

News & Types: Corporate, Finance & Acquisitions Update

Effects of Assignor's Bankruptcy on Assignment of Payment Stream

5/10/2017

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Practices: Commercial, Competition & Trade, Litigation

In a May 2, 2017 decision, the Sixth Circuit Court of Appeals decided the fate of a stream of rental payments from the bankrupt owner of a residential complex. (*In re: Town Center Flats, LLC*, No. 16-1812, May 2, 2017, Sixth Circuit Court of Appeals) The case resembled a similar one, far more controversial and with a different result, from 1993. (*Octagon Gas Systems, Inc. v. Rimmer*, 995 F.2d 948, 10th Circuit Court of Appeals, 1993) The Octagon Gas case roiled the factoring and receivables purchasing industry. Although not referenced in *Town Center*, it is possible that the discredited *Octagon Gas* case influenced the result.

Town Center Flats, LLC (Town Center) was the owner of a 53-unit residential complex in Shelby Township, Michigan. To finance the construction of the building, Town Center borrowed \$5.3 million from KeyBank, later assigned to ECP Commercial II, LLC (ECP). The loan was secured with a mortgage and an agreement to assign rents to ECP in the event of default. Rents from the residential complex were Town Center's only income source.

Town Center defaulted in December 2013. In December 2014, ECP sent a notice of default and a request for payment to tenants of the residential complex. In January 2015, ECP filed suit against Town Center. But this lawsuit was preempted by Town Center's filing for bankruptcy under Chapter 11.

Town Center wanted to use the rental payments as cash collateral so that Town Center had some chance of a successful Chapter 11 reorganization, since Town Center had no other income. The bankruptcy court agreed. ECP appealed, arguing that Michigan law would consider that the rental payments had been entirely assigned to ECP and that the rental payments could not be part of Town Center's bankruptcy estate. The Sixth Circuit agreed with ECP and reversed the bankruptcy court.

The Court of Appeals cited Michigan law that provided for an assignment of rents.

". . . [I]n connection with any mortgage . . . it shall be lawful to assign the rents . . . to the mortgagee, as security in addition to the property described in such mortgage. Such assignment of rents shall be binding upon such assignor only in the event of default in the terms and conditions of said mortgage, and shall operate against and be binding upon the occupiers of the premises from the date of filing by the mortgagee in the office of the register of deeds for the county in which the property is located of a notice of default in the terms and conditions of the mortgage and

service of a copy of such notice upon the occupiers of the mortgaged premises." Michigan Compiled Laws, Sec. 554.231

ECP took all of the necessary steps to complete the assignment of rents.

So what? What was the effect of the assignment? The critical issue was whether the rental payments could be swept into Town Center's bankruptcy estate, to which the bankruptcy court said yes. As noted, the Sixth Circuit Court of Appeals disagreed.

Citing Michigan cases as precedent, the Court of Appeals noted that Michigan courts have treated the assignment of rents as a transfer of ownership.

But Town Center cited the reference to "security" in the statute, arguing that ECP's interest was really only a security interest, not an ownership interest. The Court of Appeals returned to Michigan cases holding that the assignment was a transfer of ownership, not security.

There were also some interesting arguments about the rights retained by Town Center which seemed to argue against ECP's outright ownership in the rental payments. First, Town Center could restore its right to payment by curing the default. Second, ECP, as the assignee, did not have full control over the use of the rental payments. It was required to apply the payments to the mortgage debt. But, returning to Michigan precedents, the Court of Appeals concluded that none of "these restrictions on the assignee's [ECP's] use of rent money create a property right vested in the assignor [Town Center]."

The Court of Appeals acknowledged that federal bankruptcy law provides for a broad scope of bringing assets into the bankruptcy estate. But this did not give the Court of Appeals the ability to rewrite Michigan law to give any ownership or residual rights to Town Center, the debtor. The Court of Appeals recognized that this conclusion likely doomed the effort of Town Center to successfully reorganize under Chapter 11, but said, in effect, too bad.

The *Town Center* case was very reminiscent of the controversial 1993 *Octagon Gas* case that reached a different result. In *Octagon Gas*, the Court of Appeals dealt with a royalty interest in a natural gas system that was governed under Uniform Commercial Code Article 9. Rimmer was a purchaser of the royalty interest of Poll Gas, Inc. Poll Gas went into bankruptcy and, as part of its plan of reorganization, the gas purchase and sale contracts (which generated the royalty paid to Rimmer) were conveyed, free and clear of all liens and interests, to Octagon Gas. Octagon Gas refused to recognize Rimmer's royalty interest.

So the issues in *Octagon Gas* and in *Town Center* were very similar. Could the bankruptcy court claim jurisdiction over a stream of payments assigned by the debtor (or its successor) to a purchaser? But the results were very different.

The *Octagon Gas* court held that the sale and assignment of the royalty interest did not effectuate a transfer to Rimmer. The court stated that, "The impact of applying Article 9 to Rimmer's account is that Article 9's treatment of accounts sold as collateral would place Rimmer's account within the property of [the] bankruptcy estate." The court concluded that "a debtor's sale of an account, prior to filing for bankruptcy, does not necessarily place that account beyond the reach of the bankruptcy trustee."

The decision was attacked as erroneous, which it was. Besides misinterpreting Article 9, the concern was that the decision would affect the liquidity of sales of payment streams, so that a purchaser of accounts would always face the risk that the purchased accounts would be dragged into the bankruptcy court. It made these types of transactions either impractical or high risk which, in turn, had a business impact on sales of accounts, at least in the 10th Circuit.

The Permanent Editorial Board (PEB) for the Uniform Commercial Code took the extraordinary step of issuing Commentary No. 14 that directly opposed the holding of *Octagon Gas*. The PEB noted that UCC Article 9 covers the use of accounts as security and also covers the outright sale of accounts. Whether a particular transaction is a sale of accounts or the transfer of accounts as security is left to the courts. But *Octagon Gas* was completely wrong in concluding that accounts sold under Article 9 would always be part of the bankruptcy estate if the assignor entered bankruptcy.

"In *Octagon Gas v. Rimmer*, however, the Tenth Circuit after stating that a purchased royalty interest in a natural gas system was an account, erroneously stated that "[t]he impact of applying Article 9 to [the buyer's] account is that Article 9's treatment of accounts sold as collateral would place [the buyer's] account within the property of [the seller's] bankruptcy estate." The court reached this determination despite the transfer of the royalty interest purporting to be an outright sale of all the seller's interest. To the extent the court relied on Article 9 in reaching its determination, this Commentary adopts a contrary position." PEB Commentary No. 14 dated June 10, 1994

To emphasize this point, the PEB amended the comments to the former UCC Article 9-102 to confirm that an outright sale of accounts is governed by Article 9 and does not necessarily result in the assignor retaining any interest. It appears *Octagon Gas* was not followed by other courts. With the adoption of revised Article 9 in 2001, the issue appears to have been settled. (See, for example, UCC Section 9-318(a): "A debtor that has sold an account, chattel paper, payment intangible, or promissory note does not retain a legal or equitable interest in the collateral sold.")

The *Town Center* case illustrates the continuing difficulty of distinguishing the sale of accounts or a payment stream in which the assignor retains no rights versus the use of accounts or a payment stream as security, in which the assignor does retain rights. In fact, *Town Center* appears to be a closer call than *Octagon Gas*, in that the debtor's ability to restore the payment stream by curing its default and to require the assignee to apply the payments to the debt suggest there were some rights retained by the debtor.

Those in the factoring or receivables purchasing industry can take comfort in *Town Center* and the now-repudiated *Octagon Gas* case. But this is premature. As even the PEB commentary noted, the determination as to whether an assignment is an outright sale or transfer for security is to be decided by the courts. An assignee of accounts must be careful to follow all of the steps to establish its ownership (and to show the assignment was not intended as security). The assignee in *Town Center* took these steps and similar steps are required under Article 9. Otherwise, an assignee of accounts or a payment stream, when faced with the assignor's bankruptcy, may find itself with far less than it expected.