AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
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Post-Petition Rents as Property of the Estate: State or Federal Law?

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Recent economic conditions have resulted in significant strain on retail shopping centers, and many are facing reduced rents, failed (or failing) tenants and poor rental markets. Due to the current credit crisis, permanent financing is difficult to obtain, and construction lenders, faced with significant pressure from government regulators, are unwilling to tolerate defaulting borrowers. Reduced income streams and lack of available financing have caused many retail shopping center developers to seek advice as to whether a voluntary chapter 11 proceeding can be used as an effective tool to restructure their debt. This article will discuss the threshold legal issue of whether post-petition rents are property of the bankruptcy estate, as well as analyze a recent emerging alternative approach that has been applied by bankruptcy courts to determine this issue.

Post-Petition Rents: The Lifeblood of the Retail Center's Reorganization

Generally, a retail shopping center's financing, both construction and permanent, is sec-ured by a first mortgage or deed of trust. Additionally, the lender has, in all probability, been granted a blanket security interest in the borrower's personal property, together with an assignment of rents. Depending on the terms of assignment and applicable non-bankruptcy law, an assignment of rents may give the lender more than just a valid lien on the rents: It may transfer title and give the lender exclusive ownership of the rents.

Section 541 of the Bankruptcy Code provides that property of the estate consists of "all legal or equitable interests of the debtor in property as of the commencement of the case" and includes "all proceeds, products, offspring, *rents* or profits of or from property of the estate."[1] A threshold question in any bankruptcy case involving post-petition rents is whether such rents are property of the bankruptcy estate. Classification of rents as estate property in the context of retail shopping center reorganizations is especially important, and in many cases, determines the outcome of a distressed shopping center's ability to effectively reorganize because rents are generally the sole source of income to fund the debtor's reorganization. Few debtors enter bankruptcy with sufficient unencumbered cash reserves to finance a reorganization case. If a debtor lacks unencumbered cash and is unable to obtain post-petition financing, it is faced with two remaining options: (1) seek court approval to use cash collateral, pursuant to § 363 of the Code, which, in the case of a retail shopping center debtor, would be solely comprised of post-petition rents; or (2) convert the case to a chapter 7 liquidation proceeding. Simply put, if post-petition rents are not classified as estate property, it is unlikely that the debtor will be able to effectively reorganize.

On the Edge

The Title vs. Lien Theory Debate

The determination of whether post-petition rents are property of the estate has traditionally been decided by applicable non-bankruptcy law,[2] and hinges on (1) whether there is an assignment of rents, and, in turn, whether that assignment is an absolute assignment of rights to the rents or simply a collateral transfer for the purposes of securing an underlying indebtedness;[3] and (2) whether the applicable non-bankruptcy law is based on a "lien" or "title" theory of

1 11 U.S.C. § 541(a)(2) and (6) (emphasis added).

2 *Butner v. United States*, 440 U.S. 48, 55 (1979) (state law determines nature and extent of security interest post-petition rents in bankruptcy).

3 Michael L. Cook and Lawrence V. Gerber, "Emergency Use of Cash Collateral in Reorganization Cases," Practicing Law Institute, *Commercial Law and Practice Course Handbook Series* 780 PLI/Comm 221, 230-34 (1998).

mortgages.[4] Most bankruptcy courts are hesitant to construe an assignment of rents as an absolute transfer of rights because most states adhere to a "lien theory" rather than a "title theory"[5] of mortgages.

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In a lien theory state, the lender is not entitled to possession of rents even though it holds legal title to the mortgaged property. Thus, bankruptcy courts applying the law of lien theory states are generally reluctant to uphold an absolute transfer of rents unless it is clear from the language of the instrument and the context of the transaction that the parties intended the assignment to be absolute in nature.[6]

Accordingly, a bankruptcy court applying the law of a lien-theory state will often determine that the language attempting to create an absolute assignment of rents instead creates a collateral assignment.[7] For example, in the case of *Foundry of Barrington Partnership*,[8] the court debunked the creditor's assertion that it had an absolute assignment of rents, stating that it did not matter whether the creditor called the arrangement an "absolute assignment" or "Mickey Mouse" because the court viewed the actual arrangement to be that of a granting of a security interest.[9]

On the other hand, in a title-theory state, the lender is the fee-holder of the mortgaged property. The borrower merely holds a revocable license to remain in possession of the mortgaged property until default. Likewise, an assignment of rents makes an immediate transfer of all rights to receive rents to the lender, while the borrower again merely retains a revocable license to collect the rents. Thus, bankruptcy courts applying the law of a title-theory state are more apt to give effect to an absolute assignment of rents without inquiring beyond the language of the instrument to determine the intent of the parties.[10]

This initial determination of the nature and extent of the estate's interest in post-petition rents is crucial to a retail shopping center's ability to effectively reorganize. If an assignment of rents is held to simply constitute a collateral transfer, the rents are property of the estate and may be used to fund the debtor's reorganization.[11] However, if the assignment is absolute, the debtor has no interest in the rents, which are not property of the bankruptcy estate and must be remitted to the secured lender.[12] If post-petition rents are the sole or primary source of income, as is the case with many retail shopping centers, prohibiting the use of such rents to fund a debtor's reorganization is essentially a death sentence. In today's credit climate, it is extremely difficult for any retail shopping center to obtain financing, especially if the center is in the midst of a chapter 11 proceeding. Without financing or the ability to use post-petition rents, a debtor will be forced to forego a chapter 11 reorganization, and either close its doors, surrender its real estate and other property, including rents, to its secured lender, or file a chapter 7 liquidation.

A New Approach Emerges

A recent alternative analysis is emerging whereby bankruptcy courts hold that state law is not controlling, and instead apply federal bankruptcy law to determine that post-petition rents constitute property of the bankruptcy estate, regardless of whether those rents were assigned pre-petition. In the past year, bankruptcy courts in the Fifth and Tenth Circuits have issued three watershed opinions holding that, pursuant to § 541(a), post-petition rents are *per se* property of the bankruptcy estate, no matter if those rents have been absolutely assigned to a lender pre-petition.[13] Each of these three cases discussed applicable state property law, but ultimately concluded that analysis under state law is superfluous because federal bankruptcy law controls the issue of whether post-petition rents are estate property.

Butner v. United States

In *Butner v. United States*,[14] the Supreme Court held that there are two circumstances when bankruptcy courts need not look to state law to determine property rights in the assets of the bankruptcy estate.[15] First, an exception exists when Congress modifies state law through legislation enacted under Congress' "authority... to establish uniform laws on the subject of Bankruptcies throughout the United States."[16] Second, federal law supersedes state property law if "some federal interest requires a different result."[17]

Notably, *Butner* was decided in 1979 while the Bankruptcy Act of 1898 was still in force and had not yet been supplanted by the Bankruptcy Code.[18] The *Butner* Court lamented the fact that Congress had failed to enact a federal statute defining a lender's interest in rents generated from estate property, and challenged the legislature to "exercise its powers to fashion any such rule."[19] *Butner*'s invitation for Congress to enact such legislation was accepted by the passage of § 541(a)(6) of the Code, which unlike the former Bankruptcy Act, clearly states that "the proceeds, products, offspring, *rents* or profits of or from property of the estate" are considered property of the bankruptcy estate.[20]

In re Amaravathi Ltd. Partnership

In *Amaravathi Ltd. Partnership*,[21] the U.S. Bankruptcy Court for the Southern District of Texas noted that the Supreme Court in *Butner* left no doubt that federal bankruptcy law would trump state law if Congress were to enact a statute defining the rights to post-petition rents. *Amaravathi* dealt with a dispute between the bankruptcy trustee and a mortgagee over the rights to post-petition rents collected by the bankruptcy estate. The *Amaravathi* court, relying on *Butner*, held that the enactment of § 541(a)(6) evidenced Congress' unambiguous intent to supersede state property law and make post-petition rents estate property.[22] As such, the court held that § 541(a)(6) "*mandates* that rents generated from

4 *Wolters Village Ltd. v. Village Properties Ltd. (In re Village Properties Ltd.)*, 723 F.2d 441, 443 (5th Cir. 1984).

5 States adhering to the "lien theory" of mortgages include Alaska, Arizona, California, Colorado, Delaware, Florida, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Michigan, Minnesota, Missouri, Montana, Nebraska, Nevada, New Mexico, New York, North Dakota, Oklahoma, Oregon, South Carolina, South Dakota, Texas, Utah, Washington, Wisconsin and Wyoming. Grant S. Nelson and Dale A. Whitman, 1 *Real Estate Financing Law* § 4.1, note 11 (4th ed. 2002). Conversely, states adhering to the "title theory" of mortgages include Alabama, Arkansas, Connecticut, District of Columbia, Maine, Massachusetts, New Hampshire, Rhode Island and Tennessee. Nelson, *supra*, note 5 at § 4.2, n.1 at 157.

6 *First Fidelity Bank v. Jason Realty LP (In re Jason Realty LP)*, 59 F.3d 423, 427 (3d Cir. 1995) ("Assignments of rents are interests in real property and, as such, are created and defined in accordance with the law of the situs of the real property.") (*citing Butner*, 440 U.S. 48 at 55)).

7 *FDIC v. Int'l Prop. Mgmt. Inc.*, 929 F.2d 1033, 1035 (5th Cir. 1982).

8 *In re Foundry of Barrington P'ship*, 29 B.R. 550, 556-57 (Bankr. N.D. Ill. 1991).

9 *Id.*

10 *Commerce Bank v. Mountain View Village*, 5 F.3d 34, 37 (3d Cir. 1993); *Federal Dep. Ins. Corp. v. Int'l Prop. Mgmt. Inc.*, 929 F.2d 1033 (5th Cir. 1991).

11 On the condition that the debtor can adequately protect the secured lender for its use of those rents.

12 *In re Jason Realty LP*, 59 F.3d at 427.

13 *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 Development LLC, et al.*, 2009 WL 09-33872 (Bankr. E.D. Tex. July 22, 2009).

14 *Butner v. United States*, 440 U.S. 48 (1979).

15 *Butner*, 440 U.S. 48, 54 (1979).

16 *Id.* at 55 (quoting U.S. Const. art. I, § 8 cl. 4) (internal quotation marks omitted).

17 *Id.*

18 Although *Butner* was decided before enactment of the Bankruptcy Code, its holding applies nonetheless. *See In re Vill. Props. Ltd.*, 723 F.2d 441, 445 (5th Cir. 1984) (holding that rule set forth in *Butner* "remains unscathed by the new Bankruptcy Code.").

19 *Butner*, 440 U.S. 48, 54 (1979).

20 11 U.S.C. § 541(a)(6) (emphasis added).

21 *In re Amaravathi Ltd. P'ship*, 416 B.R. 618 (Bankr. S.D. Tex. 2009).

22 *Id.* at 625.

property of the estate are included within the bankruptcy estate."[23]

In re Bryant Manor LLC

Similarly, in *Bryant Manor LLC*,[24] the U.S. Bankruptcy Court for the District of Kansas held that even if an assignment of rents constitutes an absolute transfer of rights divesting the debtor's ownership interest in such rents under applicable non-bankruptcy law, § 541(a)(6) "*requires*" the inclusion of the rents in the bankruptcy estate as a matter of federal law.[25] In reaching its opinion, the *Bryant Manor* court extensively cited both *Butner* and *Amaravathi*, and reasoned that because there was no doubt that the debtor's real estate, an apartment complex, was property of the bankruptcy estate, pursuant to § 541(a)(6), any rents generated therefrom also constitute estate property by operation of § 541(a)(6).[26]

In re Las Torres Development

Finally, in *Las Torres Development*,[27] a chapter 11 case involving a retail shopping center debtor, the U.S. Bankruptcy Court for the Eastern District of Texas, joining lockstep with *Amaravathi* and *Bryant Manor*, held that a debtor's interest in post-petition rents generated by estate property is property of the estate pursuant to § 541(a)(6), even though the debtor had executed an absolute assignment of rents pre-petition.

The *Las Torres* court stated that because the retail shopping center itself was owned by the debtor and, as such, constituted property of the debtor's estate, the rents derived therefrom were also property of the estate in accordance with § 541(a)(6), even though the rents had been assigned pre-petition. Thus, according to the court, post-petition rents are estate property and "[§] 541(a)(6) makes no exception for rents that have been assigned—either collaterally, or absolutely—to a creditor."[28]

The court further held that where a debtor retains possession of post-petition rents, § 541(a)(1), which encompasses "all legal or equitable interests of the debtor in property as of the commencement of the case," requires inclusion of such rents as estate property because "physical possession is one of the crucial stick[s] from the bundle of property rights."[29] Thus, according to the *Las Torres* court, even if § 541(a)(6) does not place post-petition rents generated from estate property into the bankruptcy estate, the debtor nonetheless retains some minimal property interest in the rents sufficient to render those rents property of the estate pursuant to § 541(a)(1).[30]

Conclusion

Until recently, bankruptcy courts looked exclusively to applicable state law to determine the nature and extent of a lender's security interest in post-petition rents. In addition to creating inconsistent results, this traditional analysis frustrates the fundamental "fresh start" goal of bankruptcy by severely reducing the likelihood of a debtor to successfully reorganize in a title theory state. Under this traditional analysis, if an assignment of rents is found to constitute an absolute transfer of rights, the debtor is precluded from using those rents in its reorganization. As such, a struggling retail shopping center whose primary or sole source of income is rents has little chance of successfully reorganizing in a chapter 11 proceeding

By including what is often a retail shopping center debtor's sole source of income as property of the estate, § 541(a)(1) and (6) provides debtors with a chance of reorganizing under chapter 11. Granted, such debtors must still meet the requirements of §§ 361 and 363 to use rents post-petition, but those are hurdles any debtor must overcome in a chapter 11 proceeding. The inclusion of rents as property of the estate comports with the Constitution's mandate for uniform application of bankruptcy laws, as well as the Bankruptcy Code's twin goals of providing debtors with a fresh start and maximizing the value of the estate by increasing the likelihood of a debtor's ability to successfully reorganize in a chapter 11 proceeding. ■

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23 *Id.* at 638 (emphasis added).
24 *In re Bryant Manor LLC*, 422 B.R. 278 (Bankr. D. Kan. 2010).
25 *Id.* at 287-88.
26 *Id.* at 288-89.
27 *In re Las Torres Dev. LLC, et al.*, 2009 WL 09-33872 (Bankr. S.D. Tex July 22, 2009).
28 *In re Las Torres Dev. LLC, et al.*, 2009 WL 09-33872 at *13.
29 11 U.S.C § 541(a)(1).
30 *In re Las Torres Dev. LLC, et al.*, 2009 WL 09-33872 at *17.