Creditors Rights, Loan Enforcement and Creditor Bankruptcy Representation

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Lender's EDGE

Ideas and Insights for Dealing with Distressed Assets

The Creditors Rights, Loan Enforcement and Creditor Bankruptcy Representation practice group provides these e-communications periodically to keep you updated on recently adopted legislation, important issues dealing with distressed assets and key changes in the law.

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Exercising an Assignment of Rents: Who is Entitled to the Money?

When a lender takes a mortgage on rental property – whether residential, commercial or industrial – the lender usually takes a separate assignment of rents from the mortgagor (the borrower), which provides the lender a direct right to receive rent payments in the event of a default. But, at what point does the lender have a protectable interest in the rental income from the property? The answer to this question may surprise you.

Generally, a lender's right to collect rents under an assignment of rents clause is not automatic, but requires affirmative steps by the lender to activate the assignment. Often, lenders are reluctant to take possession of rental property prior to foreclosure, and want to try to collect rents without having to assume the burdens of being a "mortgagee in possession". What steps must be taken to allow a lender to collect rents directly from the tenants varies from state to state, and, to some extent, depends on which court is interpreting the applicable state's law. Thus, it is important for a lender faced with a default situation where rental property is involved to consult with an attorney to determine what steps should be taken to exercise an assignment of rents.

I. Enforcing an assignment of rents

a. Missouri law

Courts in Missouri have long held that an assignment of rents does not create an absolute conveyance of the rents to the lender. Instead, the borrower is entitled to receive the rents and profits until the lender "enters into actual possession, or takes some equivalent action" with respect to the property. In more recent times, courts in Missouri have elaborated on the conditions that must be satisfied before a lender may collect rents under an assignment of rents clause, namely:

1. Proper documentation of the assignment;
2. Proper recording of the assignment in the form required for an interest in real estate;
3. Default on the part of the borrower; and
4. Possession of the property by the lender, or action equivalent to possession by the lender.

In short, an assignment of rents is not automatic. Rather, it lies dormant until the lender takes certain steps to activate or perfect the assignment. Only after these steps have been taken may the lender collect rents directly from the tenants.

Of the four conditions outlined above, it is the last that has caused the most controversy and confusion. Specifically, courts have differed over what action by the lender is equivalent to possession under Missouri law.

The Bankruptcy Court for the Eastern District of Missouri has held that proper notice to tenants and revocation of the borrower's license to collect rents are all that is required to permit a lender to collect rents directly from the tenants. To be sure, for notice to be properly sent, it should be sent via certified first-class mail, return receipt requested, or other commercially reasonable delivery service that provides proof of delivery, or, if agreed to by the borrower, by electronic mail or facsimile transmission. The proper address for notice to the borrower is the address in the assignment of rents, and the proper address for notice to a tenant is the address in the tenant's lease, if available, or the address of the property.

In contrast to the Eastern District, the Bankruptcy Court for the Western District of Missouri has held that action equivalent to taking actual physical possession of the property, such as by appointing a receiver to manage the property, is required before the lender may collect rents directly from the tenants. For example the Bankruptcy Court for the Western District has held that a lender's notice to some but not all tenants that they should make rents payments to the lender, without physically taking possession of the property or appointing a receiver to manage the property, and thus leaving the borrower responsible for all services to tenants, did not rise to the level of taking possession or equivalent action as required under Missouri law. Thus, the lender, despite having a validly recorded assignment of rents, did not have the right to collect the rents.

b. Illinois law

Unlike in Missouri, an Illinois lender only becomes entitled to the collection of rents by actual possession or by an affirmative action that must include court authorization. The filing of a foreclosure action or requesting the appointment of a receiver, however, is insufficient to trigger the lender's right to collect rents. But an order appointing the receiver or granting a preliminary injunction ordering rents to be deposited with the court have been held sufficient to protect the lender's interest in assigned rents under Illinois law.

II. Effect of borrower's bankruptcy

When a borrower files Chapter 11 bankruptcy, who is entitled to receive the rents is critical. If the borrower, as the debtor in bankruptcy, does not have access to the rents, it cannot operate. The answer to the question of who is entitled to the rents in this situation differs under Missouri and Illinois law, and even between districts in Missouri.

a. Missouri law

In both the Eastern and Western Districts of Missouri, if the lender has not completed all of the steps necessary to activate its interest in the rents prior to the filing of the bankruptcy petition, it will hold only a security interest in the rents; the rents are "cash collateral" in which both parties have an interest, and may be used by the borrower in the ordinary course of business provided that the lender consents or the lender's interest is adequately protected.

But, in the Eastern District of Missouri, if a lender has taken appropriate pre-petition action to activate its assignment, the borrower loses its entire interest in the rents and they do not become property of the bankruptcy estate or cash collateral. By contrast, the Western District has held that a properly documented and recorded security interest in rents should be treated as though the rents were any other item of cash collateral. In short, the borrower, as the debtor in bankruptcy, does retain some interest in the rents, subject to the security interest of the lender.

Further, in the Eastern District of Missouri, it is still possible for the lender to extinguish the borrower's right to collect the rents, *even after* the bankruptcy case is filed. Under §546(b) of the Bankruptcy Code, a lender may perfect its assignment of rents *after* the filing of the petition by the filing with the bankruptcy court of a demand in lieu of foreclosure. This action gives rise to an interest in favor of the lender that is superior to the interest of the debtor or a bankruptcy trustee as to rents that accrued *after* the filing of the demand. For example, the Bankruptcy Court for the Eastern District of Missouri has held that although rents accrued between the filing of the bankruptcy petition and the §546(b) demand were to be treated as cash collateral, any rents accruing after the filing of the §546(b) demand were property of the lender and any bankruptcy estate interest or claim that may have existed in those rents was abandoned. Notably, the Western District has taken the precisely opposing view, holding that if a lender perfects its assignment of rents after the filing of a bankruptcy petition by the borrower, as provided in §546(b), the rents become cash collateral.

b. Illinois law

Like the Western District of Missouri, the bankruptcy courts in both the Northern and Southern Districts of Illinois have taken the position that even if an assignment of rents is perfected prior to the filing of a bankruptcy petition, the rents remain property of the estate to be treated as cash collateral in bankruptcy. *According to these courts,* Illinois law provides that a mortgagor's ownership interest in mortgaged property and assigned rents are not extinguished by the execution of a mortgage or the appointment of a receiver in foreclosure proceedings. Thus, rents from the mortgaged property are property of the bankruptcy estate and are cash collateral subject to the lender's perfected security interest.

III. The Uniform Assignment of Rents Act – Is help on the way?

Perhaps in response to the array of decisional law concerning assignments of rents, and the often-conflicting requirements imposed on lenders by courts in various states, the National Conference of Commissioners on Uniform State Laws approved and recommended for enactment the Uniform Assignment of Rents Act ("Act") at its July 2005 annual conference. The purpose of the Act is to streamline the ability of commercial mortgage lenders to collect rents and control property income after a default by the borrower. So far, the Act has been enacted into law in only two states – Nevada and Utah.

Compliance with FDIC Policy Guidelines On Prudent CRE Loan Workouts

The FDIC recently issued a Policy Statement on Prudent Commercial Real Estate Loan Workouts that can be found at http://www.fdic.gov/news/news/financial/2009/fil09061a1.pdf. (October, 2009). The Policy Statement updates and replaces prior FDIC guidance for examiners in evaluating a lender's efforts to renew or restructure commercial real estate loans to sound borrowers who have the ability to repay their debts if modified on reasonable terms. In particular, the Policy Statement addresses how various workout strategies may affect the classification of a loan, interest accrual and whether the loan should be reported as a troubled debt restructuring (TDR) for regulatory reporting purposes.

The Policy Statement provides numerous examples of possible debt restructurings, including a bold approach (by FDIC standards) for an acceptable restructuring of a troubled loan into two notes – one that is reasonably assured of repayment and performance that remains on accrual status, and the other that will be adversely classified and charged-off. The obvious benefit of this arrangement is to permit a lender to recognize interest income on a portion of the original obligation while limiting the amount placed on non-accrual status and reported as a TDR.

The new guidance in the Policy Statement is appealing, as it promises some welcome relief to lenders in the face of significant challenges when working with commercial real estate borrowers in the current economic climate. But, there are several issues that a lender should carefully consider when undertaking a loan split or bifurcation, as approved by the Policy Statement under certain circumstances. These issues include the borrower's repayment capacity, the strength of the guarantors and the current collateral value, as well as implementation issues such as the structure of the bifurcation, the effect of the restructuring on junior lienholders and guarantors, whether title insurance is affected, and the documents that will be needed to complete the bifurcation.

Assuming that a lender has carefully analyzed a loan and concluded that restructuring is appropriate, the lender should next determine the structure of the loan modification that will be used to create this bifurcation. The bifurcation might be accomplished with nothing more than two new promissory notes that contain references to the original note and the existing deeds of trust, mortgages and other collateral for the loan. But, the preferred approach should include the creation of a new Loan Modification Agreement that explains the basis of the loan split, the payment terms of each of the loans, the collateralization (and cross-collateralization and cross-default) of the two new loans and the rights and remedies of the lender with respect to both loans. The documentation will vary depending on the facts and circumstances surrounding the original loan, and are not form documents that are available "off the shelf." A lender should work with its counsel to determine the proper structure for the bifurcation, and to develop the forms that will be used.

Second, a lender should determine whether junior lienholders exist, whether their rights might be affected by the bifurcation, and whether they might have any credible arguments that the bifurcation and modification of the loan creates any subordination of the loan to their interests. This analysis will involve a thorough review of the lender's existing loan documents, particularly its existing mortgage or deed of trust and any intercreditor or subordination agreements between the lender and any junior lienholders. Similarly, a lender should determine whether its title insurance policy will be affected in any way by this bifurcation, and whether a date-down endorsement of the policy that specifically acknowledges and insures any modification of the lender's mortgage or deed of trust would help protect against the possibility that a junior lienholder would attain any priority as a result of the modification. A lender should also carefully consider whether the bifurcation requires a modification of the existing deeds of trust or mortgages.

Third, the effect on guarantors and pledgors, including the United States Small Business Administration, must be considered. All such parties should be required to sign acknowledgements that their respective guaranties and pledges will remain in full force and effect after the bifurcation and modification, as to both new loans. These acknowledgements should provide that the lender retains a full range of rights and remedies to enforce either or both of the new notes after bifurcation, and that the guaranties and pledges serve to secure both of the new notes, regardless of the order or priority of enforcement by the lender.

Finally, a lender should carefully consider the effect of this bifurcation and restructuring on the required classification of the loan. The FDIC's Policy Statement is far from a panacea for resolving classification issues with respect to loans, and only those loans that can reasonably be divided into performing and non-performing components will be acceptable candidates for this treatment. As the FDIC states, the restructuring of a portion of the loan "should be undertaken in ways that will improve the likelihood that the credit will be repaid in full under the modified terms in accordance with a reasonable repayment schedule." (FDIC Policy Guidelines, p. 11). Similarly, even though a lender manages to segregate and create a performing component of a loan from an otherwise classified loan, the lender must still determine appropriate loan terms for the non-performing component that will be placed on non-accrual (such as no payments required for a period of time, the creation of a balloon payment that coincides with the maturity of the performing loan, and related provisions). Lenders are encouraged to review these issues with counsel that can assist them in navigating these issues.

Bankruptcy Automatic Stay Waivers that Work

Although waivers of various bankruptcy rights routinely appear in pre-bankruptcy forbearance agreements and other loan workout documents, lenders may rightfully question whether such waivers provide any real protection or advantage if a worst-case scenario of bankruptcy comes to pass. How far will a bankruptcy court go in enforcing such waivers in favor of the lender when a borrower is unable to service the debt and seeks refuge in a Chapter 7 or 11 bankruptcy? Not surprisingly, bankruptcy court cases interpreting such waivers are a mixed bag with some absolutely refusing to enforce any pre-bankruptcy agreement that limits a debtor's fundamental bankruptcy rights, such as the right to file the bankruptcy or to discharge a debt, and other courts permitting debtors to waive certain bankruptcy rights

such as the right to use the bankruptcy automatic stay to foil a lender's efforts to obtain possession of and foreclose on its secured collateral.

The good news for commercial lenders is that the emerging trend is to enforce such waivers in certain situations at least as to waivers of the debtor's right to oppose relief from the automatic stay. The bad news for lenders is that no single bright line test exists to determine whether the bankruptcy court will enforce such contractual waivers. This lack of clarity creates lender uncertainty as to collectability of their loans in a bankruptcy. Fortunately, the bankruptcy courts have developed some guidelines for lenders to follow to maximize the enforceability of pre-bankruptcy waivers.

Although common, pre-bankruptcy waivers prohibiting a borrower from filing bankruptcy or from discharging a particular debt in bankruptcy are never enforced by the bankruptcy courts. The bankruptcy courts consider such waivers to be void as against public policy. Similarly, bankruptcy courts have refused to enforce provisions that preclude a debtor from asserting preference or fraudulent conveyance claims against a lender to recover pre-petition transfers that are intended to improve the lender's secured position in the event of bankruptcy. However, the bankruptcy courts, to varying degrees, have been more tolerant of pre-petition waivers by a borrower that limit opposition to a lender seeking relief from the automatic stay so that it may enforce its remedies under state law such as receivership, assignment of rents, and foreclosure. The bankruptcy courts are most likely to enforce such waivers in commercial bankruptcies such as single asset real estate cases or when they are included in part of a confirmed bankruptcy plan in a prior bankruptcy.

A prepetition waiver of the automatic stay is not self-executing. The prudent lender will file a motion with the court even if the waiver provides none is necessary. The presence of a contractual waiver of the automatic stay is a factor most courts consider in determining whether to grant relief. Other factors commonly considered by bankruptcy courts in evaluating the enforceability of such waivers are:

(1) whether the lender granted substantial concessions as part of the workout and in exchange for the waiver;

(2) material, significant and substantial consideration given by the lender in exchange for the waiver such as a reduced interest rate or extension of the loan maturity date;

(3) debtor and its counsel represent the waiver was voluntarily given after arms length negotiations;

(4) the rights of third party creditors are not prejudiced by granting relief from the stay because the case is essentially a two-party dispute;

(5) no substantial change in circumstances exists and the debtor's property is unnecessary to a plan of reorganization within a reasonable time period; and

(6) the waiver was negotiated by financially sophisticated parties and experienced counsel.

This last factor substantially limits the usefulness of a waiver of the automatic stay in a consumer loan workout followed by a Chapter 7 or Chapter 13 bankruptcy. As a practical matter, it may be advisable for the waiver

provision to include a statement that enforcement is expressly subject to bankruptcy court approval to avoid any appearance that the lender is overreaching and attempting to circumvent the bankruptcy court's jurisdiction to determine the stay relief issue.

Lenders should use the recitals in the pre-bankruptcy forbearance agreement to lay the groundwork for the borrower's waiver if the debtor challenges the provision's enforceability. The agreement should explain the particular concessions given by the lender and that such concessions were made in exchange for the waiver of borrower's right. A detailed recital showing that the property at issue is the debtor's sole income producing asset and that the borrower has no equity in the property may satisfy the bankruptcy court that such property cannot be subject to a successful plan of reorganization. The recitals should address all of the factors that bankruptcy courts have identified as important as well as any unique circumstances justifying the waiver. Waivers contained in forbearance agreements, as opposed to loan origination documents, are more likely to be enforced by the courts. Lenders should review and update their standard forbearance or workout agreements to include an automatic stay waiver provision.

Although pre-petition bankruptcy waivers should, by no means, be considered a "magic bullet" for lenders; if properly drafted, such waivers can substantially improve the lender's ability to obtain relief from the automatic stay in the bankruptcy court if the borrower fails in its attempts to bring the loan current. The actual language of the waiver provision may be of less importance than drafting a forbearance agreement with detailed recitals of fact supporting the particular requirements for bankruptcy relief that the waiver seeks to accomplish and the circumstances existing at the time of the workout agreement.

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Lenders in today's market are under severe stress from rising defaults, distressed portfolios and problem credits of all types. Attorneys in the Creditor's Rights, Loan Enforcement and Creditor Bankruptcy Representation Law group have assisted numerous lenders with creative remedies that help lenders maximize their recoveries.

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