

BANK WINS TUG OF WAR OVER RENTS

By: Harris Ominsky*

A recent federal circuit court case held that rents collected by a receiver before a bankruptcy filing belong to the mortgage lender and not to the borrower's bankruptcy estate, at least when the lender has first asserted possession of the property to collect those rents. *Sovereign Bank v. Schwab*, 2005 U.S. Lexis 13383 (3rd Cir. 7/06/05).

In this case, the borrower defaulted on three Pennsylvania commercial properties; and the lender, Sovereign Bank, filed a foreclosure action and obtained a default judgment in April 1999. In September 2000, the borrower continued to remain in possession and collect rents, but Sovereign then notified the tenants to pay rents directly to it. Less than a month later Sovereign arranged to appoint itself as a receiver to "take possession, charge and control the mortgaged properties." In January 2001, Sovereign finally foreclosed on the properties and bought them in at the sale "for cost."

The next month the borrower filed for bankruptcy and sought to recover the rental funds which had been collected by Sovereign. The bankruptcy court supported the trustee's claim for rents and ordered release of the funds on the theory that Sovereign's possession of the property before foreclosure was "as custodian and not owner."

After the federal district court affirmed, the Third Circuit Court of Appeals reversed both the bankruptcy court and the district court and held that Sovereign, by exercising its assignment of rent and taking possession under Pennsylvania law, obtained "title to the

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rents.” The court cited as support earlier cases, *First Federal Bank, N.A. v. Jason Realty L.P.* (3rd Cir. 1995) and *Commerce Bank v. Mountainview Village*, (3rd Cir. 1993).

Title to Rents

These cases all involved a battle between a mortgage lender and a trustee-in-bankruptcy over the issue of who is entitled to pre-petition rentals in Pennsylvania and New Jersey. The decisions have been controversial in academic circles because they sometimes turn on whether a customary assignment of rents to a lender is viewed as an “absolute assignment” or merely a “collateral pledge.” See HARRIS OMINSKY, REAL ESTATE PRACTICE: BREAKING NEW GROUND, pp 195 – 197 (Pennsylvania Bar Institute 2000).

The court framed the issue as whether these rents collected by the bank are “property of the bankruptcy estate.” Property of the bankruptcy estate is defined as “all legal or equitable interests of the debtor in property as of the commencement of the case,” wherever located by whomever held. It then disagreed with the district court’s finding that “the property of the estate” in this case, not only was the underlying real estate, but also the rental fund it generated. The court concluded that the debtor had no interest in the rents when the petition was filed because the bank took title to the rents pre-petition, and the subsequent appointment as receiver did not affect that title.

The trustee had asserted that Sovereign had several options, including exercising its rights under the assignment-of-rents provision, requesting that the court appoint a third-party receiver, or seeking appointment of itself as receiver. The trustee contended that in

appointing itself as receiver the bank became an officer of the court with a fiduciary duty to turn over the funds to the bankruptcy trustee.

The court rejected that argument and held that the bank had obtained title to the rents before its receivership appointment, and, therefore, the rental funds were not the “property of the debtor” which is required for them to be turned over to the trustee under the Bankruptcy Code. Under Pennsylvania law, a mortgagee obtains ownership of assigned rents from the moment the notice is served on the tenants. According to the court, the trustee’s argument that Sovereign’s receivership somehow divested it of ownership in the rents, or transferred title of the rents to the bankruptcy estate, “is unconvincing.”

The court further explained that its views on title to collected rents are no different whether you’re dealing with Pennsylvania, which is a title-theory jurisdiction, or New Jersey, which is a lien-theory state. In either event, title to the collected rents vests in the bank and the appointment of a receiver under the Bankruptcy Code does not alter that ownership or expand the rights of a debtor in the hands of a bankruptcy estate.

Implications

This case should emphasize to lenders the importance of taking action as early as possible under defaulted mortgages to act as mortgagees-in-possession or to otherwise start exercising their rights to collect rents. The *Sovereign* case means that in many cases debtors may not be able to reorganize because they will not be able to use collected rents as cash collateral, especially in single-asset cases involving commercial real estate. Therefore, this legal decision might discourage certain types of bankruptcy filings, and delight those

mortgage lenders who feel that borrowers tend to overuse the bankruptcy courts to impair their collateral and stall an inevitable foreclosure.

The *Sovereign* case does not raise the issue of how collected rents retained by the lender fit in with the Deficiency Judgment Act, if the lender forecloses and seeks a recovery of any shortfall. Presumably, the collected rents would have to be credited toward the mortgage debt, including interest and other costs. Therefore, upon foreclosure the recovery sought by the lender will presumably be reduced by those collections.

However if, as in the *Sovereign* case, the foreclosed properties are taken over by the foreclosing bank for costs, it is possible for the bank to wind up with a windfall . The total of the rents collected and the value of the properties could theoretically be greater than the amount owed. On the other hand, if a third-party purchaser buys the properties in a sheriff's sale, any excess collected at the sale over the reduced debt will go to the borrower, or the borrower's creditors.

It is noteworthy that in the classic battle over who rules in the kingdom of real estate and rents, *Sovereign Bank* has lived up to its namesake.

New Bankruptcy Changes

Some debtors' lawyers have raised a creative argument that new Bankruptcy Code revisions trump the *Sovereign* case's conclusions.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, S.256, has amended Section 362(d)(3) of the Code which deals with lifting a stay of proceedings in a single-asset-real-estate case. An argument may be made that this change envisions the use of

rents “generated before” commencement of the bankruptcy case as a way for the debtor to avoid lifting the stay.

It remains to be seen whether future decisions will be persuaded by this argument.

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