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In re Soho 25 Retail, LLC Benefits Mortgage Lenders in New York

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Earlier this year, Judge Sean H. Lane of the Bankruptcy Court for the Southern District of New York held that the post-petition rental income of a debtor-in-possession's commercial real property in New York City was not property of the debtor's estate under section 541 of the Bankruptcy Code, even though the underlying condominium units were owned by the debtor and had become estate property. The bankruptcy court concluded that control of the rental income had transferred to the debtor's mortgagee, who had begun (but not completed) a foreclosure on the commercial property interests of the debtor, before the bankruptcy's filing. In the decision, *In re Soho 25 Retail, LLC*, No. Adv. 11-1286-SHL, Bkr. 10-15114-SHL, 2011 WL 1333084 (Bankr. S.D.N.Y. Mar. 31, 2011), the exclusion of the rental income stream from the bankruptcy estate thwarted the debtor-in-possession's attempt to reorganize over the mortgagee's objection and markedly improved the creditor's position. Ultimately, the lender won its stay relief motion and completed its foreclosure. The bankruptcy case was dismissed.

Judge Lane's decision merits the attention of mortgage lenders and potential bankruptcy debtors alike, because it could provide significant leverage for secured parties, particularly in single asset real estate cases involving New York property. The holding supports the relatively new theory that New York law permits a mortgagor to transfer its entire interest in rents to a mortgagee upon executing the mortgage, such that the transfer will remain effective in the mortgagor's eventual bankruptcy. The decision also holds that a mortgagee's diligence in enforcing against a debtor upon and after default can cut off the ability of a debtor to use the rental proceeds of the mortgaged property in a subsequent bankruptcy. However, while the bankruptcy court's ruling is certainly good news for mortgage lenders and provides some guidelines for future strategy by both mortgagees and borrowers in distressed situations, the decision also leaves areas of doubt as to how these parties might best guide their behavior to maximize their benefits in a post-*Soho 25* world.

Background

In 2006, Soho 25 borrowed $8.5 million from Greenwich Capital Financial Products, Inc. *In re Soho 25 Retail, LLC*, 2011 WL 1333084, at *1. To secure repayment, the lender obtained a mortgage lien on Soho 25's two commercial condominium units located in a New York City building. *Id.* at *2. The borrower also executed and delivered an Assignment of Leases and Rents for the lender's benefit. *Id.* (After the transaction closed, the note, mortgage and assignment of rents were assigned from Greenwich to the current "lender.") In the Assignment, the borrower agreed that it "'absolutely and unconditionally'" assigned to Greenwich and its successors "'all right, title and interest [of the borrower] in and to all present and future Leases and Rents,'" and further stated that the "'Assignment constitut[ed] a present and absolute assignment and [was] intended to be unconditional and not as an assignment for additional security only.'" *Id.* at *2. Though the recitals of the agreement provided that the "'Assignment [was] being given as additional security for the Loan,'" the lender took the position that it owned the rent stream until the underlying debt was satisfied and that the borrower enjoyed the use of the rental income in the meantime only thanks to a "'revocable license,'" which was limited by the terms of the Assignment of Leases and Rents. *Id.* at *2 and fn. 7.

In June 2009, the debtor defaulted on payments under the loan. *Id.* at *3. On June 18, 2009, the lender sent the borrower a default notice, which "advised the Debtor that, 'by virtue of the Defaults, [its] license to collect rents from the [condominium units was] terminated and the Lender [was] entitled to all present and past due rents.'" *Id.* In late 2009 and in 2010, the lender wrote to the borrower's tenants, instructing them to pay rent directly to the lender, and the borrower joined in one of these letters. *Id.*

The Suit

Soho 25 remained in default under the loan. So, on Nov. 13, 2009, the lender filed a complaint in New York state court to foreclose on the condominium units. *Id.* In the suit, the lender also requested the appointment of a receiver to take control of the property and the rents. *Id.* Soho 25 did not appear in the action, and the state court entered a default judgment against the borrower and all other defendants. *Id.* While the state court did not appoint a receiver, the default order appointed

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a referee to "'ascertain and compute … the amount due to the [Lender] under the Loan Documents … and to examine and report … whether the mortgaged premises can be sold in one parcel.'" *Id*. On July 12, 2010, the referee issued a report, determining the debt owed at more than $11 million. *Id*. The state court entered a judgment of foreclosure and sale on Aug. 11, 2010, which directed the referee to sell the condominium units. *Id*. The public foreclosure auction was scheduled for Sept. 29, 2010, but the sale was stayed when the debtor filed for protection under Chapter 11 of the Bankruptcy Code as a "single asset real estate" case (an "SARE") on the day before the auction. *Id*. at *4.

The Bankruptcy Court Excludes Post-Petition Rent from the Estate

The lender filed a stay relief motion in the bankruptcy case, alleging that the rent payments from the debtor's property did not belong to the bankruptcy estate. *Id*. at *1. The debtor opposed the lender's motion and also filed a complaint against the lender, alleging that the mortgagee was improperly collecting and retaining the tenants' rent payments. *Id*. The bankruptcy court ruled that the lender had taken full control of the rents before the bankruptcy, even though the lender had not completed its foreclosure, thereby depriving the debtor-in-possession of any ability to use rent proceeds from its real property for a reorganization. The bankruptcy court set forth two rationales for this conclusion.

1. The Debtor Had Made an 'Absolute Assignment of Rents Prepetition'

While Judge Lane initially asserted that it was unnecessary to do so (further comment below), he ultimately determined in his opinion that the debtor had effected an "absolute assignment of rents prepetition" pursuant to its mortgage and so retained only "a revocable license in the rents at issue," pursuant to the Assignment of Leases and Rents. *Id*. at *9. The court also ruled that the lender had successfully revoked this license before the bankruptcy filing. *Id*. This revocation, coupled with the remaining debt owed under the mortgage and note, lead the bankruptcy court to conclude that "the rents are not property of the estate." *Id*.

Prior to the *Soho 25* decision, courts had generally concluded that an assignment of rents under New York law by a mortgagor cannot alone alienate the mortgagor's property interest in the rents. *Id*. at *6 (and citations therein); *see also, e.g., In re Pine Lake Village Apartment Co*., 17 B.R. 829, 833 (Bankr. S.D.N.Y. 1982); *Sullivan v. Rosson*, 223 N.Y. 217, 119 N.E. 405 (1918). *Soho 25* is important in part because it rules to the contrary and concludes that a borrower's "absolute" assignment of rents in New York instead can transfer rents to a mortgagee, with effects even after a subsequent bankruptcy filing by the mortgagor. While *Soho 25* is not the very first case where a bankruptcy judge reaches this conclusion (*see, e.g., In re Loco Realty Corp*., No. 09-11785, 2009 WL 2883050, *5 (Bankr. S.D.N.Y. June 2009) (a pre-bankruptcy receiver was also appointed in this case); *In re Brooklyn Props. Ltd. P'ship* No. 2, No. 193-15707-352, slip op. (Bankr. E.D.N.Y. Mar. 21, 1994) (unpublished order cited in Rubin, P., Absolute Assignments of Rents Survive Filings, *Am. Bankr. Inst. J.* 50, fn. 5 (Feb. 2011)), it stands at or near the forefront of this nascent doctrine.

Despite this importance, the decision also leaves some doubt concerning the pre-bankruptcy transfer of rents, because the court's conclusion that the debtor maintained only a revocable license is undermined by the court's earlier statement in the holding that it did not need to resolve the "threshold question" of "whether the Assignment is absolute and thus effective … " *Id*. at *5, 7. In short, the court's announcement that it would avoid this issue calls into question the determination of this very point that later appears in the decision, *Id*. at *8, 9, and may limit the use of *Soho 25* as precedent for the position in subsequent cases.

Judge Lane left open another issue regarding the ability of a borrower/owner to assign absolutely its interest in rents when it grants its lender a mortgage. In *Soho 25*, the court states that even "[a]n absolute assignment of rents prepetition does not necessarily mean that the estate has no interest in the rents for the purposes of section 541 analysis," but then does not elaborate what this lingering interest might be. *Id*. at *8. Lenders analyzing the decision can take comfort that this remaining interest certainly appears not to be the ability to use the rental income stream to reinstate the lender's debt pursuant to a Chapter 11 plan, since the debtor in *Soho 25* had declared early in the case that it intended to do just that, yet the court still concluded that the debtor-in-possession's bankruptcy estate excluded the rental income stream. Judge Lane's nod to some potential remaining interest under section 541 of the Bankruptcy Code, therefore, likely raises little practical challenge to the advantages of a secured lender in a SARE case as described in *Soho 25*, and the debtor-in-possession's corresponding disadvantage.

2. The Lender Took Sufficient Enforcement Steps to Enforce Its 'Right to the Rents'

In its other line of reasoning, the court concluded that the rents fell outside the bankruptcy estate thanks to the "numerous affirmative steps" that the lender had taken to enforce its right to the rents after the June, 2009 default notice. *Id*. at *7. Among these steps, the court listed the following as potentially significant:

- The commencement of a foreclosure action.
- The lender's request for a receiver of rents in the foreclosure complaint.
- Soho 25's failure to appear in the foreclosure action, and its admission that it had "no good faith defense" in the foreclosure.
- The state court's "order entering default."
- The letters to the tenants — from the lender alone and together with the borrower — instructing the tenants to pay rent to the lender.
- The state court's appointment of a referee.

Id.

The bankruptcy court highlighted that New York law permits the "right to rents and profits" to "vest" with the foreclosing lender, prior to a foreclosure sale, if the secured creditor takes sufficient "affirmative steps" to enforce its right. *Id*. at *7.

In fact, numerous court decisions before *Soho 25* had marked this vesting not at the mortgage's delivery, but later when the lender takes possession of the property, or, more often, obtains an order for the sequestration of the rents or a receiver's appointment in a foreclosure action. *See, e.g., In re Pine Lake Village Apartment Co.*, 17 B.R. 829, 833 (Bankr. S.D.N.Y. 1982); *In re Northport Marina Assocs.*, 136 B.R. 911, 916 (Bankr. E.D.N.Y. 1992); *Sullivan v. Rosson*, 223 N.Y. 217, 224-25, 119 N.E. 405, 408 (1918). For some courts, simply a mortgagee's request for a receiver's appointment in a foreclosure, *see, e.g., In re Flowers City Nursing Home, Inc.*, 38 B.R. 642, 645 (Bankr. W. D. N.Y. 1984), or a formal demand for possession of the property, *see, e.g., 1180 Anderson Ave. Realty Corp. v. Mina Equities Corp.*, 95 A.D.2d 169, 173 (N.Y. App. Div. 1st Dept. 1983), suffices. *But see, inter alia, In re Constable Plaza Assocs., L.P.*, 125 B.R. 98, 106 (Bankr. S.D.N.Y. 1991) (pre-bankruptcy receiver required, as a custodian under section 543 of the Bankruptcy Code, to turn over collected rents to the debtor-in-possession, as estate property, though subject to the mortgagee's rights pursuant to section 363 of the Bankruptcy Code.)

Under this line of reasoning, *Soho 25* represents an important decision because it holds that a mortgagee's enforcement actions before and even after a bankruptcy case's filing can determine whether the debtor-in-possession will enjoy use of rental proceeds from real property subject to the mortgagee's lien. If *Soho 25* is followed, more aggressive lenders will deprive their borrowers of the ability to use this cash in a borrower bankruptcy. Despite this strong incentive for diligent enforcement efforts by mortgagees, the *Soho 25* decision does not indicate a specific, single step that caused the lender in that case to trump the rights of the bankruptcy estate in the rental cash flow. The court even mentioned the lender's post-petition actions in its analysis, but did not expressly state whether the lender's motion for stay relief in the bankruptcy case added weight to the court's conclusion that the debtor's state law property rights as of the bankruptcy filing excluded the rental income. *Id.* at *8.

The court's unwillingness to fix the precise point in the lender's pre-bankruptcy enforcement activity that excluded the rents from the debtor's estate makes the *Soho 25* decision challenging to use in formulating future strategies. The court's reference to post-petition actions by the lender brings further doubt to both lenders and borrowers seeking to predict what is enough in the mortgagee's state law enforcement efforts to exclude a debtor's commercial rental income from its bankruptcy estate. Certainly, a mortgagee reading the *Soho 25* decision would know that it should revoke any license that it issued in the rent assignment document upon a default (if the agreement requires an act by the lender to effect revocation.) The *Soho 25* decision and its predecessor, *Loco Realty* (cited above), also teach that an order appointing a receiver in the foreclosure will likely exclude the rents from a debtor's use in a subsequent bankruptcy, if *Soho 25* and *Loco Realty* are followed. However, in a situation where, as in *Soho 25*, the lender successfully collects rents directly from the tenants, would the mortgagee really want to request and achieve a receiver's appointment in a foreclosure? *Soho 25* and *Loco Realty* both indicate this step as an important sign of a sufficiently aggressive lender, but a receivership would introduce a new third party to take over the collection of rents (who would require remuneration for doing so,) even though the lender might already be directly receiving these payments.

Conclusion

Other than the blunt guidance of simply doing everything it can to enforce and seeking a receiver's appointment, a lender cannot distinguish in the *Soho 25* decision what exact act in foreclosure and enforcement would assure that its control over rents will "stick" after a borrower files Chapter 11. As for the court's comment applauding the lender's post-filing stay relief motion, a lender could ask how post-petition activity can make a difference to the estate property present upon a bankruptcy case's commencement. A lender could also wonder if a stipulation for adequate protection in the bankruptcy — often a more cost-effective, short-term step rather than a full-blown stay relief motion — might unfortunately seem to represent insufficiently rigorous lender enforcement.

A distressed commercial real estate owner faces a similar dilemma in applying the lessons of *Soho 25*. In most cases, such a debtor simply seeks more time, but would certainly prefer not to lose the right to rental income in bankruptcy as a cost of delay. At the extreme, the *Soho 25* decision suggests that the debtor should have filed for bankruptcy before the lender sent the default notice, because only that way would the debtor have headed off the revocation of the debtor's "license" to use the rents. However, the importance that the *Soho 25* court attributed to subsequent enforcement actions leaves a debtor to wonder if it could wait until the initiation of a foreclosure action or even later. Certainly, it is a difficult calculus for a debtor, especially where, as here, the bankruptcy is a SARE, implicating the Bankruptcy Code's requirements that the debtor-in-possession pay interest to its mortgagee or file an appropriate Chapter 11 plan in relatively short order. The more that such a debtor accelerates its bankruptcy filing, the sooner it starts the time running in the fast-paced SARE case and risks a stay relief motion under section 362(d)(3) of the Bankruptcy Code.