

January 2022

Still Crazy After All These Years: The Absolute Assignment of Rents in Mortgage Loan Transactions

Julia Patterson Forrester

Follow this and additional works at: <https://scholarship.law.ufl.edu/flr>



Part of the [Law Commons](#)

Recommended Citation

Julia Patterson Forrester, *Still Crazy After All These Years: The Absolute Assignment of Rents in Mortgage Loan Transactions*, 59 Fla. L. Rev. 487 (2022).

Available at: <https://scholarship.law.ufl.edu/flr/vol59/iss3/1>

This Article is brought to you for free and open access by UF Law Scholarship Repository. It has been accepted for inclusion in Florida Law Review by an authorized editor of UF Law Scholarship Repository. For more information, please contact kaleita@law.ufl.edu.

Florida Law Review

Founded 1948

Formerly
University of Florida Law Review

VOLUME 59

JULY 2007

NUMBER 3

STILL CRAZY AFTER ALL THESE YEARS: THE ABSOLUTE ASSIGNMENT OF RENTS IN MORTGAGE LOAN TRANSACTIONS¹

*Julia Patterson Forrester**

Abstract

This Article explores the problems caused by the absolute assignment of rents in mortgage loan transactions, which have continued for more than a century, and discusses possible solutions. Rents are a significant part of the security for loans secured by income-producing properties such as office buildings, shopping centers, and apartments. Under present law in many states, the absolute assignment of rents is the only means by which lenders can create an effective security interest in the rents of mortgaged property. An absolute assignment of rents purports to transfer title to rents to the mortgage lender, although in substance it creates a security interest in rents. This Article explores the historical development of the absolute assignment of rents and discusses the confusion, unnecessary litigation, and in some cases, injustice that it causes under state law and federal bankruptcy law. The National Conference of Commissioners on Uniform State Laws has recently approved the new Uniform Assignment of Rents Act, which removes the necessity for absolute assignments of rents by creating a workable and comprehensive scheme for the creation of security interests in rents. This Article concludes by discussing the Act and recommending its adoption.

1. PAUL SIMON, *Still Crazy After All These Years*, on STILL CRAZY AFTER ALL THESE YEARS (Columbia Records 1975).

* Associate Professor of Law, Southern Methodist University School of Law, Dallas, Texas; B.S.E.E. 1981, J.D. 1985, The University of Texas at Austin. I wish to thank Ken Elmgren, Wilson Freyermuth, and Paul Rogers for their comments on drafts of this Article; Laura Justiss for her assistance as a research librarian; and Derek Dansby, Victoria Marchand Rossi, and Joshua Somers for their research assistance. In addition, I gratefully acknowledge the research grant provided by Southern Methodist University Dedman School of Law.

I.	INTRODUCTION	488
	A. <i>The Nature of Rents and Security Interests in Rents</i>	492
II.	DEFICIENCIES OF THE COLLATERAL ASSIGNMENT OF RENTS	495
	A. <i>The Perfection Problem</i>	495
	B. <i>The Enforcement Problem</i>	500
	C. <i>The Right to Previously Collected Rents</i>	504
III.	HISTORICAL DEVELOPMENT OF THE ABSOLUTE ASSIGNMENT OF RENTS	505
IV.	CREATION AND CONSEQUENCES OF THE ABSOLUTE ASSIGNMENT OF RENTS	512
	A. <i>Debating the Effect of the Absolute Assignment of Rents</i>	512
	B. <i>Creating an Absolute Assignment of Rents</i>	515
	C. <i>State Law Consequences of Confusion over Characterizing an Absolute Assignment of Rents</i>	517
	D. <i>The Absolute Assignment of Rents in Bankruptcy</i>	519
	E. <i>Analogous “Absolute” Transfers for Security</i>	522
V.	SOLUTIONS TO THE PROBLEM	524
	A. <i>The Judicial Solution</i>	524
	B. <i>The Uniform Assignment of Rents Act</i>	525
VI.	CONCLUSION	528

I. INTRODUCTION

For more than one hundred years, the absolute assignment of rents in mortgage loan transactions has caused confusion, increased transaction costs, litigation, and in some cases, injustice. The absolute assignment of rents is a necessary evil in many states, however, because mortgage lenders require an effective security interest in rents of mortgaged property.

When a loan is secured by a mortgage or deed of trust on an income-producing property, such as an office building, shopping center, or apartment complex, rents are a significant part of the security for the loan, in addition to the land and improvements.² Rents provide the funds necessary to pay for operating and maintaining the mortgaged property,

2. See Julia Patterson Forrester, *A Uniform and More Rational Approach to Rents as Security for the Mortgage Loan*, 46 RUTGERS L. REV. 349, 349-50 (1993).

and to make payments on the mortgage loan.³ After a default on the mortgage loan, a borrower, facing the possibility of losing the property to foreclosure, may apply rents to purposes unrelated to the property or the mortgage loan.⁴ The lender, on the other hand, wants rents collected after default to be applied to operation and maintenance of the property or to the mortgage debt.⁵ Therefore, a lender wants the ability to control rents from mortgaged property in the event of a default, and to this end will require the borrower to execute an assignment of rents at the loan closing.⁶ Unfortunately, the law governing assignments of rents is illogical and confusing⁷ and varies significantly from state to state.⁸

3. See *id.* at 350.

4. This practice is sometimes called “milking” the rents. *Id.* The borrower may spend rents to benefit other properties, to build a “war chest” of funds to pay attorneys’ fees for a bankruptcy filing or litigation against the lender, or for other purposes unrelated to the mortgaged property. See *id.*

5. *Id.*

6. The assignment of rents or other “[l]oan documents may also contain restrictions on the ability of the borrower to enter into, modify, or terminate leases” without the lender’s consent or to accept prepayments of rent, and tenants are often “required to acknowledge the assignment of rents and the restrictions on modification or termination of leases or on prepayments of rent.” *Id.* at 350 n.5. Loan documents may require that the borrower apply rents to pay expenses of operating and maintaining the property and to pay the mortgage debt. See *id.* When the loan is nonrecourse, the lender is particularly interested in the borrower’s use of rents, “and the application of rents for purposes other than operation, maintenance, or payment of the loan may be an exception to the nonrecourse status of the loan.” *Id.*

7. Because of this confusion, the law governing assignments of rents in mortgage loan transactions has been the subject of numerous law review articles over the years. See, e.g., Robert Abelow, *An Historical Analysis of Assignments of Rent in New York*, 6 BROOK. L. REV. 25, 25 (1936); Morris Berick, *The Mortgagee’s Right to Rents*, 8 U. CIN. L. REV. 250, 252 (1934); Forrester, *supra* note 2, at 377-83; R. Wilson Freyermuth, *Modernizing Security in Rents: The New Uniform Assignment of Rents Act*, 71 MO. L. REV. 1, 1 (2006) [hereinafter Freyermuth, *The New UARA*]; R. Wilson Freyermuth, *Of Hotel Revenues, Rents, and Formalism in the Bankruptcy Courts: Implications for Reforming Commercial Real Estate Finance*, 40 UCLA L. REV. 1461, 1462-64 (1993) [hereinafter Freyermuth, *Of Hotel Revenues*]; Carlos L. Israels & Milton A. Kramer, *The Significance of the Income Clause in a Corporate Mortgage*, 30 COLUM. L. REV. 488, 488 (1930); Comment, *The Mortgagee’s Right to Rents After Default*, 50 YALE L.J. 1424, 1424-25 (1941). The focus of most of the articles published in the past twenty years has been the treatment of assignments of rents in bankruptcy. See, e.g., Craig H. Averch et al., *The Treatment of Net Rents in Bankruptcy—Adequate Protection, Payment of Interest, Return of Collateral, or Reduction of Debt*, 48 U. MIAMI L. REV. 691, 692-96 (1994); David Gray Carlson, *Rents in Bankruptcy*, 46 S.C. L. REV. 1075, 1075-77 (1995); R. Wilson Freyermuth, *The Circus Continues—Security Interest in Rents, Congress, the Bankruptcy Courts, and the “Rents Are Subsumed in the Land” Hypothesis*, 6 J. BANKR. L. & PRAC. 115, 115-17 (1997); James McCafferty, *The Assignment of Rents in the Crucible of Bankruptcy*, 94 COM. L.J. 433, 433-34 (1989); Patrick A. Randolph, Jr., *Recognizing Lenders’ Rents Interests in Bankruptcy*, 27 REAL PROP. PROB. & TR. J. 281, 281-85 (1992); Glenn R. Schmitt, *The Continuing Confusion over Real Property Rents as Cash Collateral in Bankruptcy: The Need for a Consistent Interpretation*, 5 DEPAUL BUS. L.J. 1, 1-5 (1993).

8. See *infra* notes 33-38 and accompanying text.

Different types of assignments of rents have developed depending upon the applicable state law and the agreement reached between the borrower and the mortgage lender. Occasionally, lenders control rents from the time the loan is made, applying the rents first to loan payments and releasing the excess to the borrower to use for operating and maintaining the property. Much more commonly, however, the parties agree that the borrower has the right to control rents until after default. One type of assignment of rents, referred to as a collateral assignment of rents in this Article in order to distinguish it from an absolute assignment, creates one kind of security interest in rents. With a collateral assignment of rents, the borrower has the right to collect rents until the lender, upon the borrower's default, takes some affirmative action, such as taking possession of the mortgaged property, obtaining the appointment of a receiver, or demanding rents from the borrower or tenants.⁹ In many states, a lender must take some burdensome action, such as taking possession of the property, in order to enforce a collateral assignment of rents even if the parties have agreed that the lender is entitled to rents upon demand, and in some states, a collateral assignment may be treated as unperfected until it is enforced.¹⁰ As a result, lenders prefer another type of assignment of rents, called an absolute assignment of rents, which purports to transfer title to rents to the lender upon default. The absolute assignment provides that the borrower may collect rents until default, often based on a license from lender to borrower, but the lender's right to collect rents accrues automatically and immediately upon the borrower's default.¹¹

In states that do not give meaningful effect to a collateral assignment of rents, lenders obviously prefer an absolute assignment of rents, and borrowers are willing to execute absolute assignments of rents. However, because many courts are hostile to finding an absolute assignment, lenders have had difficulty over the years creating enforceable absolute assignments. In many states, effective creation of an absolute assignment of rents requires the pretense of a transfer of title to rents that is not a security interest.¹² This drafting challenge and the resulting litigation have continued for more than a century.¹³

9. See *infra* notes 70-74 and accompanying text.

10. See *infra* notes 44-49 and accompanying text.

11. See *infra* note 88 and accompanying text.

12. See *infra* Part IV.B.

13. In 1894, the Missouri Court of Appeals held that a lender's assignment of rents was not an absolute assignment because the assignment stated that it was given "as additional security for the payment of . . . notes." *Armour Packing Co. v. Wolff & Co.*, 59 Mo. App. 665, 665 (Ct. App. 1894). In 2001, the Bankruptcy Court for the Western District of Tennessee held that a lender's assignment of rents was not an absolute assignment despite language in the document that the borrower "absolutely and unconditionally" assigned the rents. *In re 5877 Poplar, L.P.*, 268 B.R. 140, 146-47 (Bankr. W.D. Tenn. 2001). In the years between these two cases, numerous courts also

When courts do find an absolute assignment of rents, significant uncertainty exists over its effect. Some courts hold that the absolute assignment is a transfer of title to the rents, while others hold that it creates a security interest, albeit a different type of security interest from that created by a collateral assignment of rents.¹⁴ This confusion has played out to some extent in state courts, but to a greater extent in bankruptcy courts after the borrower files a petition in bankruptcy. Therefore, although state law governs assignments of rents, federal courts frequently determine the current state of the law in the various jurisdictions.

This Article addresses the confusion over the absolute assignment of rents, the unnecessary litigation and injustice caused by this disorder, and possible solutions to the problem.¹⁵ Part I discusses the legal theories underlying the creation of a security interest in rents. Part II explains the problems that have caused lenders to prefer absolute assignments over collateral assignments, including problems relating to perfection, enforcement, and access to rents collected by the borrower after default. Part III explores the development of absolute assignments of rents from the late nineteenth century into the twentieth century.

Part IV discusses the disarray caused by absolute assignments of rents, including the challenge that lenders face in creating them, the varying treatment of absolute assignments by state and federal courts, and the problems caused by absolute assignments under state law and federal bankruptcy law. Part IV also discusses how the absolute assignment of rents should be treated. Despite its form, an absolute assignment of rents in a mortgage loan transaction creates a security interest in substance. Finally, Part IV provides analogies to other areas of the law in which courts have more successfully determined the substance of a security transaction despite its form.

Part V examines possible solutions. One solution is judicial. Courts could adopt the approach of the Restatement of Property—Mortgages that makes the charade of the absolute assignment of rents unnecessary. However, after more than one hundred years of disarray, this change is

addressed the issue of whether an assignment of rents is absolute. *See infra* Part IV.B for a discussion of these cases.

14. *See infra* Part IV.A.

15. This is not my first article that proposes a solution. In 1993, I examined the problems of using rents as security for a mortgage loan and proposed that security interests in rents should be covered by Article 9 of the Uniform Commercial Code. *See Forrester, supra* note 2, at 402. Independently, but at the same time, Professor Wilson Freyermuth reached the same conclusion. *See Freyermuth, Of Hotel Revenues, supra* note 7, at 1467. Some of the members of the PEB Study Group's Advisory Group on Real Estate-Related Collateral recommended that rents be covered by Article 9, *see* PERMANENT EDITORIAL BD. FOR THE UNIF. COMMERCIAL CODE, PEB STUDY GROUP UNIFORM COMMERCIAL CODE ARTICLE 9 app. at 154-55 (1992), but rents were ultimately excluded from Article 9. *See* U.C.C. § 9-109(d)(11) (2000).

unlikely to occur quickly. A faster and more comprehensive solution is a legislative one—adoption of the new Uniform Assignment of Rents Act (UARA),¹⁶ which also removes the necessity for absolute assignments of rents and, at the same time, clarifies and simplifies the law relating to assignments of rents. Part V also discusses the scheme adopted by UARA to handle the complex issues raised by assignments of rents in mortgage loan transactions.¹⁷

The absolute assignment of rents has created havoc in commercial real estate loans for too long. More than a century of confusion, unnecessary litigation, and injustice is enough. With UARA now recommended for enactment, a good solution is in the wings and state legislatures should adopt it.

A. *The Nature of Rents and Security Interests in Rents*

The right to unaccrued rents from real property is an incorporeal hereditament—an interest in land incident to the landlord's reversion.¹⁸ The right to collect rents is part of the bundle of property rights covered by a mortgage of the real property to which they relate. Therefore, a foreclosure

16. In 2003, the National Conference of Commissioners on Uniform State Laws (NCCUSL) appointed a drafting committee to prepare a UARA at the urging of the Joint Editorial Board for Uniform Real Property Acts. See Freyermuth, *The New UARA*, *supra* note 7, at 3. In July 2005, the NCCUSL approved the UARA and recommended it for enactment in all states. UNI. ASSIGNMENT OF RENTS ACT (2005), available at <http://www.law.upenn.edu/bll/ulc/maripp/2005Final.pdf>.

17. A full discussion of all of the provisions of the UARA is outside the scope of this Article. For such a discussion, see Freyermuth, *The New UARA*, *supra* note 7.

18. *Norwest Bank Ariz. v. Superior Court*, 963 P.2d 319, 323 (Ariz. Ct. App. 1998) (quoting *Valley Nat'l Bank of Ariz. v. AVCO Dev. Co.*, 480 P.2d 671, 673 (Ariz. Ct. App. 1971); see also *Winnisimmet Trust, Inc. v. Libby*, 122 N.E. 575, 576 (Mass. 1919); *First & Citizens Nat'l Bank of Elizabeth City v. Sawyer*, 10 S.E.2d 656, 658 (N.C. 1940); *Marine Nat'l Bank v. Nw. Pa. Bank & Trust Co.*, 454 A.2d 67, 70 (Pa. Super. Ct. 1982); *Schmid v. Baum's Home of Flowers, Inc.*, 37 S.W.2d 105, 108 (Tenn. 1931). Blackstone listed rents among the ten principal incorporeal hereditaments. See WILLIAM BLACKSTONE, 2 COMMENTARIES *21.

Jurisdictions are split on the issue whether rents are severed from the real property when they accrue, see, e.g., *White v. Irvine*, 22 S.W.2d 778, 778-79 (Mo. 1929); *Marine Nat'l Bank*, 454 A.2d at 70, or when they are collected, see, e.g., *In re Park at Dash Point L.P.*, 121 B.R. 850, 855 (Bankr. W.D. Wash. 1990), *aff'd sub nom. Steinberg v. Crossland Mortgage Corp. (In re Park at Dash Point L.P.)*, 152 B.R. 300 (W.D. Wash. 1991), *aff'd*, 985 F.2d 1008 (9th Cir. 1993); *Treetop Apts. Gen. P'tship v. Oyster*, 800 S.W.2d 628, 629 (Tex. App. 1990). A severance also occurs when the right to unaccrued rents is assigned to a third party, see, e.g., *Valley Nat'l Bank*, 480 P.2d at 674; *Brack v. Coburn*, 196 S.W.2d 230, 234 (Ark. 1946); *Winnisimmet*, 122 N.E. at 576; *Schmid*, 37 S.W.2d at 108; reserved in a transfer of the landlord's reversion, see, e.g., *Jim Davis & Co. v. Albuquerque Fed. Sav. & Loan Ass'n.*, 536 So. 2d 55, 58 (Ala. 1988) (quoting *Walsh v. Bank of Moundville*, 132 So. 52, 53 (Ala. 1930)); *Brack*, 196 S.W.2d at 234; *Winnisimmet*, 122 N.E. at 576; *Tinnon v. Tanksley*, 408 S.W.2d 98, 105 (Mo. 1966); or pledged as security for a loan apart from the land. See, e.g., *Treetop*, 800 S.W.2d at 629 (citing *Standridge v. Vines*, 81 S.W.2d 289, 290 (Tex. Civ. App. 1935)).

sale purchaser is entitled to rents accruing after the date of foreclosure from leases that remain in effect after the foreclosure.¹⁹ In most states, however, in the absence of an assignment of rents, the borrower has the right to collect rents until the lender takes possession of the property as a mortgagee-in-possession or after foreclosure, or until a receiver takes possession of the property.²⁰

Because the foreclosure process is lengthy in many states,²¹ significant time may elapse between the borrower's default and the completion of a foreclosure sale. During that period, a lender may wish to exercise provisional remedies, such as securing the appointment of a receiver for the property, taking possession of the property, or collecting rents from the property. The availability of these provisional remedies depends upon state law where the mortgaged property is located and the effect given to the mortgage instrument itself.

The traditional, but now minority, view of the effect of a mortgage is the title theory, which treats a mortgage as a transfer of title to the property to the lender.²² In title theory states, the lender theoretically has the right upon the borrower's execution of the mortgage to take possession of the mortgaged property and collect the rents therefrom.²³ Most states, however, are lien theory states in which a mortgage lender is treated as having only a lien on the mortgaged property, and the borrower retains the right to possession and rents until completion of foreclosure.²⁴ Finally, in a few states, called intermediate states, a mortgage lender has a hybrid interest

19. See *Jim Davis & Co.*, 536 So. 2d at 58 (quoting *Walsh*, 132 So. at 53); *Norwest Bank*, 963 P.2d at 323-25; *Sec. Sav. & Loan Soc. v. Dudley*, 26 P.2d 384, 385 (Wash. 1933).

20. See *Teal v. Walker*, 111 U.S. 242, 248 (1884); *Simpson v. Ferguson*, 44 P. 484, 485 (Cal. 1896); *Bornstein v. Somerson*, 341 So. 2d 1043, 1048-49 (Fla. 2d DCA 1977); *Mid-Continent Supply Co. v. Hauser*, 269 P.2d 453, 458 (Kan. 1954); *Grafeman Dairy Co. v. Mercantile Club*, 241 S.W. 923, 927 (Mo. 1922); *Wyckoff v. Scofield*, 98 N.Y. 475, 477 (N.Y. 1885); *Met. Life Ins. Co. v. Begin*, 16 N.E.2d 1015, 1016 (Ohio Ct. App. 1938); *Treetop*, 800 S.W.2d at 629. In title and intermediate theory states, discussed *infra* notes 23-27 and accompanying text, a lender may collect rents from tenants whose leases are senior to the mortgage after default and demand upon the tenant even without an assignment of rents. See Robert Kratovil, *Mortgages—Problems in Possession, Rents, and Mortgagee Liability*, 11 DEPAUL L. REV. 1, 9 (1961).

21. See GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 7.1 (4th ed. 2001); *Cost and Time Factors in Foreclosure of Mortgages*, 3 REAL PROP. PROB. & TR. J. 413, 413-14 (1968). See generally FORECLOSURE LAW & RELATED REMEDIES (Sidney A. Keyles ed., 1995) (describing the foreclosure process in each of the fifty states). A number of states give the borrower a statutory right of redemption for a period that begins after foreclosure, and in these states it is only after the statutory redemption period has expired that the borrower's rights in the property are extinguished. See NELSON & WHITMAN, *supra* § 8.4.

22. See RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 4.1 cmt. a (1997); NELSON & WHITMAN, *supra* note 21, § 4.1; Kratovil, *supra* note 20, at 4.

23. See Kratovil, *supra* note 20, at 5.

24. See *id.* at 4, 6. In some states the borrower's right of possession is extended until the expiration of a statutory redemption period. See *id.* at 5.

that gives the lender the right to take possession of the property and collect rents after the borrower's default.²⁵

As a practical matter, the differences between title, lien, and intermediate theory states may not be so great as they would first appear. In many lien theory states, a lender has the right to take possession of the property and collect rents after default if the mortgage has a provision to that effect.²⁶ In title theory states, a borrower and lender will generally agree to permit the borrower to remain in possession of the property at least until default.²⁷ Therefore, borrowers and lenders contractually adopt the treatment of the intermediate theory states in title theory states and in those lien theory states in which it is permissible, giving the lender the right to take possession of the property and to begin collecting rents upon default.

In most states, therefore, a lender may collect rents upon default by taking possession of the mortgaged property. Rents collected by a lender in possession of mortgaged property must be applied to pay expenses of operating and maintaining the property and to the payment of the indebtedness secured by the mortgage.²⁸ Even if the lender is not permitted to take possession of the mortgaged property, the lender has the right to the appointment of a receiver for the property upon making the required showing to a court of the necessity therefor.²⁹ The remedies of possession by a lender or receivership are necessary for a lender if the borrower is wasting or mismanaging the mortgaged property.³⁰ However, lenders usually want the ability upon a default to control rents without taking possession of the property or obtaining the appointment of a receiver,³¹ and lenders therefore typically require the borrower to execute an assignment of rents in an attempt to make this remedy available.³²

Assignments of rents are recognized as valid and enforceable in every jurisdiction regardless of the mortgage theory that the jurisdiction has adopted, but they receive widely varying treatment in different

25. *See id.* at 4, 6. *See generally* NELSON & WHITMAN, *supra* note 21, §§ 4.1-4.3.

26. *See, e.g.*, *Kinnison v. Guar. Liquidating Corp.*, 115 P.2d 450, 452 (Cal. 1941); *Topeka Sav. Ass'n v. Beck*, 428 P.2d 779, 782 (Kan. 1967); *Cent. Sav. Bank v. First Cadco Corp.*, 181 N.W.2d 261, 264 (Neb. 1970); *Carlquist v. Coltharp*, 248 P. 481, 483 (Utah 1926).

27. Massachusetts is a title theory state, *see J & W Wall Sys., Inc. v. Shawmut First Bank & Trust Co.*, 594 N.E.2d 859, 860 n.3 (Mass. 1992), but the borrower has a statutory right to remain in possession until default in the absence of an agreement to the contrary, *see MASS. GEN. LAWS* ch. 183, § 26 (2006).

28. *See* NELSON & WHITMAN, *supra* note 21, § 4.27.

29. *See infra* notes 83-86 and accompanying text.

30. *See* NELSON & WHITMAN, *supra* note 21, § 4.34.

31. For a discussion of the disadvantages to a lender of the mortgagee-in-possession and receivership remedies, *see* Part II.B.

32. *See* NELSON & WHITMAN, *supra* note 21, § 4.35.

jurisdictions.³³ States vary in the steps required for perfection of a collateral assignment of rents³⁴ and in the methods permitted for enforcement.³⁵ Most states recognize and give effect to an absolute assignment of rents,³⁶ but some states do not recognize the absolute assignment of rents or treat it the same as a collateral assignment of rents.³⁷ In many states, a collateral assignment of rents will not accomplish the lender's objectives because of problems relating to perfection, enforcement, and the lender's access to collected rents.³⁸ As a result, lenders often require the borrower to give an absolute assignment of rents.

II. DEFICIENCIES OF THE COLLATERAL ASSIGNMENT OF RENTS

A. *The Perfection Problem*

The issues that arise with respect to perfection of a security interest in rents are best understood by first examining perfection of other types of security interests. Security interests in personal property become effective between the parties upon creation but must be perfected if the secured party is to have "maximum . . . protection against third parties, including

33. *See id.*

34. *See infra* Part II.A.

35. *See infra* Part II.B.

36. *See, e.g.*, *FDIC v. Int'l Prop. Mgmt.*, 929 F.2d 1033, 1038 (5th Cir. 1991) (applying Texas law); *Equitable Mortgage Co. v. Fishman (In re Charles D. Stapp of Nev., Inc.)*, 641 F.2d 737, 740 (9th Cir. 1981) (applying Nevada law); *Fid. Bankers Life Ins. Co. v. Williams (In re O'Neill Euters, Inc.)*, 506 F.2d 1242, 1243-44 (4th Cir. 1974) (applying Virginia law); *First Fid. Bank, N.A. v. Eleven Hundred Metroplex Assocs.*, 190 B.R. 510, 511-12 (Bankr. S.D.N.Y. 1995); *First Fed. Sav. of Ark. v. City Nat'l Bank of Fort Smith, Ark.*, 87 B.R. 565, 567-68 (Bankr. W.D. Ark. 1988); *In re Kingsport Ventures, L.P.*, 251 B.R. 841, 846 (Bankr. E.D. Tenn. 2000) (citing *Am. Trust & Banking Co. v. Twinam*, 216 S.W.2d 314, 319 (Tenn. 1948)); *Robin Assocs. v. Metro. Bank & Trust Co. (In re Robin Assocs.)*, 275 B.R. 218, 221 (Bankr. W.D. Pa. 2001); *In re Carter*, 126 B.R. 811, 813 (Bankr. M.D. Fla. 1991); *In re Galvin*, 120 B.R. 767, 771-72 (Bankr. D. Vt. 1990); *In re Gould*, 78 B.R. 590, 592 (Bankr. D. Idaho 1987); *In re P.M.G. Props.*, 55 B.R. 864, 869 (Bankr. E.D. Mich. 1985); *HomeCorp v. Secor Bank*, 659 So. 2d 15, 20 (Ala. 1994); *Vector Realty Group, Inc. v. 711 Fourteenth St., Inc.*, 711 A.2d 1265, 1267 (D.C. 1998); *Haw. Nat'l Bank v. Cook*, 58 P.3d 60, 68 (Haw. 2002); *MetLife Capital Fin. Corp. v. Wash. Ave. Assocs. L.P.*, 732 A.2d 493, 503 (N.J. 1999); *801 Nolana, Inc. v. RTC Mortgage Trust 1994-S6*, 994 S.W.2d 751, 754-56 (Tex. App. 1997).

In some states the absolute assignment is treated as creating a security interest, albeit a different type of security interest from a collateral assignment, and other courts treat an absolute assignment of rents as a transfer to the lender of the borrower's interest in the rents. *See infra* Part IV.A.

37. *See, e.g.*, CAL. CIV. CODE § 2938(a) (West 2006); *In re Century Inv. Fund VIII Ltd. P'ship.*, 937 F.2d 371, 377 (7th Cir. 1991) (applying Wisconsin law); *Drummond v. Farm Credit Bank of Spokane (In re Kurth Ranch)*, 110 B.R. 501, 506 (Bankr. D. Mont. 1990).

38. *See infra* Part II.

the trustee in bankruptcy.”³⁹ Under Article 9 of the Uniform Commercial Code (UCC), the method of perfection is determined by the type of collateral, but the more common means of perfection include filing a financing statement or taking possession of the collateral.⁴⁰ Both filing and possession give notice of the security interest.⁴¹

The term “perfection” is not typically used with respect to security interests in real property, but comparable concepts exist. A creditor with a lien on real property gets maximum protection against third parties and obtains priority over other creditors by recording the lien in the real property records.⁴² Recordation in the context of real property, like perfection in the context of Article 9, is a step that is designed to give notice to third parties of the creditor’s interest in the property.

Perfection of assignments of rents has caused a great deal of confusion. Under the traditional common law approach, a collateral assignment of rents creates what is called an “inchoate”⁴³ lien that is not perfected until the lender takes whatever action is required to enforce the assignment of rents.⁴⁴ Several states⁴⁵ and a number of federal courts interpreting state law⁴⁶ still follow this approach. To make matters worse for lenders, states that follow the common law approach to perfection may also require

39. JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 22-1, at 748 (5th ed. 2000).

40. *See id.* § 22-4, at 757-58.

41. *See id.*

42. *See* RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 4.2 cmt. b (1997).

43. “Inchoate” means “[p]artially completed or imperfectly formed; just begun.” BLACK’S LAW DICTIONARY 776 (8th ed. 2004).

44. *See* O’Neal Steel, Inc. v. E B Inc. (*In re Millette*), 186 F.3d 638, 641 (5th Cir. 1999).

45. *See, e.g.,* Bevins v. Peoples Bank & Trust Co., 671 P.2d 875, 879 (Alaska 1983); Martinez v. Cont’l Enters., 730 P.2d 308, 316 (Colo. 1986) (en banc); Taylor v. Brennan, 621 S.W.2d 592, 594 (Tex. 1981).

46. *See* O’Neal Steel, 186 F.3d at 641 n.6 (citing *In re Century Inv. Fund VIII L.P.*, 937 F.2d 371, 377 (7th Cir. 1991) (applying Wisconsin law); *In re 1301 Conn. Ave. Assocs.*, 126 B.R. 1, 3 (Bankr. D.D.C. 1991) (applying D.C. law); *First Fed. Sav. & Loan Assoc. of Toledo v. Hunter* (*In re Sam A. Tisci, Inc.*), 133 B.R. 857, 859 (Bankr. N.D. Ohio 1991) (applying Ohio law); *Condor One, Inc. v. Turtle Creek, Ltd.* (*In re Turtle Creek, Ltd.*), 194 B.R. 267, 278 (Bankr. N.D. Ala. 1996) (applying Alabama law); *In re Mews Assocs., L.P.*, 144 B.R. 867, 868-69 (Bankr. W.D. Mo. 1992) (applying Missouri law); *Drummond v. Farm Credit Bank of Spokane* (*In re Kurth Ranch*), 110 B.R. 501, 506 (Bankr. D. Mont. 1990) (applying Montana law); *Armstrong v. United States* (*In re Neideffer*), 96 B.R. 241, 243 (Bankr. D.N.D. 1988) (applying North Dakota law); *Ziegler v. First Nat’l Bank of Volga* (*In re Ziegler*), 65 B.R. 285, 287 (Bankr. D.S.D. 1986) (applying South Dakota law)). *But cf.* *Vienna Park Props. v. United Postal Sav. Ass’n* (*In re Vienna Park Props.*), 976 F.2d 106, 112-13 (2d Cir. 1992) (holding security interest in rents was inchoate under Virginia law but nevertheless perfected); *In re Park at Dash Point L.P.*, 121 B.R. 850, 855 (Bankr. W.D. Wash. 1990) (holding security interest inchoate but perfected), *aff’d sub nom.* *Steinberg v. Crossland Mortgage Corp.* (*In re Park at Dash Point L.P.*), 152 B.R. 300 (Bankr. W.D. Wash. 1991), *aff’d*, 985 F.2d 1008 (9th Cir. 1993).

burdensome action for enforcement.⁴⁷ Therefore, the lender does not have a perfected security interest in rents until the lender takes possession of the property or takes some other burdensome action such as obtaining the appointment of a receiver.⁴⁸ Typical of this troublesome approach is *Taylor v. Brennan*, in which the Texas Supreme Court held that a collateral assignment of rents is inchoate and “does not become operative until the mortgagee obtains possession of the property, or impounds the rents, or secures the appointment of a receiver, or takes some other similar action.”⁴⁹

Most states, whether by statute⁵⁰ or judicial decision,⁵¹ have now adopted the modern approach that perfection of an assignment of rents is accomplished by recordation. Perfection in these states, therefore, is analogous to perfection under Article 9 of the U.C.C. and perfection of a mortgage lien. Filing a financing statement or recording an instrument in the real property records is the step by a lender that gives notice to the world of the security interest or lien. Similarly, recording an assignment of rents in the real property records gives notice of the security interest in rents and thus perfects the security interest.

Nevertheless, in a significant minority of states, a recorded collateral assignment of rents is not treated as perfected until the lender takes steps to enforce the security interest.⁵² As a result, in a priority contest between a mortgage lender with a recorded but unenforced assignment of rents and a judgment lien creditor who has served a writ of garnishment on rents, the judgment lien creditor will win.⁵³ The Court of Appeals for the Fifth Circuit, in criticizing the common law approach stated: “This leads to a bizarre result: A mortgagee, which has done all it could to secure its interest in the rents, loses priority to a judgment creditor who had constructive knowledge by the recordation of the mortgagee’s assignment of rents.”⁵⁴ This result defeats the public policy concerns underlying

47. See *infra* Part II.B for a discussion of permitted methods of enforcement.

48. See *Taylor*, 621 S.W.2d at 594.

49. *Id.* The court has not elaborated on what “other similar action” might include.

50. See, e.g., CAL. CIV. CODE § 2938(b) (West 2006); DEL. CODE ANN. tit. 25, § 2121(a) (2006); FLA. STAT. § 697.07(2) (2006); KAN. STAT. ANN. § 58-2343(b) (2006); MD. CODE ANN., REAL PROP. § 3-204 (West 2006); NEB. REV. STAT. § 52-1704 (2006); N.C. GEN. STAT. § 47-20(c) (2006); TENN. CODE ANN. § 66-26-116(a) (2006); VA. CODE ANN. § 55-220.1 (2006); WASH. REV. CODE § 7.28.230(3) (2006).

51. See, e.g., *O’Neal Steel*, 186 F.3d at 642 n.7 (citing *Travelers Ins. Co. v. First Nat’l Bank of Blue Island*, 621 N.E.2d 209, 214-15 (Ill. App. Ct. 1993); *Teachers Ins. & Annuity Ass’n of Am. v. Okla. Tower Assocs. L.P.*, 798 P.2d 618, 622 (Okla. 1990)).

52. See *supra* notes 45-46 and accompanying text.

53. See, e.g., *O’Neal Steel*, 186 F.3d at 642.

54. *Id.*

recording acts.⁵⁵

Before the Bankruptcy Reform Act of 1994,⁵⁶ the confusion over perfection of assignments of rents created havoc in the bankruptcy courts.⁵⁷ The Bankruptcy Code gives a trustee in bankruptcy, as well as a debtor in possession, the power to avoid transfers to the same extent as a bona fide purchaser of real property from the debtor or a lien creditor of the debtor.⁵⁸ Therefore, the trustee or debtor in possession can avoid an unrecorded transfer of an interest in real property or an unperfected security interest. In bankruptcy cases, courts look to state law to determine the extent of property rights, including a mortgage lender's rights to rents.⁵⁹ Thus, depending on state law or a federal court's interpretation of state law, courts in bankruptcy cases adopted different approaches to the issue of whether the trustee or debtor in possession could avoid a mortgage lender's assignment of rents that was recorded but not yet enforced.⁶⁰ Some courts determined that the trustee could avoid the lender's interest in rents if state law required enforcement for perfection.⁶¹ Other courts permitted the

55. *See id.*

56. Pub. L. No. 103-394, 108 Stat. 4106 (1994) (codified as amended in scattered sections of 11 U.S.C.).

57. *See* Forrester, *supra* note 2, at 354-55 n.21 ("The author found more than 300 bankruptcy cases reported from 1980 to [1993] involving the issue of rents.").

58. *See* 11 U.S.C. § 544(a) (2000).

59. *See* *Butner v. United States*, 440 U.S. 48, 54-55 (1979). In *Butner*, the U.S. Supreme Court said,

Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving "a windfall merely by reason of the happenstance of bankruptcy." The justifications for application of state law are not limited to ownership interests; they apply with equal force to security interests, including the interest of a mortgagee in rents earned by mortgaged property.

Id. at 55 (quoting *Lewis v. Mfrs. Nat'l Bank*, 364 U.S. 603, 609 (1961)). The Court has continued to follow its mandate set forth in *Butner* under the current Bankruptcy Code. *See* *Raleigh v. Ill. Dep't of Revenue*, 530 U.S. 15, 20 (2000); *Nobelman v. Am. Sav. Bank*, 508 U.S. 324, 329 (1993).

60. *See* Forrester, *supra* note 2, at 386-92.

61. *See, e.g.,* *Glessner v. Union Nat'l Bank & Trust Co. (In re Glessner)*, 140 B.R. 556, 561 (Bankr. D. Kan. 1992), *superseded by statute*, KAN. STAT. ANN. § 58-2343 (2005); *Drummond v. Farm Credit Bank (In re Kurth Ranch)*, 110 B.R. 501, 506 (Bankr. D. Mont. 1990); *In re Multi-Group III Ltd. P'ship*, 99 B.R. 5, 10 (Bankr. D. Ariz. 1989); *In re TM Carlton House Partners, Ltd.*, 91 B.R. 349, 357 (Bankr. E.D. Pa. 1988); *In re Ass'n Ctr. Ltd. P'ship*, 87 B.R. 142, 147 (Bankr. W.D. Wash. 1988), *superseded by statute*, WASH. REV. CODE § 7.28.230(3) (2006); *In re Hamlin's Landing Joint Venture*, 77 B.R. 916, 919-20 (Bankr. M.D. Fla. 1987), *superseded by statute*, FLA. STAT. § 697.07 (2006); *Exch. Nat'l Bank v. Gotta (In re Gotta)*, 47 B.R. 198, 203 (Bankr. W.D.

lender to perfect the assignment of rents by filing a notice in the bankruptcy court, even if it was treated as unperfected under state law before the bankruptcy filing.⁶² A third group of courts found that a properly recorded assignment of rents was perfected and thus would not permit the trustee to avoid the lender's interest in rents.⁶³

Congress addressed this issue in the Bankruptcy Reform Act of 1994⁶⁴ by amending § 552(b) of the Bankruptcy Code.⁶⁵ According to the

Wis. 1985).

62. See, e.g., *Casbeer v. State Fed. Sav. & Loan Ass'n of Lubbock* (*In re Casbeer*), 793 F.2d 1436, 1443 (5th Cir. 1986); *Wolters Vill., Ltd. v. Vill. Props., Ltd.* (*In re Vill. Props., Ltd.*), 723 F.2d 441, 446-47 (5th Cir. 1984); *Consol. Capital Income Trust v. Colter, Inc.* (*In re Consol. Capital Income Trust*), 47 B.R. 1008, 1011 (Bankr. D. Colo. 1985); *McCombs Props. VI, Ltd. v. First Tex. Sav. Ass'n* (*In re McCombs Props. VI, Ltd.*), 88 B.R. 261, 264 (Bankr. C.D. Cal. 1988); *In re Mears*, 88 B.R. 419, 421 (Bankr. S.D. Fla. 1988); *In re Gelwicks*, 81 B.R. 445, 448 (Bankr. N.D. Ill. 1987); *FDIC v. Lancaster* (*In re Sampson*), 57 B.R. 304, 307 (Bankr. E.D. Tenn. 1986); *United States v. Farrell* (*In re Fluge*), 57 B.R. 451, 454 (Bankr. D.N.D. 1985).

63. See, e.g., *Steinberg v. Crossland Mortgage Corp.* (*In re Park at Dash Point L.P.*), 985 F.2d 1008, 1011 (9th Cir. 1993); *Vienna Park Props. v. United Postal Sav. Ass'n* (*In re Vienna Park Props.*), 976 F.2d 106, 112-13 (2d Cir. 1992); *J.H. Streiker & Co. v. SeSide Co.* (*In re SeSide Co.*), 152 B.R. 878, 885 (Bankr. E.D. Pa. 1993); *Nw. Nat'l Life Ins. Co. v. Metro Square* (*In re Metro Square*), 106 B.R. 584, 588 (Bankr. D. Minn. 1989); *In re Northport Marina Assocs.*, 136 B.R. 911, 919 (Bankr. E.D.N.Y. 1992); *In re White Plains Dev. Corp.*, 136 B.R. 93, 95 (Bankr. S.D.N.Y. 1992); *In re Rancourt*, 123 B.R. 143, 147 (Bankr. D.N.H. 1991); *In re Somero*, 122 B.R. 634, 638-39 (Bankr. D. Me. 1991); *In re Raleigh/Spring Forest Apartments Assocs.*, 118 B.R. 42, 45 (Bankr. E.D.N.C. 1990).

64. Pub. L. No. 103-394, 108 Stat. 4106 (1994) (codified as amended in scattered sections of 11 U.S.C.).

65. 11 U.S.C.A. § 552(b)(2) (West 2007). Section 552(b)(2) now reads:

Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title, and notwithstanding section 546(b) of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to amounts paid as rents of such property or the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties, then such security interest extends to such rents and such fees, charges, accounts, or other payments acquired by the estate after the commencement of the case to the extent provided in such security agreement, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

Id. The Act deleted "and by applicable nonbankruptcy law" after "security agreement" and added "and notwithstanding section 546(b) of this title" as shown above. The Act also rephrased "proceeds, product, offspring, rents, or profits of such property" to read "amounts paid as rents of such property or the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties." Pub. L. No. 103-394, § 214(a), 108 Stat. 4106, 4126 (1994) (codified as amended at 11 U.S.C.A. § 552(b)).

legislative history of the Act, the amendment “provides that lenders may have valid security interests in post-petition rents for bankruptcy purposes notwithstanding their failure to have fully perfected their security interest under applicable state law.”⁶⁶ Thus, according to this legislative history, a bankruptcy trustee or debtor in possession should no longer be able to avoid properly recorded assignments of rents. Some commentators have disputed the effectiveness of the language of the current § 522(b)(2) to resolve the perfection problem in bankruptcy,⁶⁷ but the spate of litigation over this issue has subsided.

Under the law in a number of states, the perfection problem for a collateral assignment of rents persists. A solution, however, that lenders have found to the perfection problem is the absolute assignment of rents. An absolute assignment does not create an inchoate lien on rents and is effective upon default.⁶⁸ Therefore, even in those states that have equated perfection with enforcement for a collateral assignment of rents, courts have held that an absolute assignment does not require additional action by the lender in order to be perfected.⁶⁹ Consequently, lenders have an incentive to require an absolute assignment of rents rather than a collateral assignment in those states that retain the traditional common law approach to perfection. In other states, issues over enforcement may create that incentive.

B. *The Enforcement Problem*

The method by which a collateral assignment of rents may be enforced varies from state to state. In some states, a lender may enforce a collateral assignment of rents by taking some nominal action, such as making demand on the borrower⁷⁰ or the tenants.⁷¹ Other states may require

66. 140 CONG. REC. H10752-01 (daily ed. Oct. 4, 1994) (statement of Rep. Brooks).

67. See Carlson, *supra* note 7, at 1145; Freyermuth, *The New UARA*, *supra* note 7, at 28; Marvin E. Jacob et al., *An Analysis of the Provisions of the Bankruptcy Reform Act of 1994 Relating to Cases Administered Under Chapter 11*, 4 J. BANKR. L. & PRAC 339, 370-73 (1995).

A Texas bankruptcy court recently discussed the issue of perfection of a security interest in rents in the bankruptcy context without referring to the Bankruptcy Reform Act of 1994 (the 1994 Act). See *In re Allen*, 357 B.R. 103, 110 (Bankr. S.D. Tex. 2006). The court cited and discussed pre-1994 Act cases as being authoritative with respect to the perfection issue. *Id.* The case cannot, however, be taken as holding that the 1994 Act did not resolve the perfection issue in bankruptcy because the court failed to even discuss the Act.

68. See *O’Neal Steel, Inc. v. E B Inc. (In re Millett)*, 186 F.3d 638, 643 (5th Cir. 1999).

69. See, e.g., *id.*; *Geary’s Bottled Liquors Co. v. Independence One Fin. Servs. (In re Geary’s Bottled Liquors Co.)*, 184 B.R. 408, 413 (Bankr. D. Mass. 1995).

70. See, e.g., CAL. CIV. CODE § 2938(c)(4) (West 2006); *United States v. Farrell (In re Fluge)*, 57 B.R. 451, 454 (Bankr. D.N.D. 1985); *Bevins v. Peoples Bank & Trust Co.*, 671 P.2d 875, 879 (Alaska 1983); *Haw. Nat’l Bank v. Cook*, 58 P.3d 60, 67-68 (Haw. 2002).

71. See, e.g., CAL. CIV. CODE § 2938(c)(3); *Imperial Gardens Liquidating Trust v. Nw.*

somewhat more onerous action, such as filing a request for a receiver⁷² or initiating a foreclosure proceeding.⁷³ To enforce a collateral assignment of rents in many states, however, the lender must take possession of the mortgaged property or take some action, such as obtaining the appointment of a receiver, that is considered the equivalent of taking possession of the property.⁷⁴

Requiring a lender to take possession of mortgaged property or obtain the appointment of a receiver in order to enforce a collateral assignment of rents is a significant disadvantage to lenders. A lender must go to court to obtain the appointment of a receiver,⁷⁵ and obtaining possession of the mortgaged property requires judicial intervention as well, unless the borrower is willing to relinquish possession of the property voluntarily.⁷⁶ The delay can give a borrower time to collect and misapply rents.⁷⁷ In addition, when a lender becomes a mortgagee-in-possession, the lender faces potential liability that can exceed the amount of the mortgage debt. First, a lender in possession might face liability for environmental problems on the property.⁷⁸ Second, the lender can be held liable to the

Commons, Inc. (*In re* Nw. Commons, Inc.), 136 B.R. 215, 218 (Bankr. E.D. Mo. 1991), *criticized in* *In re* Mews Assocs., L.P., 144 B.R. 867, 868 (Bankr. W.D. Mo. 1992); *Fluge*, 57 B.R. at 454; *Haw. Nat'l Bank*, 58 P.3d at 67-68.

72. See, e.g., *In re* Century Inv. Fund VIII Ltd. P'ship, 937 F.2d 371, 378 (7th Cir. 1991); *In re* Flower City Nursing Home, Inc., 38 B.R. 642, 645 (Bankr. W.D.N.Y. 1984).

73. See, e.g., *Martinez v. Cont'l Enters.*, 730 P.2d 308, 316 (Colo. 1986).

74. See, e.g., *Freedman's Sav. & Trust Co. v. Shepherd*, 127 U.S. 494, 502-03 (1888) (requiring that the lender take actual possession, that a receiver take possession, or that the lender's demand for possession be refused); *In re* Park at Dash Point L.P., 121 B.R. 850, 856 (Bankr. W.D. Wash. 1990) (requiring the lender to obtain possession either directly or through a receiver), *aff'd sub nom.* *Steinberg v. Crossland Mortgage Corp.* (*In re* Park at Dash Point L.P.), 152 B.R. 300 (Bankr. W.D. Wash. 1991), *aff'd*, 985 F.2d 1008 (9th Cir. 1993); *Taylor v. Brennan*, 621 S.W.2d 592, 594 (Tex. 1981) (requiring the lender to obtain possession, impound the rents, secure appointment of a receiver, or take some similar action).

75. See *Fed. Home Loan Mortgage Corp. v. Spark Tarrytown, Inc.*, 829 F. Supp. 82, 85 (S.D.N.Y. 1993).

76. Although the mortgagee-in-possession remedy is designed to take effect without judicial intervention, a lender may not use force to dispossess a borrower who refuses to give up possession of the mortgaged property.

77. A lender with a collateral assignment of rents cannot reach rents collected by the borrower during this period. See *infra* Part II.C.

78. The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA), 42 U.S.C.A. §§ 9601-9675 (West 2007), imposes liability upon owners and operators of hazardous waste sites. *Id.* § 9607(a). "Owner or operator" does not include "a lender that, without participating in the management of a . . . facility, holds indicia of ownership primarily to protect the security interest . . . in the . . . facility." *Id.* § 9601(20)(E). CERCLA defines participation in management as "actually participating in the management or operational affairs of a . . . facility" and "does not include merely having the capacity to influence, or the unexercised right to control . . . facility operations." *Id.* § 9601(20)(F). The statute includes within the meaning of the term the exercise of "decisionmaking control over the environmental compliance related to

borrower for mismanagement if the lender fails to “manage the property in a reasonably prudent and careful manner so as to keep it in a good state of preservation and productivity.”⁷⁹ A mortgagee-in-possession is held to the standard of a “prudent” or “provident” owner.⁸⁰ Finally, the lender might be liable to third parties for injuries caused by dangerous conditions on the property.⁸¹ For these reasons, lenders are generally hesitant to become mortgagees-in-possession.⁸²

the . . . facility” or the exercise of “control at a level comparable to that of a manager of the . . . facility” if the borrower remains in possession of the facility. *Id.* Therefore, a lender’s exercise of such control while in possession of the facility is probably within the scope of “participation in management.”

The statute provides a safe harbor for a lender after foreclosure if the lender is attempting to sell the property as prescribed by the statute, *id.* § 9601(20)(F), but the rule provides no similar safe harbor for a lender in possession prior to foreclosure. Therefore, a mortgagee-in-possession is likely participating in the management of a facility and does not fit within the exemption from liability.

79. *Myers-Macomber Eng’rs v. M.L.W. Constr. Corp.*, 414 A.2d 357, 360 (Pa. Super. Ct. 1979).

80. *See United Nat’l Bank v. Parish*, 750 A.2d 238, 241 (N.J. Super. Ct. Ch. Div. 1999) (quoting *Essex Cleaning v. Amato*, 317 A.2d 411, 412 (N.J. Super. Ct. App. Div. 1974)); *Koury v. Sood*, 62 A.2d 649, 653 (R.I. 1948); *Bomar v. Smith*, 195 S.W. 964, 980 (Tex. Civ. App. 1917); *Coleman v. Hoffman*, 64 P.3d 65, 68 (Wash. Ct. App. 2003); RESTATEMENT (THIRD) OF PROP.: MORTGAGES, § 4.1 cmt. c (1997).

81. *See Daniels v. Hart*, 118 Mass. 543, 544 (1875); *Barter & Co. v. Wheeler*, 49 N.H. 9, 34 (1869); *First Nat’l Bank v. Motor Club of Am. Ins. Co.*, 708 A.2d 69, 70 (N.J. Super. Ct. App. Div. 1997); *Rogers v. Wheeler*, 43 N.Y. 598, 603-04 (1871); *Zisman v. City of Duquesne*, 18 A.2d 95, 97 (Pa. Super. Ct. 1941); *Sprague v. Smith*, 29 Vt. 421, 425-26 (1857); *Coleman*, 64 P.3d at 68; *NELSON & WHITMAN*, *supra* note 21, § 4.26.

82. Even in states that permit enforcement of a collateral assignment of rents by less onerous action than taking possession, courts may consider the required action to be the equivalent of taking possession. *See J.H. Streiker & Co. v. SeSide Co. (In re SeSide Co.)*, 152 B.R. 878, 883 (Bankr. E.D. Pa. 1993) (classifying a lender’s service of demand notices on tenants as taking constructive possession); *Imperial Gardens Liquidating Trust v. Nw. Commons, Inc. (In re Nw. Commons, Inc.)*, 136 B.R. 215, 218 (Bankr. E.D. Mo. 1991) (finding that a lender’s notifications to tenants was “equivalent to taking possession”), *criticized in In re Mews Assocs., L.P.*, 144 B.R. 867, 868 (Bankr. W.D. Mo. 1992); *Spiotta v. Nat’l Grocery Co.*, 168 A. 159, 160 (Hudson County Ct. 1933) (finding constructive possession where lender had served notice on tenant demanding payment of rent to lender). As a result, the lender could be treated as a mortgagee-in-possession with the attendant risks and liabilities. *See United Nat’l Bank v. Parish*, 750 A.2d 238, 239-40 (N.J. Super. Ct. Ch. Div. 1999) (treating a lender who collected rents pursuant to an assignment of rents as a mortgagee-in-possession). However, most courts have held that simply collecting rents after making demand on the borrower or tenants without otherwise taking control of the property does not make a lender a mortgagee-in-possession. *See, e.g., Prince v. Brown*, 856 P.2d 589, 590 (Okla. Civ. App. 1993); *Coleman*, 64 P.3d at 69-70; *NELSON & WHITMAN*, *supra* note 21, § 4.25; *see also Strutt v. Ontario Sav. & Loan Ass’n*, 105 Cal. Rptr. 395, 405 (Ct. App. 1973) (finding that a lender “who, after default, does no more than collect rents by means of a letter request to the tenants and who does not undertake management of the property is [not] a ‘mortgagee-in-possession’”); *Luther P. Stephens Inv. Co. v. Berry Schs.*, 3 S.E.2d 68, 71 (Ga. 1939) (“[T]he mere fact that the mortgagee receives the rents and profits does not constitute him a mortgagee-in-possession, unless he takes the rent in such a way as to take out of the hands of the mortgagor the management and control of

There are also disadvantages to the receivership remedy. First, a lender might find it difficult to make the necessary showing to a court that a receiver should be appointed. In many states, the insolvency of the borrower and inadequacy of the security are insufficient as the sole reasons for a receivership.⁸³ Some additional equitable ground for the receivership, “such as danger of loss, waste, destruction, or serious impairment of the property,” must exist.⁸⁴ The effectiveness of a provision in loan documents entitling a lender to the appointment of a receiver varies from jurisdiction to jurisdiction.⁸⁵ If the lender does procure the appointment of a receiver, fees paid to the receiver reduce funds available for payment of the mortgage debt and a risk exists that the receiver will mismanage the property.⁸⁶ Finally, in states that permit non-judicial foreclosure, a lender risks being deemed to have elected a judicial foreclosure by going to court to obtain the appointment of a receiver.⁸⁷ Therefore, receivership may be undesirable to lenders as a means to control rents.

The absolute assignment of rents has provided a solution for lenders to the enforcement problem for collateral assignments of rents. An absolute assignment of rents gives the lender the right to collect rents automatically upon default.⁸⁸ Therefore, the lender can take control of rents upon default

the estate.”); *Ireland v. U.S. Mortgage & Trust Co.*, 76 N.Y.S. 177, 182 (N.Y. App. Div. 1902) (finding that a lender’s receipt of rents does not make the lender a mortgagee-in-possession), *aff’d*, 67 N.E. 1083 (1903).

83. *See, e.g., Grether v. Nick*, 213 N.W. 304, 306 (Wis. 1927).

84. *Id.*; *see also Totten v. Harlowe*, 90 F.2d 377, 380 (D.C. Cir. 1937); *Atco Constr. & Dev. Corp. v. Beneficial Sav. Bank*, F.S.B., 523 So. 2d 747, 750 (Fla. 5th DCA 1988); *First Nat’l Bank of Joliet v. Ill. Steel Co.*, 51 N.E. 200, 202 (Ill. 1898); *Crowley v. Valley W. Water Co.*, 882 P.2d 1022, 1026 (Mont. 1994); *Cortleyeu v. Hathaway*, 11 N.J. Eq. 39, 43 (N.J. Ch. 1855). *See generally NELSON & WHITMAN, supra* note 21, § 4.34 (discussing the basis for appointment of a receiver in title and lien jurisdictions).

85. The presence of a receivership clause in the mortgage has virtually no effect in some states. *See, e.g., Gage v. First Fed. Sav. & Loan Ass’n of Hutchinson, Kan.*, 717 F. Supp. 745, 750-51 (D. Kan. 1989); *Dart v. W. Sav. & Loan Ass’n*, 438 P.2d 407, 410-11 (Ariz. 1968); *ANJ Future Invs., Inc. v. Alter*, 756 So. 2d 153, 154 (Fla. 3d DCA 2000) (quoting *Seasons P’ship I v. Kraus-Anderson, Inc.*, 700 So. 2d 60, 61 (Fla. 2d DCA 1997); *Aetna Life Ins. Co. v. Broecker*, 77 N.E. 1092, 1092 (Ind. 1906); *Hazeltine v. Granger*, 7 N.W. 74, 75 (Mich. 1880). In other states, such a clause is helpful, but not conclusive, on the issue. *See Barclays Bank of Cal. v. Superior Court*, 137 Cal. Rptr. 743, 748 (Ct. App. 1977); *Fleet Bank v. Zimelman*, 575 A.2d 731, 734 (Me. 1990); *Riverside Props. v. Teachers Ins. & Annuity Ass’n*, 590 S.W.2d 736, 738 (Tex. Civ. App. 1979). Finally, in a few states, such a clause is enforceable by a lender without the necessity for a showing of any of the ordinary grounds for the appointment of a receiver. *See MINN. STAT. § 559.17* (2006); *Febbraro v. Febbraro*, 416 N.Y.S.2d 59, 60 (N.Y. App. Div. 1979).

86. *See* RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 4.3 cmt. e (1997).

87. *See First S. Props., Inc. v. Vallone*, 533 S.W.2d 339, 341-42 (Tex. 1976).

88. *See, e.g., Equitable Mortgage Co. v. Fishman (In re Charles D. Stapp, of Nev., Inc.)*, 641 F.2d 737, 740 (9th Cir. 1981); *Vector Realty Group, Inc. v. 711 Fourteenth St., Inc.*, 711 A.2d 1265, 1267 (D.C. 1998); *Haw. Nat’l Bank v. Cook*, 58 P.3d 60, 67 (Haw. 2002); *MetLife Capital Fin. Corp. v. Wash. Ave. Assocs. L.P.*, 732 A.2d 493, 503 (N.J. 1999); *Taylor v. Brennan*, 621

without taking any burdensome action.

C. *The Right to Previously Collected Rents*

Another problem with the collateral assignment of rents from a lender's perspective is that the lender cannot reach rents collected by the borrower after default. Rents collected by the borrower are severed from the realty, and the lender's interest in rents under a collateral assignment of rents does not extend to these personal property "proceeds" of rents.⁸⁹ An agreement of the parties to the contrary is not effective.⁹⁰ The lender's inability to reach rents collected by the borrower between default and the lender's exercise of its rights under a collateral assignment of rents is particularly troublesome in those states where the lender must take some burdensome action in order to begin collecting rents. Since the lender may not be able to take possession of the property or obtain the appointment of a receiver quickly, the borrower may be able to collect rents for several months and misapply those rents without recourse by the lender.

An absolute assignment of rents, on the other hand, gives the lender the right to rents collected by the borrower or other parties after default.⁹¹ Therefore, the lender's inability to reach rents collected by the borrower after default pursuant to a collateral assignment of rents gives the lender

S.W.2d 592, 594 (Tex. 1981).

89. *In re Park at Dash Point L.P.*, 121 B.R. 850, 855 (Bankr. W.D. Wash. 1990), *aff'd sub nom.* Steinberg v. Crossland Mortgage Corp. (*In re Park at Dash Point L.P.*) 152 B.R. 300 (W.D. Wash. 1991), *aff'd*, 985 F.2d 1008 (9th Cir. 1993). Even after default, a borrower has the right to collect rents until the lender enforces its assignment of rents, and the lender has no rights whatsoever to those rents collected by the borrower prior to enforcement. *See Prudential Ins. Co. v. Liberdar Holding Corp.*, 74 F.2d 50, 51 (2d Cir. 1934); *In re Park at Dash Point L.P.*, 121 B.R. at 855; *In re Prichard Plaza Assocs. Ltd. P'ship*, 84 B.R. 289, 297 (Bankr. D. Mass. 1988); *Martinez v. Cont'l Enters.*, 730 P.2d 308, 316 (Colo. 1986); *Taylor*, 621 S.W.2d at 594. *But cf.* *Fed. Land Bank of Omaha v. Lower*, 421 N.W.2d 126, 129 (Iowa 1988) (holding that a lender with a valid lien on rents created by chattel mortgage was entitled to an accounting from the borrower for rents collected by the borrower during the period between entry of a foreclosure decree and request by the lender for appointment of a receiver).

90. *See, e.g., Glessner v. Union Nat'l Bank & Trust Co. (In re Glessner)*, 140 B.R. 556, 561 (Bankr. D. Kan. 1992) ("Reason and authority lead us to the conclusion that the mortgagee is not entitled to the benefits of the contract for the rents and profits of the land until he has, by appropriate proceedings through the courts, taken the possession and control of such rents and profits.") (quoting *Hall v. Goldsworthy*, 14 P.2d 659, 661 (Kan. 1932)); *Drummond v. Farm Credit Bank of Spokane (In re Kurth Ranch)*, 110 B.R. 501, 506 (Bankr. D. Mont. 1990) ("[I]n Montana, a mortgagee may secure a security interest in the rents from the mortgaged property only by appointment of a receiver, even though . . . the mortgage instrument contains an assignment of rent provision upon default.").

91. *See FDIC v. Int'l Prop. Mgmt., Inc.*, 929 F.2d 1033, 1035 (5th Cir. 1991); *Fid. Bankers Life Ins. Co. v. Williams (In re O'Neill Enters., Inc.)*, 506 F.2d 1242, 1244 (4th Cir. 1974); *Great W. Life Assurance Co. v. Rothman (In re Ventura-Louise Props.)*, 490 F.2d 1141, 1145 (9th Cir. 1974).

another incentive to require an absolute assignment of rents.

The absolute assignment of rents is not a recent development. Borrowers, lenders, and courts have struggled with the problems related to assignments of rents for many years. Lenders have attempted to solve these problems by using the absolute assignment of rents for more than a century.

III. HISTORICAL DEVELOPMENT OF THE ABSOLUTE ASSIGNMENT OF RENTS

The use of rents as additional security for a mortgage loan was recognized very early in American law. John Powell acknowledged in his 1807 mortgage law treatise that “rents . . . may be made the subject of a mortgage.”⁹² The earliest known corporate deed of trust, dated March 29, 1830, had a clause that allowed the trustee, upon the occurrence of a default, to enter and take possession of the property, and to collect rents and profits therefrom.⁹³ The problem for both nineteenth-century and modern-day attorneys was drafting language that would create a security interest in rents that could be enforced in accordance with the intent of the parties.

Many early cases acknowledge the right of a mortgage lender pursuant to a “pledge” of rents to collect rents after taking possession of the property, obtaining the appointment of a receiver, or some similar action such as demanding and being refused possession.⁹⁴ More difficult to find are early cases recognizing the ability of a lender to collect rents upon default without taking possession or some equivalent action. In many of the early cases, the parties agreed that the lender must take possession or equivalent action in order to collect rents; therefore, the right of the lender to collect rents without taking possession was not at issue. In other cases, there was no assignment of rents, but the granting clause of the mortgage or deed of trust covered the real property together with rents and profits.⁹⁵ In these cases, courts properly held that the mortgagor was entitled to the rents until the lender took possession or obtained the appointment of a receiver. In other cases, however, courts simply refused to give effect to the language of the agreement giving the lender the right to rents upon default.⁹⁶

92. JOHN J. POWELL, A TREATISE ON THE LAW OF MORTGAGES 25 (1st Am. ed. 1811). The first American edition was adapted from the fourth English edition.

93. See Israels & Kramer, *supra* note 7, at 488; James G. Smith, *A Forgotten Chapter in the Early History of the Corporate Trust Deed*, 61 AM. L. REV. 900, 904-05 (1927).

94. See *Freedman's Sav. & Trust Co. v. Shepherd*, 127 U.S. 494, 502 (1888); *In re Banner*, 149 F. 936, 939 (S.D.N.Y. 1907); *Sullivan v. Rosson*, 119 N.E. 405, 408 (N.Y. 1918).

95. See, e.g., *Myers v. Brown*, 112 A. 844, 845 (N.J. Ch. 1921).

96. See *infra* notes 124-36 and accompanying text.

In some late-nineteenth and early-twentieth century cases, the parties agreed that the lender could collect rents from the outset of the loan without taking possession.⁹⁷ Typical of these cases is *Harris v. Taylor*,⁹⁸ decided in 1898, in which a first mortgage lender was assigned “the sum of \$200 of the rents collected for each month.”⁹⁹ A second lienholder had sued for foreclosure and appointment of a receiver, and the first lienholder was seeking to have rents paid over to him by the receiver.¹⁰⁰ Holding for the first lienholder, the court said that his assignment of rents “purports to be an absolute, primary security for the debt, and was so treated prior to the appointment of the receiver.”¹⁰¹ The court thus enforced the assignment of rents in accordance with the agreement of the parties that the lender could collect rents without taking possession of the mortgaged property.

Although courts gave effect to an agreement of the parties whereby the lender could collect rents from the outset, what lenders often wanted was the ability to collect rents upon default without taking possession. Courts were then, as now, reluctant to find this type of agreement. In 1888 in *Freedman’s Savings & Trust Co. v. Shepherd*,¹⁰² the U.S. Supreme Court stated:

97. See *Cargill v. Thompson*, 59 N.W. 638, 639 (Minn. 1894); *Harris v. Taylor*, 54 N.Y.S. 864, 866 (N.Y. App. Div. 1898); see also *Kelly v. Bowerman*, 71 N.W. 836, 837 (Mich. 1897) (involving a mortgagee who, through his brother, took possession at the time of execution of the mortgage and holding that an “assignment of rents of mortgaged property, to be received by the mortgagee and applied upon the mortgage, is valid”); *Bank of Commerce & Trust Co. v. City of Memphis*, 290 S.W. 990, 991 (Tenn. 1927) (requiring borrower, pursuant to trust deed terms, to keep rents on deposit in lender bank for application only to operation and maintenance of property and payment of debt).

98. 54 N.Y.S. 864 (N.Y. App. Div. 1898).

99. *Id.* at 866.

100. See *id.* at 864.

101. *Id.* at 866-67.

102. 127 U.S. 494 (1888). *Freedman’s Savings* was decided long before *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938), struck down *Swift v. Tyson*, 41 U.S. 1 (1842). Under *Swift*, federal courts were not constrained by state court rulings in deciding issues of “general” commercial law because state court decisions were merely evidence of the law, not law themselves. See *Swift*, 41 U.S. at 18. *Swift* was consistent with early-nineteenth century ideas that “the common law grew from general principles of right and reason that existed independent of judicial decisions, and the function of judges was to find, ‘declare,’ and apply the proper ones to each new fact situation.” Edward A. Purcell, Jr., *The Story of Erie: How Litigants, Lawyers, Judges, Politics, and Social Change Reshape the Law*, in *CIVIL PROCEDURE STORIES* 21, 24 (Kevin M. Clermont ed., 2004). Under *Swift*, state court opinions regarding “rights and titles to things having a permanent locality, such as the rights and titles to real estate” were laws that federal courts were required to respect. *Swift*, 41 U.S. at 18. Thus, although property law was not included as part of the general common law under *Swift*, a Supreme Court decision on a property law issue would nevertheless be influential as “evidence of the law.” Based on the number of subsequent opinions that have cited or quoted *Freedman’s Savings*, it clearly was influential. See *infra* note 104.

It is, of course, competent for the parties to provide in the mortgage for the payment of rents and profits to the mortgagee, even while the mortgagor remains in possession. But when the mortgage contains no such provision, and even where the income is expressly pledged as security for the mortgage debt, with the right in the mortgagee to take possession upon failure of the mortgagor to perform the conditions of the mortgage, the general rule is that the mortgagee is not entitled to the rents and profits of the mortgaged premises until he takes actual possession, or until possession is taken in his behalf by a receiver, . . . or until, in proper form, he demands, and is refused, possession.¹⁰³

Therefore, the Court recognized the enforceability of an agreement between the parties that the lender collect rents upon default without taking possession long before the term “absolute assignment” was used for that purpose. However, the Court’s distinction between an interest in rents that can be enforced without taking possession and a “pledge of rents” may have contributed to the use of the absolute assignment to create an interest in rents that can be enforced without possession. This language from the *Freedman’s Savings* case has been cited or quoted in more than one hundred cases¹⁰⁴ and exerts a clear influence on the law governing assignments of rents.

A few early courts simply gave effect to language in an assignment of rents that the lender was entitled to rents upon default.¹⁰⁵ For example, in *Thomson v. Erskine*,¹⁰⁶ decided in 1901, a mortgage lender sued a tenant for two months of rent that accrued after the borrower’s default and notice by the lender to the tenant.¹⁰⁷ The assignment of rents “by its terms was to become operative upon default.”¹⁰⁸ In holding for the lender, the court stated, “We see no reason why a mortgagor may not, if he so desires, agree with his mortgagee, and so stipulate in the bond, to assign the rents of the

103. *Freedman’s Savings*, 127 U.S. at 502-03.

104. A search conducted on Westlaw in September of 2006 found 114 cases citing *Freedman’s Savings* on the issue of the treatment of rents in a mortgage loan.

105. See *State Bank v. Cohen*, 123 N.Y.S. 747, 748-49 (N.Y. Sup. Ct. 1910); *Thomson v. Erskine*, 73 N.Y.S. 166, 166-67 (N.Y. App. Term 1901); *Grannis-Blair Audit Co. v. Maddux*, 69 S.W.2d 238, 238-39 (Tenn. 1934); *Franzen v. G.R. Kinney Co.*, 259 N.W. 850, 852 (Wis. 1935); see also *Cullen v. Foote*, 61 N.W. 818, 820 (Minn. 1895) (holding that a mortgage lender was entitled to rent for payment of taxes and insurance after default despite a Minnesota statute that prohibited a mortgagee from taking possession or collecting rents for other purposes); *accord* *Fid.-Phila. Trust Co. v. West*, 226 N.W. 406, 407-09 (Minn. 1929).

106. 73 N.Y.S. 166 (N.Y. App. Term 1901).

107. See *id.* at 166.

108. *Id.*

mortgaged property in the event of his default.”¹⁰⁹ In *Grannis-Blair Audit Co. v. Maddux*,¹¹⁰ the court held that the right of a mortgage lender not in possession of the property to rents pursuant to an assignment of rents clause in the deed of trust was superior to the claim of a garnishor, stating:

The general rule . . . is that, so long as mortgagors are permitted to remain in possession, they are entitled to the rents, but, in view of the explicit provision in the trust mortgage before us giving to the trustee the right to the rents upon default in the payment of interest or principal of the debt, upon making demand therefor, neither entry, nor foreclosure proceedings, was a necessary prerequisite, this agreement taking the case out of the general rule.¹¹¹

Most courts in the late-nineteenth century and early-twentieth century would not give a lender rents accruing after default until the lender took possession or obtained the appointment of a receiver. Courts sometimes found that was the intent of the parties to the assignment of rents. For example, in *One Hundred Forty-Eight Realty Co. v. Conrad*,¹¹² the assignment of rents provided that “rents and profits are hereby, in the event of any default . . . pledged and assigned to the party of the second part . . . with full power and authority to the said party of the second part to enter upon and to take possession of the mortgaged premises.”¹¹³ The court found that the clause required the lender to take possession in order to collect rents.¹¹⁴ In *Simpson v. Ferguson*,¹¹⁵ the court stated:

109. *Id.* at 167. Several courts followed the decision in *Thomson*, including *State Bank v. Cohen*, 123 N.Y.S. 747, 748-49 (N.Y. Sup. Ct. 1910), *Sullivan v. Rosson*, 151 N.Y.S. 613, 615 (N.Y. App. Div. 1915), *rev'd*, 119 N.E. 405, 408 (N.Y. 1918), and *In re Jarmulowsky*, 224 F. 141, 142-43 (S.D.N.Y. 1915) (following *Sullivan v. Rosson*, in an opinion written by then District Judge Learned Hand). *Sullivan v. Rosson*, however, was reversed on appeal. *Sullivan*, 119 N.E. at 408; see also *infra* notes 128-31 and accompanying text.

In a subsequent New York case, an assignment of rents upon default was again enforced according to its terms. See *Katz v. Goodman*, 238 N.Y.S. 700, 701 (N.Y. App. Div. 1929). In *Katz*, a borrower sought to evict a tenant who had paid rent to the mortgage lender after the lender had demanded possession from the buyer. See *id.* The court said: “By the provisions of the mortgage, the rents were assigned and pledged to the mortgagee after default and the right of entry to collect and apply the rents was given. The mortgagor in equity could not assert his own violation of his agreement to prevent its enforcement.” *Id.* at 702.

110. 69 S.W.2d 238 (Tenn. 1934).

111. *Id.* at 238-39. The California Supreme Court in *Kinnison v. Guar. Liquidating Corp.*, discussed *infra* notes 149-50, cited *Grannis-Blair* as an “absolute assignment of rents” case. *Kinnison*, 115 P.2d 450, 453 (Cal. 1941).

112. 210 N.Y.S. 400 (N.Y. App. Div. 1925).

113. *Id.* at 401.

114. See *id.* at 405.

115. 44 P. 484 (Cal. 1896).

Even if the rents and profits of the mortgaged property are expressly pledged for the security of the mortgage debt, with the right in the mortgagee to take possession upon default, the mortgagee is not entitled to the rents and profits until he takes actual possession, or until possession is taken in his behalf by a receiver.¹¹⁶

Therefore, when the assignment of rents itself required the lender to take possession, courts required the lender to take possession in order to collect rents. However, even in cases in which the assignment of rents purported to give the lender the right to rents upon default, a number of courts required the lender to take possession or obtain the appointment of a receiver in order to collect rents on the basis that the parties intended a pledge rather than an absolute assignment of the rents.¹¹⁷

The pledge was one of several common law security devices that were for the most part superseded by Article 9 of the U.C.C.¹¹⁸ A common law pledge requires a debt, an offer of property as security for the debt, and delivery of possession of the property from the pledgor to the pledgee.¹¹⁹ The possession element is essential to make the pledge effective,¹²⁰ and possession must continue in order for the pledge to remain in effect.¹²¹ Possession can be actual or constructive, such as the delivery of a key to a warehouse holding the pledged property.¹²² The possession requirement of the common law pledge may be the source of the requirement that a pledge of rents is not effective until the lender takes possession of the mortgaged property or some similar action. It may also explain the terminology used by courts that an assignment of rents is “inchoate” until the lender takes possession of the mortgaged property or some similar

116. *Id.* at 484 (quoting LEONARD A. JONES, A TREATISE ON THE LAW OF MORTGAGES OF REAL PROPERTY § 670 (5th ed. 1894)).

117. *See, e.g., In re Banner*, 149 F. 936, 939 (S.D.N.Y. 1907); *Sullivan v. Rosson*, 119 N.E. 405, 407-08 (N.Y. 1918).

118. *See* WHITE & SUMMERS, *supra* note 39, §§ 21-1(a), 21-2. Even after widespread adoption of Article 9 of the UCC, the common law pledge continued to be used for certain purposes. For example, lenders continued to take a common law pledge of collateral such as deposit accounts that were not covered by earlier versions of Article 9. *See* U.C.C. § 9-104 (1) (1972); U.C.C. § 9-104(1) (1978). Article 9 no longer excludes deposit accounts from its scope. *See* U.C.C. § 9-109 cmt. 16 (2000).

119. *See* *Mechs.' & Traders' Ins. Co. v. Kiger*, 103 U.S. 352, 356 (1880); *Ala. Land & Mineral Corp. v. Toffel*, 292 F.3d 1319, 1325 (11th Cir. 2002).

120. *See* *Casey v. Cavaroc*, 96 U.S. 467, 477 (1877); *Toffel*, 292 F.3d at 1326; *Thurber v. Oliver*, 26 F. 224, 227 (C.C.D. Md. 1885).

121. *See* *Casey*, 96 U.S. at 477; *Thurber*, 26 F. at 227.

122. *See* *Casey*, 96 U.S. at 477.

action, and thus explain the roots of the perfection problem.¹²³

In order to avoid the possession requirement of a “pledge” of rents, lenders attempted the “absolute assignment” argument very early. In *Armour Packing Co. v. Wolff & Co.*,¹²⁴ an assignment of rents stated that the mortgagor did “hereby transfer, assign and make over” to the lender the rents “as additional security for the payment of said notes.”¹²⁵ The lender, in an interpleader in a garnishment proceeding, claimed rents collected prior to the lender’s foreclosure on the basis that the assignment of rents was an absolute assignment.¹²⁶ The court held it was not, stating: “Being a mere security for the payment of money, the legal incidents to such securities attach. One of these is that, until the mortgagee takes possession, the mortgagor is entitled to the rents.”¹²⁷ In *Sullivan v. Rosson*,¹²⁸ rents were “assigned to the holder of this mortgage as further security for the payment of said indebtedness.”¹²⁹ The lender claimed that this language made him the “unqualified owner of the rents . . . to an amount sufficient to pay said mortgage.”¹³⁰ The court held that the assignment of rents was not an absolute transfer, but rather was a pledge of the rents as security for the debt.¹³¹ *In re Banner*¹³² involved an assignment of rents clause in a mortgage that provided, “And the said rents and profits are hereby, in the event of any default . . . assigned to the holder of this mortgage.”¹³³ The lender argued that the assignment clause gave the lender title to the rents upon the occurrence of a default.¹³⁴ The court found that the language created a pledge, distinguishing the earlier *Harris v. Taylor* case¹³⁵ on the basis that the assignment of rents in that case was in a separate document.¹³⁶

Lenders were eventually successful in making the “absolute assignment” argument.¹³⁷ In *Paramount Building and Loan Ass’n v.*

123. See *supra* notes 43-44 and accompanying text.

124. 59 Mo. App. 665 (1894).

125. *Id.* at 667.

126. See *id.*

127. *Id.* at 668.

128. 119 N.E. 405 (N.Y. 1918).

129. *Id.* at 406.

130. *Id.* at 407.

131. See *id.*

132. 149 F. 936 (S.D.N.Y. 1907).

133. *Id.* at 937.

134. See *id.* at 938.

135. See *supra* notes 98-101 and accompanying text.

136. See *Banner*, 149 F. at 938-39.

137. See, e.g., *Kinnison v. Guar. Liquidating Corp.*, 115 P.2d 450, 453 (Cal. 1941); *Paramount Bldg. & Loan Ass’n of Newark v. Sacks*, 152 A. 457, 458-59 (N.J. Ch. 1930); *Stanton v. Metro. Lumber Co.*, 152 A. 653, 654-55 (N.J. Ch. 1930). Some early cases did not necessarily use the “absolute” assignment terminology but distinguished between a pledge and an assignment. See, e.g.,

Sacks,¹³⁸ three mortgagees claimed rents collected by a receiver after default and before foreclosure by the first lienholder.¹³⁹ The first lienholder had an assignment of rents that by its terms became effective upon filing a bill to foreclose; the second lienholder had an assignment of rents effective upon default; and the third lienholder was in possession of the property and collecting rents pursuant to his assignment of rents.¹⁴⁰ The court held that the second lienholder was entitled to rents that accrued after default and before the first lienholder filed a bill of foreclosure.¹⁴¹ The court, citing *Freedman's Saving and Trust Co. v. Shepherd*,¹⁴² distinguished between a pledge of the rents that would require possession and an assignment of the rents.¹⁴³ In *Stanton v. Metropolitan Lumber Co.*,¹⁴⁴ decided about the same time as *Paramount*, another New Jersey court held that an assignment of rents gave a mortgage lender the right to rents accruing after default.¹⁴⁵ The court said: "The assignment, though conditional, became absolute upon default of the mortgage debt, and was valid and enforceable against the assignor As the rents accrued, after the default, the ownership was in the assignee; the title was never in the receiver and he, having collected them, is accountable."¹⁴⁶

Courts could have simply decided to enforce an assignment of rents effective upon default in accordance with the intent of the parties. Instead, courts began focusing to a greater extent on whether the assignment was an absolute assignment transferring title to the rents. For example, Judge Augustus Hand, in *Prudential Insurance Co. of America v. Liberdar Holding Corp.*,¹⁴⁷ distinguished between an assignment for security and "a transfer . . . of outright ownership."¹⁴⁸ The California Supreme Court stated

Stanton, 152 A. at 655.

138. 152 A. 457 (N.J. Ch. 1930).

139. *See id.* at 457.

140. *See id.*

141. *See id.* at 459.

142. *Freedman's Sav. & Trust Co. v. Shepherd*, 127 U.S. 494 (1888).

143. *Paramount*, 152 A. at 458 (citing *Freedman's*, 127 U.S. at 502-03).

144. 152 A. 653 (N.J. Ch. 1930).

145. *See id.* at 654-55.

146. *Id.*

147. 74 F.2d 50 (2d Cir. 1934).

148. *Id.* at 51. Judge Hand discussed the policy behind this distinction as follows:

It seems unlikely that mere words of assignment of future rents can entitle a mortgagee to claim rentals which have been collected by a mortgagor and mingled with its other property. Sound policy as well as every probable intention should prevent a mortgagee from interfering with the mortgagor's possession until the mortgagee takes steps to get the rentals within his control. To hold otherwise would be to impose unworkable restrictions upon industry in cases where mortgagors have been led to suppose that they might rightfully apply the rentals

in the frequently cited case of *Kinnison v. Guaranty Liquidating Corp.*:¹⁴⁹

The agreement between the parties . . . may provide that in the event of default the rents are assigned absolutely to the mortgagee. It has been held that such a provision, rather than pledging the rents as additional security, operates to transfer to the mortgagee the mortgagor's right to the rentals upon the happening of the specified condition.¹⁵⁰

This distinction is probably a result of the language of Justice Harlan's opinion in *Freedman's Savings* in which he acknowledged the ability of the parties to agree that the lender would be entitled to rents without taking possession but distinguished such an agreement from a "pledge" of the rents.¹⁵¹ Regardless of the reasons for its development, the movement towards the concept of the absolute assignment of rents was unfortunate because it has caused confusion, has increased transaction costs and litigation, and in some cases, has created injustice.

IV. CREATION AND CONSEQUENCES OF THE ABSOLUTE ASSIGNMENT OF RENTS

A. *Debating the Effect of the Absolute Assignment of Rents*

A number of courts have stated that an absolute assignment of rents is one which transfers "title" or "ownership" of the rents to the lender contingent upon some future event such as default.¹⁵² These courts treat the absolute assignment of rents as a sale of the rental stream rather than as a type of security interest because of the form and language of the document. They are clearly elevating form over substance and have been routinely

to their own business.

Id.

149. 115 P.2d 450 (Cal. 1941).

150. *Id.* at 453. *Kinnison* involved an assignment of rents that was executed by the borrower after the borrower's default. *See id.* at 451. The agreement required the borrower to collect rents for the account of the lender. *See id.* at 451-52.

151. *See Freedman's Sav. & Trust Co. v. Shepherd*, 127 U.S. 494, 502 (1888); *see also supra* text accompanying note 103 (quoting *Freedman's*).

152. *See, e.g., Great W. Life Assurance Co. v. Rothman (In re Ventura-Louise Props.)*, 490 F.2d 1141, 1144 (9th Cir. 1974) (stating that "by assignment, title is transferred" (quoting *Paramount Bldg. & Loan Ass'n of Newark v. Sacks*, 152 A. 457, 458 (N.J. Ch. 1930))); *In re Salem Plaza Assocs.*, 135 B.R. 753, 756 (Bankr. S.D.N.Y. 1992) (reasoning that absolute assignment, "upon default, divests the [borrower] of every interest in the rents"); *Taylor v. Brennan*, 621 S.W.2d 592, 594 (Tex. 1981) (explaining that absolute assignment "passes title to the rents").

criticized by commentators.¹⁵³

Other courts have acknowledged that an absolute assignment does in fact create a security interest, albeit a different type of security interest from a collateral assignment of rents.¹⁵⁴ For example, the Court of Appeals for the Fifth Circuit recognized that “[t]he concept of a present transfer of title to rents contingent upon default, as opposed to a security interest in rents, is essentially a legal fiction.”¹⁵⁵ An Illinois bankruptcy court made the same point in a more humorous manner, stating, “[The lender] can call this arrangement an ‘absolute assignment’ or, more appropriately, ‘Mickey Mouse.’ It’s still a lien.”¹⁵⁶

The courts holding that an absolute assignment does in fact create a type of security interest are correct because of the true substance of the assignment of rents in the context of a mortgage loan. The substance of the transaction is the creation of a security interest for a number of reasons. First, an absolute assignment of rents is given in connection with (and only because of) the related mortgage loan. Second, the borrower is typically permitted to collect rents prior to default. Although the borrower may be required to apply rents to pay for operation and maintenance of the property and to pay debt service, the borrower’s use of excess rents is not restricted. Third, the lender is not entitled to collect rents until after a default under the terms of the mortgage loan. Fourth, the rents that the

153. See RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 4.2, cmt. a (1997); Averch et al., *supra* note 7, at 709; Carlson, *supra* note 7, at 1105-07; Forrester, *supra* note 2, at 379-81; Freyermuth, *The New UARA*, *supra* note 7, at 29-35; Randolph, *supra* note 7, at 290.

154. See, e.g., *FDIC v. Int’l Prop. Mgmt., Inc.*, 929 F.2d 1033, 1035 (5th Cir. 1991); *500 Ygnacio Assocs., Ltd. v. Aetna Life Ins. Co. (In re 500 Ygnacio Assocs., Ltd.)*, 141 B.R. 191, 195-96 (Bankr. N.D. Cal. 1992); *In re Bethesda Air Rights Ltd. P’ship*, 117 B.R. 202, 206 (Bankr. D. Md. 1990); *Provident Mut. Life Ins. Co. v. Winslow Ctr. Assocs. (In re Winslow Ctr. Assocs.)*, 50 B.R. 679, 681 n.2 (Bankr. E.D. Penn. 1985); *Nat’l Operating, L.P. v. Mut. Life Ins. Co. of N.Y.*, 630 N.W.2d 116, 131-32 (Wis. 2001).

The Ninth Circuit Court of Appeals characterized the absolute assignment as follows:

The assignment here is “absolute” in the sense that it was effective upon default without further action by the creditor. . . . “Absolute” does not mean, however, that the assignee is relieved of all obligation to account or that the right to the rents is independent of the underlying debt. Upon foreclosure, the creditor, of course, must account for any excess derived from the sale and rents collected between the date of default and the date of foreclosure sale over and above the amount of the obligation owed.

Equitable Mortgage Co. v. Fishman (In re Charles D. Stapp of Nev., Inc.), 641 F.2d 737, 740 (9th Cir. 1981).

155. *Int’l Prop. Mgmt., Inc.*, 929 F.2d at 1035 (citing Patrick A. Randolph, Jr., *When Should Bankruptcy Courts Recognize Lenders’ Rents Interests?*, 23 U.C. DAVIS L. REV. 833 (1990)).

156. *Foundry of Barrington P’ship v. Barrett (In re Foundry of Barrington P’ship)*, 129 B.R. 550, 557 (Bankr. N.D. Ill. 1991).

lender collects must be applied to the indebtedness or for expenses related to the mortgaged property. The lender cannot use rents to give its stockholders a dividend, to give its employees a raise, or to redecorate its offices. Fifth, the borrower retains the risk of nonpayment of rents by the tenants. If a tenant fails to pay rent, the debt is not reduced. Finally, the absolute assignment of rents terminates upon payment in full of the debt. After the debt is paid, the “lien” on rents must be released, and the borrower may collect them unencumbered by any obligation to the lender. All of these factors point to the fact that the absolute assignment is in fact a security interest.

Theoretically, a property owner could sell the right to collect rents from the property to a mortgage lender. If the transaction were truly a sale of the rents to the lender, the lender would give some consideration for the purchase, such as a reduction in the debt by an amount equal to the present value of the future rental stream. Instead, rents collected by a lender are applied to the indebtedness only to the extent collected. If the lender purchased the rental stream, the lender would begin collecting rents immediately, and the lender would bear the risk of non-payment by tenants. A true sale of the rents would not terminate on the final repayment of the indebtedness.¹⁵⁷

Other types of receivables are commonly sold. The business of factoring involves the sale of accounts at a discount to a factor who then collects the accounts.¹⁵⁸ The modern practice of asset securitization involves the “true sale” of assets, such as mortgage loans, car loans, credit card receivables, or other receivables to a special purpose vehicle (SPV) that issues securities to investors.¹⁵⁹ The transfer is structured as a “true sale” in order to remove the assets from the originator’s bankruptcy estate.¹⁶⁰

Rents are typically not transferred in a “true sale” because the property owner/landlord of necessity retains the landlord’s obligation to perform under the leases. Without the rental stream, a landlord would have little

157. Although unlikely, it is, of course, possible that a lender could purchase its borrower’s rents, reducing the indebtedness by an amount equal to the value of the rental stream and taking the risk of collection of the rent and defaults by the tenants. Such a purchase would probably be of rents under specific leases and would terminate when the terms of the assigned leases had expired rather than when the borrower’s indebtedness to the lender was repaid.

158. See WHITE & SUMMERS, *supra* note 39, § 21-6. Traditionally, the factor purchased the accounts on a non-recourse basis, meaning that the factor took the entire risk of collecting the accounts. See *id.* Article 9 covers sales of accounts. U.C.C. § 9-109(a)(3) (2001).

159. See WHITE & SUMMERS, *supra* note 39, § 21-6; Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 135 (1994).

160. See Schwarcz, *supra* note 159, at 135-36. Some courts have incorrectly held that an absolute assignment of rents removes the right to rents from the borrower’s bankruptcy estate. See *infra* Part IV.D.

incentive to perform the landlord's duties under the leases. If the landlord stops performing, the tenants are likely to stop paying rent. Thus, rents are not a particularly desirable "receivable" for a prospective purchaser.

A mortgage lender, on the other hand, has every reason to want an assignment of rents as an incident to its mortgage, and the lender has an incentive to maintain the rental stream and the value of the real property that is security for the mortgage loan. This transfer is not a transfer of title at all, but is actually a transfer of a security interest. The superior treatment of the "absolute assignment" type of security interest creates the lender's incentive to couch its security interest in terms of an absolute assignment rather than a collateral assignment. However, the confusion over the effect of absolute assignments has created problems in their creation and their treatment.

B. *Creating an Absolute Assignment of Rents*

The uncertainty over whether an absolute assignment of rents creates a security interest or transfers title to rents has made them difficult to create. In most cases, courts have been reluctant to find that a borrower and lender intended an absolute assignment and, therefore, have required the parties to clearly express their intent to create an absolute assignment.¹⁶¹ This presumption of a collateral assignment of rents is not warranted given the sophisticated nature of parties to a commercial real estate loan secured by an income-producing property. Nevertheless, the presumption persists. Language in an assignment of rents requiring the lender to take some action after default in order to collect rents may be fatal to the finding of an absolute assignment.¹⁶² Furthermore, if an assignment of rents provides that it is given "as security" or "as additional security" for the mortgage debt, courts will hold that it is not an absolute assignment.¹⁶³ This elevation

161. See *FDIC v. Int'l Prop. Mgmt., Inc.*, 929 F.2d 1033, 1036 (5th Cir. 1991); *Prudential Ins. Co. of Am. v. Liberdar Holding Corp.*, 74 F.2d 50, 51 (2d Cir. 1934); *In re 5877 Poplar, L.P.*, 268 B.R. 140, 146 (Bankr. W.D. Tenn. 2001).

162. See, e.g., *In re Allen*, 357 B.R. 103, 112 (Bankr. S.D. Tex. 2006); *In re 1301 Conn. Ave. Assocs.*, 117 B.R. 2, 7 (Bankr. D.D.C. 1990), *aff'd*, 126 B.R. 1 (D.D.C. 1991); *Taylor v. Brennan*, 621 S.W.2d 592, 594-95 (Tex. 1981); *Cadle Co. v. Collin Creek Phase II Assocs., Ltd.*, 998 S.W.2d 718, 723-24 (Tex. App. 1999); *Schoenfelder v. American General Life Ins. Co.*, No. 05-0047, 2006 WL 778719, at *4-5 (Iowa App. 2006) (Schechtman, J., dissenting).

163. See, e.g., *In re 5877 Poplar, L.P.*, 268 B.R. at 146-47; *In re 1301 Conn. Ave. Assocs.*, 117 B.R. at 7-8; *In re Ass'n Ctr. Ltd. P'ship*, 87 B.R. 142, 145 (Bankr. W.D. Wash. 1988); *Taylor*, 621 S.W.2d at 594-95; *Schoenfelder*, 2006 WL 778719, at *5 (Schechtman, J., dissenting). *But see In re Carretta*, 220 B.R. 203, 211-12 (D.N.J. 1998) (finding an absolute assignment despite language in assignment of rents that it was given "[a]s further security"); *In re Galvin*, 120 B.R. 767, 771-72 (Bankr. D. Vt. 1990) (finding an absolute assignment based on intent of the parties despite language in the assignment that it was given to secure the debt). In *FDIC v. International Property Management, Inc.*, the Court of Appeals for the Fifth Circuit recognized that all assignments of

of form over substance has created a drafting nightmare for lenders and their attorneys attempting to secure a loan with an absolute assignment that passes title to the rents upon default and is not “security” for the loan. This difficulty has continued for more than a century and has caused a substantial amount of litigation.

Armour Packing Co. v. Wolff and Co.,¹⁶⁴ decided in 1894, involved a contest between a garnishor and a mortgagee over rents collected by the garnishee after default in the mortgage and before the foreclosure sale.¹⁶⁵ An assignment of rents executed after the mortgage provided that the mortgagor did “hereby transfer, assign and make over to said company (the mortgagee) any and all rents . . . as additional security for the payment of said notes.”¹⁶⁶ The mortgagee argued that he was entitled to rents because the assignment was an absolute assignment.¹⁶⁷ The court rejected this argument based on of the “security” language in the assignment, and stated, “[b]eing a mere security for the payment of money, the legal incidents to such securities attach. One of these is that, until the mortgagee takes possession, the mortgagor is entitled to the rents.”¹⁶⁸

Through the twentieth century and into the twenty-first, courts have continued to struggle with these same issues.¹⁶⁹ In *Condor One, Inc. v. Turtle Creek, Ltd.*,¹⁷⁰ decided in 1996, an assignment of rents provided “[t]hat all rents, profits and income from the property covered by this Mortgage are hereby assigned to the Mortgagee for the purpose of discharging the debt hereby secured.”¹⁷¹ The lender argued that the assignment of rents was absolute, but the court held that it was intended only as security based on the language in the document.¹⁷² In 2001, a Tennessee bankruptcy court considered an assignment of rents that stated, “As part of the consideration for the indebtedness secured hereby, Borrower hereby absolutely and unconditionally assigns and transfers to Lender and grants to the Lender a security interest in any and all leases . . . with all the security deposits, rents . . . issues, profits, revenues

rents made in connection with a mortgage loan are undoubtedly made to secure the debt, but the court nevertheless stressed the fact that the assignment in that case did not use the words “security” or “pledge” in holding that it was an absolute assignment. 929 F.2d 1033, 1038 (5th Cir. 1991).

164. 59 Mo. App. 665 (Ct. App. 1894).

165. *See id.* at 666-67.

166. *Id.* at 667.

167. *See id.*

168. *Id.* at 668.

169. *See, e.g., In re Banner*, 149 F. 936, 939 (S.D.N.Y. 1907); *Sullivan v. Rosson*, 119 N.E. 405, 408 (N.Y. 1918).

170. 194 B.R. 267 (Bankr. N.D. Ala. 1996).

171. *Id.* at 278.

172. *See id.* at 278-79.

and other income of the premises.”¹⁷³ The court concluded, based on the “inconsistent and contradictory language contained in the deed of trust” and a “presumption that an assignment operates as security for a debt,” that the parties intended a pledge rather than an absolute assignment.¹⁷⁴ In 2006, a Texas bankruptcy court considered an assignment of rents clause that stated, “[P]rior to Lender’s notice to Borrower of Borrower’s breach of any covenant . . . , Borrower shall collect and receive all rents . . . as trustee for the benefit of Lender and Borrower. This assignment of rents constitutes an absolute assignment”¹⁷⁵ The court concluded that the assignment of rents was a collateral assignment because it made the lender the sole beneficiary of rents only after the lender gave notice of default.¹⁷⁶

Because of the pretense involved in creating an absolute assignment of rents, lenders still struggle with these drafting issues, thus incurring additional transaction costs. Lenders and borrowers must still spend money litigating these issues, and courts are using scarce judicial resources in hearing these disputes.

C. State Law Consequences of Confusion over Characterizing an Absolute Assignment of Rents

Confusion over the characterization of an absolute assignment of rents as a transfer of title to rents or a security interest has also been a source of unnecessary litigation. The problems arise because assignments that are in fact made for security appear on their face to be transfers of title to rent and because courts characterize absolute assignments of rents as passing ownership of the rents to the lender. As a result, lenders may be sued by tenants or other parties as if the lender is the owner of the landlord’s reversion. These problems have also persisted for over a century.

An 1894 case, *Cargill v. Thompson*,¹⁷⁷ involved an assignment of rents that on its face was an absolute assignment.¹⁷⁸ In *Cargill*, the borrower executed a deed, absolute on its face, conveying several tracts of land to the lender, including “the right to receive, collect, and hold all rentals from any and all persons for the use of said property.”¹⁷⁹ In addition to the deed, the parties executed other agreements providing for reconveyance upon certain conditions, including repayment of the debt, providing that the borrower would stay in possession of the property, and providing that the lender would collect rents and apply them to payment of taxes, insurance,

173. *In re* 5877 Poplar, L.P., 268 B.R. 140, 146-47 (Bankr. W.D. Tenn. 2001).

174. *Id.* at 147-48.

175. *In re* Allen, 357 B.R. 103, 112 (Bankr. S.D. Tex. 2006).

176. *Id.*

177. 59 N.W. 638 (Minn. 1894).

178. *See id.* at 638-39.

179. *Id.* at 638.

interest on the debt, repairs, and principal on the debt, with surplus eventually being returned to the borrower.¹⁸⁰ The lessees sued the lender, claiming that the transaction was a conditional sale, which put the lender in privity with lessees, and claiming that the absolute assignment of rents brought the lender into privity with lessees, making the lender liable under the lease covenants.¹⁸¹ The court concluded that the transaction was a mortgage and that an assignment of rents “by way of mortgage” gives the lender a relationship to rents “the same as that of the mortgagee of the land towards the legal title,—that of one holding a lien He is not, therefore, an assignee, so as to be liable on the covenants in the lease.”¹⁸²

In a similar lawsuit in 1990, a tenant sued a lender for breaches under a lease that occurred prior to the lender’s foreclosure.¹⁸³ The tenant claimed that the lender’s absolute assignment of rents placed the lender in privity of estate with the tenant and therefore obligated the lender to comply with lease covenants.¹⁸⁴ The court did not decide whether the assignment of rents created “only a pledge or an absolute assignment.”¹⁸⁵ Instead, the court looked to a provision in the assignment of rents stating that the assignee was undertaking no obligation under the lease.¹⁸⁶ Based on that provision, the court held that the lender was not liable.¹⁸⁷ Therefore, the court reached the correct result, but incorrectly implied that a finding of an absolute assignment without any special language abrogating assignee liability would be relevant in determining whether the lender was liable.

Ten years later, in a suit by a landlord against a tenant for breach of lease, the tenant argued that the lender was a necessary party in the suit because of an absolute assignment of rents.¹⁸⁸ The court looked to the provisions of the assignment of rents that granted the borrower the right to collect rents until the lender gave notice of default.¹⁸⁹ Because the lender

180. *See id.* at 638-39.

181. *See id.* at 639. The lessees also argued that if the lender were merely a mortgagee, he was liable on lease covenants as a mortgagee-in-possession because he was collecting rents. *See id.* The court did not decide the issue whether collecting rents made the lender a mortgagee-in-possession but found that the lender would not be liable on lease covenants even if he were a mortgagee-in-possession. *See id.* at 640.

182. *Id.* at 640.

183. *See Naficy v. Woodmen of the World Life Ins. Soc’y*, No. A14-89-00964-CV, 1990 WL 122128, at *1 (Tex. App. Aug. 23, 1990). As an unreported case, *Naficy* does not create precedent, but it is useful to illustrate the litigation that can result from the use of an absolute assignment of rents.

184. *See id.* at *5.

185. *Id.* at *7.

186. *See id.* at *6.

187. *See id.* at *7.

188. *See Leon’s Fine Foods, Inc. v. Merit Inv. Partners, Ltd.*, No. 05-97-005430CV, 2000 WL 1048491, at *1-2 (Tex. App. July 31, 2000).

189. *See id.* at *2.

never gave notice of default, the court held that the borrower retained the right to bring or defend a suit under the lease and, therefore, that the lender was not a necessary party to the suit.¹⁹⁰ Once again, the court reached the right result, but the court incorrectly implied that a lender with an absolute assignment of rents could be treated as a party to the lease after default under the terms of the mortgage.

In another recent case, a mechanic's lien claimant argued that its lien was superior to a lender's mortgage lien because a purported absolute assignment of rents gave the lender an interest in property that made the lender an "owner" under the mechanic's lien statute.¹⁹¹ The court held for the lender based on Illinois law, which does not recognize absolute assignments.¹⁹² The court said that an assignment of rents in Illinois grants an equitable lien as security for a mortgage.¹⁹³ Thus, the court implied that finding an absolute assignment of rents could have changed the result in the case.

In these particular cases, the courts reached the correct result—that the lender was not liable under lease covenants, was not a necessary party in litigation involving a lease, and was not an owner for purposes of a mechanic's lien statute. However, one has to wonder whether these arguments would have been made absent the use of a purported "absolute" assignment of rents. Although reaching the right result, the courts did not always articulate a good reason for their holdings. In fact, the court in 1894 did a better job of articulating the effect of a purported absolute assignment of rents than did the later courts because the court acknowledged that the assignment of rents created a lien on rents rather than an assignment of the landlord's interest in the lease.¹⁹⁴ Ultimately, although the absolute assignment of rents has served lenders in providing a type of security interest that avoids some of the pitfalls of the collateral assignment of rents, it has caused needless litigation and confusion. This uncertainty has carried over into bankruptcy cases in which it has caused more significant problems.

D. *The Absolute Assignment of Rents in Bankruptcy*

The confusion regarding characterization of an absolute assignment of rents as a transfer of title to rents or a security interest has created uncertainty in bankruptcy cases as well as under state law. Federal courts are split on the treatment of an absolute assignment of rents when the

190. *See id.* at *2-3.

191. *M. Ecker & Co. v. LaSalle Nat'l Bank*, 645 N.E.2d 335, 339 (Ill. App. Ct. 1994).

192. *See id.* at 340.

193. *See id.*

194. *See supra* text accompanying note 182.

debtor is in bankruptcy. Most courts addressing the issue in the bankruptcy context have held that an absolute assignment gives a lender only a security interest in rents.¹⁹⁵ These courts recognize the continuing interest of the bankruptcy estate in rents covered by an absolute assignment and have held that the rents covered by a duly recorded absolute assignment of rents are cash collateral.¹⁹⁶

Some federal courts have treated an absolute assignment of rents as giving the lender an absolute ownership interest in rents.¹⁹⁷ These courts have held that, because the lender owns the rents absolutely as a matter of state law, the bankruptcy estate has no interest in the rents.¹⁹⁸ Therefore, the bankruptcy trustee or debtor-in-possession has no right to use the rents to operate and maintain the property in a reorganization.

Bankruptcy courts holding that an absolute assignment of rents gives a lender ownership of rents rather than a security interest are simply

195. See, e.g., *In re Allen*, 357 B.R. 103, 115 (Bankr. S.D. Tex. 2006); *Cavros v. Fleet Nat'l Bank (In re Cavros)*, 262 B.R. 206, 210-11 (Bankr. D. Conn. 2001); *In re 5877 Poplar, L.P.*, 268 B.R. 140, 146-47 (Bankr. W.D. Tenn. 2001); *In re Guardian Realty Group, L.L.C.*, 205 B.R. 1, 4-6 (Bankr. D.D.C. 1997); *Lyons v. Fed. Sav. Bank (In re Lyons)*, 193 B.R. 637, 647-48 (Bankr. D. Mass. 1996); *500 Ygnacio Assocs., Ltd. v. Aetna Life Ins. Co. (In re 500 Ygnacio Assocs., Ltd.)*, 141 B.R. 191, 192 (Bankr. N.D. Cal. 1992); *Foundry of Barrington P'ship v. Barrett (In re Foundry of Barrington P'ship)*, 129 B.R. 550, 556-57 (Bankr. N.D. Ill. 1991); *In re Rollingwood Apartments, Ltd.*, 133 B.R. 906, 910 (Bankr. S.D. Ohio 1991); *In re Bethesda Air Rights Ltd. P'ship*, 117 B.R. 202, 206 (Bankr. D. Md. 1990); see also *FDIC v. Int'l Prop. Mgmt., Inc.*, 929 F.2d 1033, 1035 (5th Cir. 1991); *In re Princeton Overlook Joint Venture*, 143 B.R. 625, 633 (Bankr. D.N.J. 1992); *Provident Mut. Life Ins. Co. v. Winslow Ctr. Assocs. (In re Winslow Ctr. Assocs.)*, 50 B.R. 679, 681-82 (Bankr. E.D. Penn. 1985).

196. See *Princeton Overlook*, 143 B.R. at 633; *Rollingwood*, 133 B.R. at 913; *Bethesda*, 117 B.R. at 209, 211.

197. See, e.g., *First Fid. Bank, N.A. v. Jason Realty, L.P. (In re Jason Realty, L.P.)*, 59 F.3d 423, 427-29 (3d Cir. 1995); *In re Kingsport Ventures, L.P.*, 251 B.R. 841, 848-49 (Bankr. E.D. Tenn. 2000); *In re Carretta*, 220 B.R. 203, 211 (Bankr. D.N.J. 1998); *Condor One, Inc. v. Turtle Creek, Ltd. (In re Turtle Creek, Ltd.)*, 194 B.R. 267, 279 (Bankr. N.D. Ala. 1996); *First Fid. Bank v. Eleven Hundred Metroplex Assocs.*, 190 B.R. 510, 511 (Bankr. S.D.N.Y. 1995); *MacArthur Executive Assocs. v. State Farm Life Ins. Co.*, 190 B.R. 189, 195 (Bankr. D.N.J. 1995); *In re Carter*, 126 B.R. 811, 813 (Bankr. M.D. Fla. 1991); *In re Galvin*, 120 B.R. 767, 771-72 (Bankr. D. Vt. 1990); *In re Gould*, 78 B.R. 590, 592 (Bankr. D. Idaho 1987); *In re Fry Rd. Assocs., Ltd.*, 64 B.R. 808, 809 (Bankr. W.D. Tex. 1986); *In re P.M.G. Props.*, 55 B.R. 864, 870 (Bankr. E.D. Mich. 1985). A related problem in bankruptcy is that some courts have held that a lender owns the rental stream after enforcing a collateral assignment of rents. See *Commerce Bank v. Mountain View Vill., Inc.*, 5 F.3d 34 (3d Cir. 1993); *In re Century Inv. Fund VIII Ltd. P'ship*, 937 F.2d 371, 375 (7th Cir. 1991); *Robin Assocs. v. Metro. Bank & Trust Co. (In re Robin Assocs.)*, 275 B.R. 218 (Bankr. W.D. Pa. 2001); *VIII S. Mich. Assocs. v. N. Trust Co. (In re VIII S. Michigan Assocs.)*, 145 B.R. 912 (N.D. Ill. 1992); *In re Mount Pleasant Ltd. P'ship*, 144 B.R. 727 (Bankr. W.D. Mich. 1992); *Imperial Gardens Liquidating Trust v. Nw. Commons, Inc. (In re Nw. Commons)*, 136 B.R. 215 (Bankr. E.D. Mo. 1991).

198. See *In re Carter*, 126 B.R. at 813; *In re Galvin*, 120 B.R. at 772; *In re Fry Rd. Assocs.*, 64 B.R. at 809; *In re P.M.G. Props.*, 55 B.R. at 870.

incorrect. Although the form of the transaction may indicate a transfer of title to rents, the substance of such a transaction is a security interest. Some of these courts are following state law precedent on the theory that property rights are a matter of state law.¹⁹⁹ They should, however, “look to the substance of state law rights, not merely the label that state law places on them.”²⁰⁰

The better-reasoned bankruptcy opinions look to the substance of the transaction and to factors such as the borrower’s right to collect rents until default, the lender’s obligation to apply rents to payment of the debt, and the termination of the assignment of rents upon payment of the loan in full.²⁰¹ If the borrower has any remaining property rights in the rental stream under state law, bankruptcy law dictates that the rental stream be treated as part of the bankruptcy estate.²⁰²

When a court holds that rents covered by an absolute assignment are owned by the lender, the debtor-in-possession does not have the rents available for operation and maintenance of the mortgaged property, as would be the case if rents were treated as cash collateral.²⁰³ If rents are unavailable for operation and maintenance of the property, almost no hope of reorganization exists for a borrower in Chapter 11.²⁰⁴ If the debtor has no equity in the property and there is not “a reasonable possibility of a successful reorganization within a reasonable time,”²⁰⁵ the lender is

199. See *Jason Realty*, 59 F.3d at 427 (citing *Butner v. United States*, 440 U.S. 48, 55 (1979)).

200. *In re Guardian Realty*, 205 B.R. at 4 (citing *United States v. Nat’l Bank of Commerce*, 472 U.S. 713, 727 (1985)).

201. See *id.*; *500 Ygnacio Assocs., Ltd. v. Aetna Life Ins. Co. (In re 500 Ygnacio Assocs.)*, 141 B.R. 191, 195 (Bankr. N.D. Cal. 1992); *In re Bethesda*, 117 B.R. at 206-08; *Bryn Athyn Investors, Ltd. v. Hutton/Conam Realty Pension Investors (In re Bryn Athyn Investors, Ltd.)*, 69 B.R. 452, 457 (Bankr. E.D.N.C. 1987).

202. See 11 U.S.C.A. § 541 (West 2007); *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 208-09 (1983).

203. If rents are cash collateral, the debtor-in-possession may not use the rents without consent of the lender or authorization of the bankruptcy court. See 11 U.S.C.A. § 363(c)(2). A bankruptcy court may not authorize the use of cash collateral by the debtor unless the secured lender is adequately protected. See *id.* § 363(e). Bankruptcy courts generally permit the debtor to use rents for operation and maintenance of the mortgaged property because that use preserves the value of the property and, thus, provides the lender adequate protection. See Forrester, *supra* note 2, at 388.

204. See Craig A. Averch, *Revisitation of the Fifth Circuit Opinions of Village Properties and Casbeer: Is Post-Petition “Perfection” of an Assignment of Rents Necessary to Characterize Rental Income as Cash Collateral?*, 93 COM. L.J. 516, 519 (1988); Carlson, *supra* note 7, at 1109. In a single-asset bankruptcy, the borrower will have no income available to continue operation and maintenance of the mortgaged property. See Carlson, *supra* note 7, at 1152-53.

205. *United Sav. Ass’n of Tex. v. Timbers of Inwood Forest Assocs., Ltd. (In re Timbers of Inwood Forest Assocs., Ltd.)*, 484 U.S. 365, 376 (1988) (quoting *United Sav. Ass’n of Tex. v. Timbers of Inwood Forest Assocs., Ltd.*, 808 F.2d 363, 370-71 & nn.12-13 (5th Cir. 1987), *aff’d*, 484 U.S. 365 (1988)).

entitled to relief from the automatic stay.²⁰⁶ Therefore, the borrower's efforts to reorganize under the protection of Chapter 11 will be frustrated even in those cases where a reorganization might otherwise have been successful.²⁰⁷ This result defeats the policies behind the Bankruptcy Code and Chapter 11, is simply an injustice.

E. Analogous "Absolute" Transfers for Security

Many types of transactions create a security interest in substance but take on another form. Courts interpret these various transactions regularly and are accustomed to considering substance over form. Some examples include the mortgage in a title theory state, the absolute deed of real property given as security for a loan, and certain sale-leaseback transactions involving equipment and other personal property. These analogous situations are valuable tools for use in analyzing the treatment of assignments of rents.

In title theory states, a mortgage is treated as a conveyance that gives title to the lender.²⁰⁸ However, when faced with determining the substance of the transaction, courts acknowledge that the mortgagor "is the equitable owner of the property and thus its real owner" during the term of the mortgage.²⁰⁹ Therefore, a mortgagor could not escape a conviction for violation of building ordinances on the ground that the mortgagee had legal title to the property,²¹⁰ and a mortgagee could not escape the payment of transfer taxes upon purchase at foreclosure sale on the basis that it already had legal title to the property.²¹¹ The Rhode Island Supreme Court called the title theory "a fiction designed to aid in decision making . . . not an absolute per se rule of law."²¹² Therefore, courts have been able to focus on the substance of the mortgage transaction when necessary.

Even in states that do not follow the title theory of mortgages, the parties to a mortgage loan transaction may document that transaction as a sale of the property rather than as a mortgage.²¹³ Under some circumstances, usually involving an unsophisticated borrower in desperate need of credit,

206. See 11 U.S.C.A. § 362(d)(2).

207. If the lender is treated as the owner of rents under an absolute assignment of rents, rents are not available for operation and maintenance of the property, and the lender is likely to be granted relief from the stay and thus be permitted to foreclose. See *First Fid. Bank v. Jason Realty, L.P.* (*In re Jason Realty, L.P.*), 59 F.3d 423, 430 (3d Cir. 1995); *In re Fry Rd. Assocs., Ltd.*, 66 B.R. 602, 604-05 (Bankr. W.D. Tex. 1986).

208. See *Block Island Land Trust v. Wash. Trust Co.*, 713 A.2d 199, 201 (R.I. 1998).

209. *State v. Stonybrook, Inc.*, 181 A.2d 601, 604 (Conn. 1962).

210. See *id.* at 604-05.

211. See *Block Island*, 713 A.2d at 201.

212. *Id.*

213. See, e.g., *Flack v. McClure*, 565 N.E.2d 131, 135 (Ill. App. Ct. 1990).

the borrower will give a lender an absolute deed to property to secure a loan.²¹⁴ The parties typically agree that the lender will return the deed unrecorded upon repayment of the debt.²¹⁵ In determining the substance of the transaction, courts consider a number of factors, including whether a debt exists, whether the grantor retained possession of the property, whether a disparity exists between the value of the property and the consideration, and whether the parties agree to a reconveyance.²¹⁶ Courts permit the introduction of parol evidence to prove the true nature of the transaction.²¹⁷ If a court determines that the substance of such a transaction is in fact a mortgage rather than a transfer of title, the court will treat the deed as a mortgage on the property. Therefore, in the context of the absolute deed intended as security, courts have been able to look beyond the form of the transaction to determine its substance.

With regard to personal-property-secured transactions, the scope provision of Article 9 of the U.C.C. applies to “a transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract.”²¹⁸ The purpose of this provision is to consider the substance of a transaction rather than its form.²¹⁹ Therefore, courts are often asked to determine whether a transaction is a true lease or an installment sale with the “lessor” retaining a security interest securing the obligation of the “lessee” to purchase goods.²²⁰

Courts must also distinguish between a true sale of personal property and a transfer that creates a security interest. Although Article 9 covers sales of accounts, chattel paper, payment intangibles, and promissory notes,²²¹ a true sale receives different treatment under Article 9 and must, therefore, be distinguished from a transaction that creates a security interest. Sales of these intangibles are covered by Article 9 for purposes of perfection. If the purchaser fails to perfect its interest, the seller retains the power to transfer good title to a subsequent purchaser,²²² just as with real property recording acts. At the same time, however, the seller “does not

214. *See id.*

215. *See id.*

216. *See id.* at 136; *Johnson v. Cherry*, 726 S.W.2d 4, 7 (Tex. 1987); *Sannerud v. Brantz*, 928 P.2d 477, 481 (Wyo. 1996); RESTATEMENT (THIRD) OF PROP.: MORTGAGES §§ 3.2(b), 3.3(b) (1997); NELSON & WHITMAN, *supra* note 21, § 3.8.

217. *See* NELSON & WHITMAN, *supra* note 21, § 3.6.

218. U.C.C. § 9-109(a)(1) (2000). In addition, Article 9 applies to some transactions that are not intended to create a security interest, including “a sale of accounts, chattel paper, payment intangible, or promissory notes” and “a consignment.” *Id.* § 9-109(a)(3), (4).

219. *See* WHITE & SUMMERS, *supra* note 39, § 21-2.

220. *Id.* § 21-3.

221. *See* U.C.C. § 9-109(a)(3).

222. *See id.* § 9-318(b).

retain a legal or equitable interest in the collateral sold.”²²³ Sales of these intangibles have raised some of the same issues in bankruptcy that absolute assignments of rents have raised.²²⁴ If a transfer is a true sale, a bankruptcy trustee or debtor-in-possession has no interest in the property transferred, but if the transfer is of a security interest only, the bankruptcy estate retains an interest in the collateral. Courts seem to have navigated these issues more successfully than issues relating to absolute assignments of rents.

V. SOLUTIONS TO THE PROBLEM

The absolute assignment of rents is not a satisfactory method of creating a security interest in rents. It causes problems for lenders in drafting and enforcing the assignment of rents. It causes injustice for borrowers in bankruptcy. It causes unnecessary litigation that may raise the cost of credit. It is, nevertheless, the best alternative for lenders at this time. The absolute assignment of rents cannot simply be eliminated unless replaced by a workable solution to the problems it solves. Therefore, comprehensive change is necessary. This change has occurred gradually in some states through the judicial process, but the legislative process provides a faster and more comprehensive solution.

A. *The Judicial Solution*

Courts may adopt the Restatement approach, which provides a workable system for lenders to take a security interest in rents, making the absolute assignment unnecessary.²²⁵ The Restatement takes the position that “[t]he use of ‘absolute assignment’ terminology . . . creates needless confusion and is rejected.”²²⁶ In fact, the Restatement uses the terminology that rents are “mortgage[d]” rather than assigned to avoid the confusion that the absolute assignment doctrine has engendered.²²⁷

Because the Restatement resolves the problems that lenders have encountered with the collateral assignment of rents, lenders would not need the absolute assignment of rents under the Restatement regime. First, the Restatement provides that a mortgage of rents “is effective as against the mortgagor and, subject to the operation of the recording act, as against third parties, upon execution and delivery.”²²⁸ Therefore, a recorded mortgage of rents would have priority over a creditor garnishing rents and

223. *Id.* § 9-318(a).

224. *See, e.g.,* Octagon Gas Sys., Inc. v. Rimmer (*In re Meridian Reserve, Inc.*), 995 F.2d 948, 957 (10th Cir. 1993); *In re LTV Steel Co.*, 274 B.R. 278, 285-86 (Bankr. N.D. Ohio 2001).

225. RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 4.2 (1997).

226. *Id.* § 4.2 cmt. a.

227. *Id.* § 4.2 cmt. b.

228. *Id.* § 4.2(b).

would not be subject to avoidance by a trustee in bankruptcy. Second, the Restatement provides that a mortgage may entitle the lender to collect rents upon default and is enforced by “delivery of a demand for the rents to the mortgagor.”²²⁹ Therefore, a lender is not required to take any burdensome action such as taking possession or obtaining the appointment of a receiver in order to enforce the assignment of rents. A lender would not be entitled to rents that the mortgagor collected after default and before the demand is made, but lenders can easily make demand after default in order to capture rents that accrue after default. Therefore, the Restatement resolves the perfection problem and the enforcement problem that lenders have faced with collateral assignments of rents. With a workable scheme for mortgaging rents, the absolute assignment of rents becomes unnecessary. Thus, judicial adoption of the Restatement approach to mortgaging rents would solve the problems existing under current law.

B. *The Uniform Assignment of Rents Act*

The new Uniform Assignment of Rents Act (UARA) provides an even better solution to the problems caused by the absolute assignment of rents. The UARA is more comprehensive in scope than the Restatement, and it can be adopted as a package by state legislatures rather than in a piecemeal fashion by the courts.

The UARA provides that an assignment of rents, including an assignment absolute in form, creates a security interest regardless of its form.²³⁰ Therefore, an absolute assignment of rents made in connection with a mortgage loan would be treated the same as any assignment of rents under the Act.²³¹ In addition, because the UARA provides for a workable security interest in rents for mortgage lenders with due regard for the concerns of borrowers and tenants, it eliminates the need for an absolute

229. *Id.* § 4.2(c)(2). In addition to the demand, the lender must satisfy any additional conditions imposed by the mortgage, *see id.* § 4.2(c)(1), and the demand must also be delivered to the owner of the property and other lienholders, *see id.* § 4.2(c)(2).

230. UNIF. ASSIGNMENT OF RENTS ACT § 4(b) (2005).

231. The comments to § 4 provide:

[N]othing in the Act precludes an owner of real property from making a truly absolute transfer of rents in a transaction that is not a security transaction, such as a “true sale” of rents (in which the owner of the real property transfers full legal, equitable ownership and control of unaccrued rents immediately upon execution and delivery). Such a transfer, however, is not an “assignment of rents” as defined in the Act (unless applicable state law dictates otherwise), and thus the provisions of the Act governing the enforcement of an assignment of rents would not apply to such a transfer.

Id. § 4 cmt. 3.

assignment of rents.

The UARA resolves the problems that lenders have encountered with collateral assignments of rents. First, the Act provides that an assignment of rents is fully perfected upon recordation.²³² The Act further provides that a perfected security interest in rents has priority against a judicial lien creditor or a purchaser of the rents or the real property.²³³ With state law clarified by the Act, a recorded assignment of rents would be treated as perfected in bankruptcy, resolving that issue once and for all. Therefore, the Act resolves the perfection problem that lenders have tried to avoid by using absolute assignments.

Second, the UARA provides detailed provisions relating to the enforcement of an assignment of rents. Under the Act, an assignment of rents may be enforced by obtaining the appointment of a receiver,²³⁴ by giving notice to the mortgagor,²³⁵ by giving notice to the tenants,²³⁶ or by any other method permitted under the particular state's law.²³⁷ Therefore, a lender is not required to take any burdensome action in order to enforce the assignment of rents. The lender is entitled to collect from tenants those rents that accrue on or after the date of enforcement or that previously accrued but remain unpaid on the date of enforcement.²³⁸

The Act makes the borrower personally liable for failing to turn over to the lender rents that the borrower collects after the date of enforcement.²³⁹ This provision is particularly important for the lender if the borrower is not personally liable for the debt because the debt is non-recourse or because the mortgaged property has been conveyed to a non-assuming grantee.²⁴⁰ Although most courts hold that the borrower's misapplication of rents is waste,²⁴¹ the Act makes clear the liability of a borrower who wrongfully fails to turn over rents.

232. *See id.* § 5(b).

233. *See id.* § 5(c).

234. *See id.* § 7. This provision also lays out the requirements for a lender to obtain the appointment of a receiver. *See id.*

235. *See id.* § 8. The notice must also be sent to the holders of other recorded assignments of rents. *See id.* § 8(a).

236. *See id.* § 9.

237. *See id.* § 6(a).

238. *See id.* § 6(b). The Act does not give the lender a right to proceeds of rents collected by the borrower before the date of enforcement. *See id.* § 6 cmt. 2.

239. *See id.* § 14(b), (d). The lender is also entitled to reasonable attorneys' fees and costs if provided for by agreement. *See id.* § 14(d)(2).

240. A grantee of mortgaged property not personally liable on the debt should nevertheless be liable for misapplying rents.

241. *See, e.g.,* Ginsberg v. Lennar Fla. Holdings, Inc., 645 So. 2d 490, 500 (Fla. 3d DCA 1994); Taylor v. Brennan, 621 S.W.2d 592, 593 (Tex. 1981); UNIF. ASSIGNMENT OF RENTS ACT § 14 cmt. 1; RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 4.6(a)(5) (1997).

Third, the UARA addresses the issue of the lender's security interest in proceeds of rents collected by the borrower after the mortgage lender enforces its assignment of rents. The Act makes clear that the mortgage lender has a security interest in identifiable cash proceeds of such rents²⁴² and that the security interest in proceeds is perfected if the security interest in rents is perfected.²⁴³ The Act deals with priority issues relating to cash proceeds in the same manner as Article 9 of the U.C.C.²⁴⁴ Therefore, the Act provides a comprehensive scheme for the enforcement of an assignment of rents.

The UARA goes much further to clarify and define the rights and duties of the parties to an assignment of rents and to resolve in advance the issues that the parties and tenants affected by an assignment of rents might need to litigate. First, the Act provides that the enforcement of an assignment of rents does not "make the assignee a mortgagee-in-possession of the real property."²⁴⁵ A few courts have found that a lender collecting rents pursuant to an assignment of rents is a mortgagee-in-possession with the attendant liabilities.²⁴⁶ Lenders tend to avoid taking possession of mortgaged property prior to foreclosure to avoid these liabilities, and, therefore, lenders do not want to be liable as a mortgagee-in-possession simply because they are collecting rent. The UARA resolves this issue by providing that the lender does not become a mortgagee-in-possession simply by virtue of collecting rents.²⁴⁷ The Act further provides that the lender is not obligated by virtue of collecting rents to pay "expenses of protecting or maintaining the real property."²⁴⁸ The assumption is that mortgage lenders have sufficient incentive to pay taxes and insurance premiums and to maintain the mortgaged property if the borrower is unable or unwilling to do so.²⁴⁹ The Act makes clear that if the lender's failure to maintain the property results in a breach of the lease by the landlord, tenants may have a defense to paying rent.²⁵⁰ Furthermore, tenants may be entitled to the appointment of a receiver to protect and maintain the

242. See UNIF. ASSIGNMENT OF RENTS ACT § 14(b)(2). The Act does not give the lender a security interest in proceeds of rents collected by the borrower before the date of enforcement. See *id.* § 6 cmt. 2.

243. See *id.* § 15(b). "[C]ash proceeds are identifiable if they are maintained in a segregated account or . . . to the extent the assignee can identify them by a method of tracing . . ." *Id.* § 14(c).

244. See *id.* § 15(c).

245. *Id.* § 11(1).

246. See *supra* note 82.

247. See UNIF. ASSIGNMENT OF RENTS ACT § 11 cmt.1.

248. *Id.* § 13(a).

249. See Freyermuth, *The New UARA*, *supra* note 7, at 55-56.

250. See UNIF. ASSIGNMENT OF RENTS ACT § 13(b).

property.²⁵¹ Therefore, the concerns of tenants, as well as borrowers and lenders, are considered in the Act.

The Act also addresses other concerns that tenants have relating to the enforcement of an assignment of rents. Tenants receiving notice to begin paying rent to a lender rather than to the landlord are understandably reluctant to do so because of the risk that they may pay the wrong party. Tenants in this position often stop paying rent altogether to avoid paying the wrong party. The Act provides detailed provisions that strongly encourage tenants to pay an assignee who has exercised its rights under an assignment of rents rather than the landlord and at the same time protect the tenants in paying the assignee.²⁵² In addition, tenants are given a grace period for payment of rent after receiving a notice during which time the tenant may seek the advice of counsel.²⁵³ These provisions of the Act should make tenants more likely to pay rent to a lender who has enforced an assignment of rents and at the same time alleviate tenants' concerns about making the payments.

The Act considers and balances the rights of borrowers, lenders, and tenants. It would eliminate the need for absolute assignments of rents by creating a workable security interest for lenders. It would therefore reduce transaction costs and litigation caused by this device. The Act would resolve confusion over the perfection of an assignment of rents. In addition, under the Act, lenders could enforce an assignment of rents upon default simply by giving notice to the borrower or tenants. For borrowers, this method of enforcement is no more onerous than rights that lenders have under current law to enforce an absolute assignment of rents. In addition, for the benefit of borrowers, an absolute assignment of rents could no longer be used by lenders to block a borrower's ability to reorganize under Chapter 11 of the Bankruptcy Code. Furthermore, the Act addresses tenants' concerns. Overall, the Act provides a clear and comprehensive scheme for the creation of security interests in rents.

VI. CONCLUSION

The law regarding assignments of rents has been in great disarray for more than a century. Lenders, dissatisfied with the problems they have encountered with collateral assignments of rents in many states, have turned to the absolute assignment of rents as a solution. The absolute assignment, however, has caused even more confusion. Courts have made drafting an absolute assignment difficult to accomplish by requiring the pretense of a transfer of title to the rents. Courts have caused additional

251. *See id.* § 13(c).

252. *See id.* § 9(c), (d).

253. *See id.* § 9(d) & cmt. 5.

uncertainty by treating absolute assignments as a transfer of title to rents, when in fact they simply create a different type of security interest. The refusal of courts to give lenders reasonable security interests under collateral assignments and lenders' use of absolute assignments to overcome the deficiencies of collateral assignments have led to additional transaction costs and unnecessary litigation.

A solution to the century-old problems relating to assignments of rents in mortgage loan transactions is now at hand. The new Uniform Assignment of Rents Act provides a comprehensive and logical scheme for creating security interests in rents that will satisfy mortgage lenders while considering the needs of borrowers and tenants. State legislatures should consider and adopt this Act.

