



Bankruptcy ADVISORY ■

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No Rents for You! Bankruptcy Court Finds Assigned Rents Are Not Property of the Estate

On February 4, 2014, the United States Bankruptcy Court for the District of New Jersey in *In re Surma*, 2014 WL 413572 (Bankr. D.N.J. Feb. 4, 2014), held that rents were not property of the debtor's bankruptcy estate because they were subject to an absolute and unconditional assignment of rents in favor of the secured lender. As a result, the court concluded that the debtor may not, through his Chapter 11 plan of reorganization, use or allocate rents.

Background

In *Surma*, an individual debtor owned a multifamily property encumbered by two mortgages—a first mortgage in the original amount of \$375,200 and a second mortgage in the original amount of \$93,800—and an assignment of rents in favor of the lender. The debtor proposed a plan of reorganization that sought to bifurcate the lender's claim into two claims—a secured claim in the amount of \$250,000 (the fair market value of the property, the debtor contended) and an unsecured claim in the amount of the balance owed. The plan then proposed to apply the rents from the property towards payment of the secured claim only and classified the lender's deficiency claim as a general unsecured claim. The lender objected to the debtor's attempt, through the plan, to apply the rents to the secured portion of the bifurcated claim and argued that, per *Jason Realty L.P.*, 59 F.3d 423 (3d Cir. 1995), the lender maintained the right to apply the rents in its sole and absolute discretion, which would lead to the rents being applied as payment on the unsecured portion of the bifurcated claim.

Holding

The *Surma* court agreed with the lender. In analyzing the assignment of rents in favor of the lender, the court concluded that the Bankruptcy Code defers to property rights created by state law in determining property of the estate. As the Third Circuit concluded in *Jason Realty*, because New Jersey law provides that an absolute and unconditional assignment of rents passes title to the mortgagee, the debtor retains no interest in the rents and the rents do not become property of the debtor's estate. Thus, rents subject to an absolute and unconditional assignment of rents are unavailable as a funding source for the debtor's plan of reorganization. Specifically, the *Jason Realty* court stated that unequivocally assigned rents are "unavailable for use, *allocation* or utilization in any plan." *Jason Realty*, 59 F.3d at 431 (emphasis added).

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Although the debtor attempted to circumvent *Jason Realty* by arguing the debtor was not utilizing the rents (because they were in fact being used to repay the lender's claim), the court disagreed. Specifically, because the debtor sought to bifurcate the claims and then apply the rents to the crammed-down, secured portion of the lender's claim, the *Surma* court found that the debtor was attempting to use its plan to impermissibly "allocate" the lender's rents. While acknowledging cases that hold Section 506(d) requires avoidance of both the mortgage lien and the assignment of rents, the *Surma* court found that *Dewsnup v. Timm*, 502 U.S. 410 (1993), provides that Section 506(d) does not apply if a lender's secured claim has not been disallowed. Given the inapplicability of Section 506(d), the *Surma* court held that no aspect of the Bankruptcy Code overrode the lender's unequivocal right under New Jersey law to apply the rents in its discretion.

The debtor's plan, which depended on the debtor's ability to use the rents in this manner, was thus patently unconfirmable and the *Surma* court declined to approve the associated disclosure statement.

While issued in the context of an individual rather than a corporate bankruptcy case, the *Surma* ruling adds to the body of case law that protects a secured lender's right to apply rents, subject to an unequivocal assignment of rents, in the secured lender's discretion and prohibits debtors' attempts to "use, allocate[e] or utiliz[e]" such rents in any plan.

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