixth Circuit.

The Sixth Circuit began by reviewing the extent of property rights held by the assignor and assignee of rents under Michigan law before moving on to the question of whether the rights retained by the assignor are sufficient for those rents to be included in the bankruptcy estate. The court first noted that the “default rule” in Michigan is that an assignment of rents is unenforceable because it would interfere with the mortgagor’s right of redemption. However, a 1953 statute authorized the assignment of rents “as security” in connection with a mortgage on commercial or industrial property (the “1953 Statute”). Tracing the history of the enforceability of assignments of rents in Michigan, the court noted that Michigan courts generally regard assignments of rents as “ownership transfers.” The court cited to prior Michigan decisions holding that, once an assignee enters into an agreement to assign rents and records the agreement, upon the occurrence of a default, the assignee’s rights “are perfected and binding against the assignor” and the assignor loses its right to collect rents. Therefore, a completed assignment of rents constitutes a “transfer of ownership.”

Town Center argued that the 1953 Statute only allowed for the transfer of a security interest in the rents — not an ownership interest — and so any attempt to transfer ownership of the rents was barred by the default rule that an assignment of rents is unenforceable. In rejecting Town Center’s argument, the court found that the use of an assignment “as security” does not foreclose an ownership transfer, and noted that Michigan courts consistently view assignments of rents as transfers of ownership once the requisite steps for perfection required under state law are completed. In reviewing the assignment of rents agreement at issue, the court found that the broad language stating that Town Center “irrevocably, absolutely and unconditionally” transferred to ECP its right to a “present, absolute and executed assignment of the Rents and of the Leases” was an ownership transfer to the maximum extent permitted by Michigan law. The court also rejected Town Center’s additional arguments that it retained “some rights” to the rents because a completed assignment of rents effectuates a change of ownership that leaves the assignor without any residual property rights in the assigned rents.

While noting that Congress intended for Chapter 11 bankruptcy estates to be broad in scope, the court held that Town Center did not have rights under Michigan law to the assigned rents and they were correctly not included in the bankruptcy estate because Town Center lost all ownership and residual rights to the rent following their assignment in accordance with the 1953 Statute. The concern that single-asset real estate entities may be foreclosed from Chapter 11 was set aside in favor of strict enforcement of the unambiguous state law.

Town Center reaffirms that property rights to collateral must first be analyzed under state law. The result under Illinois law for instance might be different. While a lien in Illinois is deemed perfected as against third parties when it is recorded in the county where the property is located, granting the mortgagee priority “against all parties whose claims or interests arise or are perfected thereafter”,² a security interest in rents arising under an assignment of rents (while perfected against third parties upon recordation), does not grant an interest in

particular amounts, paid after default and constituting rents from the property, until affirmative steps are taken by the mortgagee to acquire possession of the property through either foreclosure or the appointment of a receiver pending foreclosure.³

For More Information

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- 1 2017 WL 1573827 (6th Cir. May 2, 2017).
 - 2 735 ILCS 5/31.5(b); see also *In re Benanti*, 2015 WL 6460010, *4 (C.D. Ill. Oct. 26, 2015) (citing *Matter of Wheaton Oaks Office Partners Ltd. P'ship*, 27 F.3d 1234 (7th Cir. 1994)).
 - 3 *In re Callas*, 2015 WL 1850260, *7 (N.D. Ill. Apr. 23, 2015).

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