

Assignment of Rents and Bankruptcy

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If you are a lender whose collateral includes rents from an apartment building, shopping mall, or other income-producing property, you might want to check your loan documents to be sure that you have taken an absolute assignment of those rents. It could save you time, resources, and frustration if the borrower files a Chapter 11 bankruptcy.

Arkansas law makes a distinction between the two main categories of rent assignments. The first type of assignment of rents is one for security only. Many assignment of rents clauses will specify that the lender is taking an assignment of rents, and that assignment is for security only. The second type of assignment of rents is an absolute assignment of rents. The language in an absolute assignment of rents must be specific that the assignment is absolute and not for security only. The distinction is important if the lender wants to avoid getting sucked into a long and slow-moving Chapter 11 bankruptcy.

Under Arkansas law, an assignment of rents for security only is just like any other security interest a lender may take to secure repayment of the debt. This security interest is perfected by filing the mortgage or separate assignment of rents document in the real estate records in the county where the property is located. However, those rents remain property of the borrower until and unless a receiver is appointed. At that point, Arkansas law holds that the rents are conveyed to the lender—meaning the borrower no longer has an ownership interest. With an absolute assignment of rents, the rents are conveyed to the lender upon the filing of the mortgage or assignment in the real estate records. Even if the borrower collects the rents after the filing in the real estate records and uses them for operations, Arkansas law provides that the borrower is simply holding those rents in trust for the lender and never has a legal or equitable interest in them.

This distinction as to when the borrower conveys its interest in the rents to the lender is critical if the borrower files for bankruptcy. Upon the filing of a bankruptcy petition, any property in which the borrower has a legal or equitable interest becomes property of the bankruptcy estate. If a lender has an assignment of rents for security only, and the borrower files bankruptcy before a receiver can be appointed, then the rents are property of the bankruptcy estate and can be used to fund the bankruptcy. Usually a borrower is going to file bankruptcy before that receiver gets appointed in state court. If a lender has an absolute assignment of rents, then the borrower has already conveyed its legal and equitable interest when the assignment was filed in the real estate records. If the borrower files bankruptcy, the lender will have the ability to move for dismissal of the case early on the basis that the rents are not property of the estate, meaning the borrower will not have income to fund a plan (assuming of course that the rents are the main source of the borrower's income). Bankruptcy courts in Arkansas have consistently held that when a lender has a valid, absolute assignment of rents, the rents do not come into the bankruptcy estate and cannot be used to fund a plan. The courts will dismiss the case absent a separate agreement between the lender and borrower.

Whether you are making a new loan or reviewing your current ones and your collateral consists of income-producing rental property, be sure you have the appropriate language in your loan documents regarding the assignment of rents. You will be glad you did if your borrower files a Chapter 11 bankruptcy.