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## STILL CRAZY AFTER ALL THESE YEARS: THE ABSOLUTE ASSIGNMENT OF RENTS IN MORTGAGE LOAN TRANSACTIONS\*

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*This Article explores the problems arising from the use of the absolute assignment of rents in mortgage loan transactions, which have continued for over a century, as well as 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 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. The Article explores the historical development of the absolute assignment of rents and discusses the confusion, unnecessary litigation, and even injustice that it causes under state law and in bankruptcy. 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. The Article concludes by discussing the Act and recommending its adoption.*

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

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## INTRODUCTION

For over 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 of the needs of mortgage lenders to create 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.<sup>1</sup> Rents provide the funds necessary to pay for operating and maintaining the mortgaged property and to make payments on the mortgage loan. After a default on the mortgage loan, a borrower, facing the possibility of losing the property to foreclosure, may apply rents for purposes unrelated to the property or the mortgage loan.<sup>2</sup> The lender, on the other hand, continues to want rents collected during the time period between default and foreclosure to be applied to operation, maintenance, and loan payments. 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 at the time of the closing of the loan to execute an assignment of rents.<sup>3</sup> Unfortunately, the law governing

<sup>1</sup>See Julia Patterson Forrester, *A Uniform and More Rational Approach to Rents as Security for the Mortgage Loan*, 46 RUTGERS L. REV. 349 (1993).

<sup>2</sup>This practice is sometimes called "milking" the rents. 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.

<sup>3</sup>The assignment of rents or other loan documents may also contain restrictions on the ability of the

assignments of rents is illogical and confusing<sup>4</sup> and varies significantly from state to state.<sup>5</sup>

Different types of assignments of rents have developed depending upon state law and the agreement reached between borrower and 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, called 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 default, takes some affirmative action, depending on state law, such as taking possession of the mortgaged property, obtaining the appointment of a receiver, or making demand for rents on the borrower or tenants.<sup>6</sup> In many states, a lender must take some burdensome action such as taking possession of the property in order to enforce an assignment of rents that is held to be a collateral assignment regardless of the agreement of the parties, and in some states a collateral assignment may be treated as unperfected until it is enforced.<sup>7</sup> 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 effective 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.<sup>8</sup>

In states that do not give meaningful effect to a collateral assignment of rents,

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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 and termination of leases and on prepayments of rent. Loan documents may require that the borrower apply rents to pay expenses of operating and maintaining the property and to pay the mortgage debt. 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.

<sup>4</sup>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 Rents in New York*, 6 BROOK. L. REV. 25 (1936); Morris Berick, *The Mortgagee's Right to Rents*, 8 U. CIN. L. REV. 250 (1934); Forrester, *supra* note 1; R. Wilson Freyermuth, *Modernizing Security in Rents: The New Uniform Assignment of Rents Act*, 71 MO. L. REV. 1 (2006) [hereinafter *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 (1993) [hereinafter *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. REV. 1424 (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 (1994); David Gray Carlson, *Rents in Bankruptcy*, 46 S.C. L. REV. 1075 (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 (1997); James McCafferty, *The Assignment of Rents in the Crucible of Bankruptcy*, 94 COM. L.J. 516 (1988); Patrick A. Randolph, Jr., *Recognizing Lenders' Rents Interests in Bankruptcy*, 27 REAL PROP., PROB. & TR. J. 281 (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 (1992-93).

<sup>5</sup>See *infra* notes 28-33 and accompanying text.

<sup>6</sup>See *infra* notes 60-64 and accompanying text.

<sup>7</sup>See *infra* notes 37-42 and accompanying text.

<sup>8</sup>See *infra* note 78 and accompanying text.

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 an enforceable absolute assignment. 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.<sup>9</sup> This drafting challenge and the resulting litigation have continued for over a century.<sup>10</sup>

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.<sup>11</sup> 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.

In this Article, I address the confusion over the absolute assignment of rents, the unnecessary litigation and the injustice caused by this disorder, and possible solutions to the problem.<sup>12</sup> Part I discusses the legal theories underlying the creation of a security interest in rents. In Part II, I explain 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, and in Part III, I explore 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 one, the varying treatment of absolute assignments by state and federal courts, and the problems caused by absolute assignments under state law and in bankruptcy. 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 in substance creates a security interest. 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.

In Part V, I examine possible solutions. One solution is judicial—courts could

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<sup>9</sup>See *infra* Part IV.B.

<sup>10</sup>In 1894 the Missouri Court of Appeals held that a lender's assignment of rents was not an absolute assignment because of language in the assignment that it was given "as additional security for the payment of . . . notes." *Armour Packing Co. v. Wolff & Co.*, 59 Mo. App. 665 (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). Numerous courts in the years between also addressed the issue of whether an assignment of rents is absolute. See *infra* Part IV.B. for a discussion of these cases.

<sup>11</sup>See *infra* Part IV.A.

<sup>12</sup>This is not my first attempt at proposing a solution. In an article published 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 1, at 402. Independently, but at the same time, Professor Wilson Freyermuth reached the same conclusion. See Freyermuth, *Of Hotel Revenues*, *supra* note 4, 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, AM. LAW INST. AND NAT'L CONF. OF COMM'RS ON UNIFORM STATE LAWS, REPORT OF THE PEB STUDY GROUP ON ARTICLE 9 OF THE UNIFORM COMMERCIAL CODE app. 154-55, 196 (1992), but rents were ultimately excluded from Article 9, U.C.C. § 9-109(d)(11) (2001).

adopt an 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 unlikely to occur quickly. A more appropriate solution is a legislative one—adoption of the new Uniform Assignment of Rents Act (“UARA”),<sup>13</sup> 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.<sup>14</sup>

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.

## I. 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.<sup>15</sup> 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 sale purchaser is entitled to rents accruing after the date of foreclosure from leases that remain in effect after the foreclosure.<sup>16</sup> 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.<sup>17</sup>

<sup>13</sup>The National Conference of Commissioners on Uniform State Laws (NCCUSL) appointed a drafting committee in 2003 to prepare a Uniform Assignment of Rents Act at the urging of the Joint Editorial Board for Real Property Acts. See Freyermuth, *The New UARA*, *supra* note 4, at 3. NCCUSL approved UARA and recommended it for enactment in all states in July 2005. UNIFORM ASSIGNMENT OF RENTS ACT (2005).

<sup>14</sup>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 4.

<sup>15</sup>See *Norwest Bank v. Superior Court*, 963 P.2d 319, 323 (Ariz. Ct. App. 1998); *Winnisimmet Trust Inc. v. Libby*, 122 N.E. 575, 576 (Mass. 1919); *First & Citizens Nat’l Bank v. Sawyer*, 10 S.E.2d 656, 658 (N.C. 1940); *Marine Nat’l Bank v. Northwest Pennsylvania Bank & Trust Co.*, 454 A.2d 67, 70 (Pa. Super. Ct. 1982); *Schmid v. Baum’s Home of Flowers*, 37 S.W.2d 105, 108 (Tenn. 1931). Blackstone listed rents among the ten principal incorporeal hereditaments. 2 WILLIAM BLACKSTONE, COMMENTARIES \*20.

Jurisdictions are split on the issue of whether rents are severed from the real property when they accrue, *White v. Irvine*, 22 S.W.2d 778, 778 (Mo. 1929); *Marine Nat’l Bank*, 454 A.2d at 70, or when they are collected, *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.)*, 985 F.2d 1008 (9th Cir. 1993); *Treetop Apartments Gen. Partnership v. Oyster*, 800 S.W.2d 628, 629 (Tex. Ct. App. 1990).

A severance also occurs when the right to unaccrued rents is assigned to a third party, *Brack v. Coburn*, 196 S.W.2d 230, 234 (Ark. 1946); *Valley Nat’l Bank v. Avco Dev. Co.*, 480 P.2d 671, 674 (Ariz. Ct. App. 1971); *Winnisimmet*, 122 N.E. at 576; *Schmid*, 37 S.W.2d at 108, reserved in a transfer of the landlord’s reversion, *Jim Davis & Co. v. Albuquerque Federal Sav. & Loan Assoc.*, 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, *Treetop*, 800 S.W.2d at 629 (citing *Standridge v. Vines*, 81 S.W.2d 289, 290 (Tex. Civ. App. 1935)).

<sup>16</sup>See *Jim Davis & Co.*, 536 So. 2d at 58 (quoting *Walsh*, 132 So. at 53); *Norwest Bank*, 963 P.2d at 323-25; *Security Sav. & Loan Soc. v. Dudley*, 26 P.2d 384, 385 (Wash. 1933).

<sup>17</sup>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 (Fla. Dist. Ct. App. 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 (1885); *Metropolitan 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

Because the foreclosure process is lengthy in many states,<sup>18</sup> a significant time period may elapse between the borrower's default and 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 extent to which these provisional remedies are available depends upon the law of the state where the mortgaged property is located and the effect given in that state 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.<sup>19</sup> 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.<sup>20</sup> Most states 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.<sup>21</sup> Finally, in a few states, called intermediate states, a mortgage lender has a hybrid interest which gives the lender the right to take possession of the property and collect rents after the borrower's default.<sup>22</sup>

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.<sup>23</sup> 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.<sup>24</sup> Therefore, borrowers and lenders adopt by contract 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

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intermediate theory states, discussed *infra* at notes 19-24, 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, 8 (1961).

<sup>18</sup>See NELSON & WHITMAN, REAL ESTATE FINANCE LAW § 7.1 (2001); ABA Report of Committee on Mortgage Law & Practice, *Cost and Time Factors in Foreclosure of Mortgages*, 3 REAL PROP., PROB. & TR. J. 413, 414 (1968). See also Sidney A. Keyles, FORECLOSURE LAW & RELATED REMEDIES: A STATE-BY-STATE DIGEST (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 which 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.

<sup>19</sup>See NELSON & WHITMAN, *supra* note 18, § 4.1; RESTATEMENT (THIRD) OF PROPERTY-SECURITY (MORTGAGES) § 4.1 cmt. a (1997); Kratovil, *supra* note 17, at 4.

<sup>20</sup>See Kratovil, *supra* note 17, at 5.

<sup>21</sup>*Id.* at 4, 6. In some states the borrower's right of possession is extended until the expiration of a statutory redemption period. *Id.*

<sup>22</sup>*Id.* at 4-5. See generally NELSON & WHITMAN, *supra* note 18, § 4.1-4.3.

<sup>23</sup>See *Kinnison v. Guaranty Liquidating Corp.*, 115 P.2d 450, 452 (Cal. 1941); *Topeka Sav. Ass'n v. Beck*, 428 P.2d 779, 782 (Kan. 1967); *Central Sav. Bank v. First Cadco Corp.*, 181 N.W.2d 261, 264 (Neb. 1970); *Carlquist v. Coltharp*, 248 P. 481, 483 (Utah 1926).

<sup>24</sup>Massachusetts is a title theory state, *J & W Wall Systems, 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. ANN. L. ch. 183, § 26 (Law. Co-op. 1996).

maintaining the property and to the payment of the indebtedness secured by the mortgage.<sup>25</sup> 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 for a receiver.<sup>26</sup> The remedies of possession by a lender or receivership are necessary for a lender if the borrower is wasting or mismanaging the mortgaged property. 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,<sup>27</sup> and lenders therefore typically require the execution by the borrower of an assignment of rents in an attempt to make this remedy available.

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 jurisdictions.<sup>28</sup> States vary in the steps required for perfection of a collateral assignment of rents,<sup>29</sup> and in the methods permitted for enforcement.<sup>30</sup> Most states recognize and give effect to an absolute assignment of rents,<sup>31</sup> but some states do not recognize the absolute assignment of rents or treat it no differently from a collateral assignment of rents.<sup>32</sup> 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.<sup>33</sup> 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

<sup>25</sup>See NELSON & WHITMAN, *supra* note 18, § 4.27.

<sup>26</sup>See *infra* notes 75-77 and accompanying text.

<sup>27</sup>For a discussion of the disadvantages to a lender of the mortgagee in possession and receivership remedies, see Part II.B.

<sup>28</sup>NELSON & WHITMAN, *supra* note 18, § 4.35.

<sup>29</sup>See *infra* Part II.A.

<sup>30</sup>See *infra* Part II.B.

<sup>31</sup>See, e.g., FDIC v. Int'l Property Management, Inc., 929 F.2d 1033 (5th Cir. 1991) (applying Texas law); Matter of Charles D. Stapp of Nevada, Inc., 641 F.2d 737, 740 (9th Cir. 1981) (applying Nevada law); Fidelity Bankers Life Ins. Co. v. Williams (*In re O'Neill Enterprises, Inc.*), 506 F.2d 1242 (4th Cir. 1974) (applying Virginia law); First Fidelity Bank v. Eleven Hundred Metroplex Assocs., 190 B.R. 510 (S.D.N.Y. 1995); First Fed. Sav. v. City Nat'l Bank, 87 B.R. 565 (W.D. Ark. 1988); *In re Kingsport Ventures, L.P.*, 251 B.R. 841 (Bankr. E.D. Tenn. 2000) (citing American Trust & Banking Co. v. Twinam, 216 S.W.2d 314, 319 (Tenn. 1948)); *In re Robin Associates*, 275 B.R. 218 (Bankr. W.D. Pa. 2001); *In re Carter*, 126 B.R. 811 (Bankr. M.D. Fla. 1991); *In re Galvin*, 120 B.R. 767 (Bankr. D. Vt. 1990); *In re Gould*, 78 B.R. 590 (D. Idaho 1987); *In re P.M.G. Properties*, 55 B.R. 864 (E.D. Mich. 1985); HomeCorp v. Secor Bank, 659 So.2d 15 (Ala. 1995); Vector Realty Group v. 711 Fourteenth St., Inc., 711 A.2d 1265, 1267 (D.C. 1998); Hawaii National Bank v. Cook, 58 P.3d 60 (Hawaii 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 (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 state at least that an absolute assignment of rents is a transfer to the lender of the borrower's interest in the rents. See *infra* Part IV.A.

<sup>32</sup>See CAL. CIV. CODE § 2938(a) (West Supp. 2006); *In re Century Inv. Fund VIII Ltd. Partnership*, 937 F.2d 371, 377 (7th Cir. 1991) (Wisconsin law); Drummond v. Farm Credit Bank (*In re Kurth Ranch*), 110 B.R. 501, 506 (Bankr. D. Mont. 1990).

<sup>33</sup>See *infra* Part II.

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 the trustee in bankruptcy.”<sup>34</sup> Under Article 9 of the 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.<sup>35</sup> Both filing and possession give notice of the security interest.

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. 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” lien<sup>36</sup> that is not perfected until the lender takes whatever action is required to enforce the assignment of rents.<sup>37</sup> Several states<sup>38</sup> and a number of federal courts interpreting state law<sup>39</sup> still follow this approach. To make matters worse for lenders, states that follow the common law approach to perfection may also require burdensome action for enforcement.<sup>40</sup> Therefore, the lender does not have a perfected security interest in rents until the lender takes possession of the property or takes some similar action.<sup>41</sup> 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 effective 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.”<sup>42</sup>

Most states by statute<sup>43</sup> or judicial decision<sup>44</sup> have now adopted a modern

<sup>34</sup>JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE §31-1 (5<sup>th</sup> ed. 2002).

<sup>35</sup>*Id.* § 31-4.

<sup>36</sup>“Inchoate” means “[p]artially completed or imperfectly formed; just begun.” BLACK’S LAW DICTIONARY 776 (8th ed. 2004).

<sup>37</sup>*O’Neal Steel, Inc. v. E B Inc. (In re Millette)*, 186 F.3d 638, 641 (5<sup>th</sup> Cir. 1999).

<sup>38</sup>*See Bevins v. Peoples Bank & Trust Co.*, 671 P.2d 875, 879 (Alaska 1983); *Martinez v. Continental Enter.*, 730 P.2d 308, 316 (Colo. 1986) (en banc); *Taylor v. Brennan*, 621 S.W.2d 592, 594 (Tex. 1981).

<sup>39</sup>*See Millette*, 186 F.3d at 641 n.6 (citing *In re Century Inv. Fund VIII L.P.*, 937 F.2d 371, 377 (7th Cir.1991) (Wisconsin law); *In re 1301 Conn. Ave. Assocs.*, 126 B.R. 1, 3 (D.D.C.1991) (District of Columbia law); *First Federal Savings and Loan Assoc. of Toledo v. Hunter (In re Sam A. Tisci, Inc.)*, 133 B.R. 857, 859 (N.D.Ohio 1991) (Ohio law); *Condor One, Inc. v. Turtle Creek, Ltd. (In re Turtle Creek, Ltd.)*, 194 B.R. 267, 278 (Bankr.N.D.Ala.1996) (Alabama law); *In re Mews Assocs., L.P.*, 144 B.R. 867, 868-69 (Bankr.W.D.Mo.1992) (Missouri law); *Drummond v. Farm Credit Bank of Spokane (In re Kurth Ranch)*, 110 B.R. 501, 506 (Bankr.D.Mont.1990) (Montana law); *Armstrong v. United States (In re Neideffer)*, 96 B.R. 241, 243 (Bankr.D.N.D.1988) (North Dakota law); *Ziegler v. First Nat’l Bank of Volga (In re Ziegler)*, 65 B.R. 285, 287 (Bankr.D.S.D.1986) (South Dakota law). *But cf. Vienna Park Properties v. United Postal Savings Ass’n (In re Vienna Park Properties)*, 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), *aff’d sub nom. Steinberg v. Crossland Mortgage Corp. (In re Park at Dash Point L.P.)*, 985 F.2d 1008 (9th Cir. 1993) (holding security interest inchoate but perfected).

<sup>40</sup>*See infra* Part II.B. for a discussion of permitted methods of enforcement.

<sup>41</sup>*See Taylor v. Brennan*, 621 S.W.2d 592, 594 (Tex. 1981).

<sup>42</sup>*Taylor*, 621 S.W.2d at 594.

<sup>43</sup>*See, e.g.*, CAL. CIV. CODE § 2938(b) (West Supp. 2006); DEL. CODE ANN. tit. 25, § 2121(a) (2004); FLA. STAT. § 697.07 (West 2006); KAN. STAT. ANN. § 58-2343(b) (West 2005); MD. CODE

approach to perfection of an assignment of rents—that perfection is accomplished by recordation. Perfection in these states, therefore, is analogous to perfection under Article 9 of the UCC 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.<sup>45</sup> 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.<sup>46</sup> 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.”<sup>47</sup> This result defeats the public policy concerns underlying recording acts.<sup>48</sup>

Before the Bankruptcy Reform Act of 1994,<sup>49</sup> the confusion over perfection of assignments of rents created havoc in the bankruptcy courts.<sup>50</sup> 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.<sup>51</sup> 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,

ANN., REAL PROP. § 3-204 (LexisNexis 2003); NEB. REV. STAT. § 52-1704 (2004); N.C. GEN. STAT. § 47- 20(c) (2005); TENN. CODE ANN. § 66-26-116(a) (2004); VA. CODE ANN. § 55-220.1 (2003); WASH. REV. CODE § 7.28.230(3) (West Supp. 2006).

<sup>44</sup>See *Millette*, 186 F.3d at 642 (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. and Annuity Ass'n of Am. v. Oklahoma Tower Assocs. L.P.*, 798 P.2d 618, 622 (Okla.1990)).

A number of federal courts have interpreted state law as opting for the modern approach to perfection of an assignment of rents. See *Millette*, 186 F.3d at 642 n.7 (citing *Commerce Bank v. Mountain View Village, Inc.*, 5 F.3d 34, 39 (3d Cir.1993) (Pennsylvania law); *Scottsdale Med. Pavilion v. Mutual Benefit Life Ins. Co.* (In re *Scottsdale Med. Pavilion*), 52 F.3d 244 (9th Cir.1995), *adopting as its own opinion*, 159 B.R. 295, 302 (9th Cir. BAP 1993) (Arizona law); *In re Sansone*, 126 B.R. 16, 19 (Bankr. D. Conn.1991) (Connecticut law); *In re May*, 169 B.R. 462, 467 (Bankr. S.D. Ga.1994) (Georgia law); *Federal Land Bank v. Terpstra* (In re *Porter*), 90 B.R. 399, 404 (N.D. Iowa 1988) (Iowa law); *First Nat'l Bank of Bar Harbor v. United States Dep't of Agric.* (In re *Dorsey*), 155 B.R. 263, 268 (Bankr. D. Me.1993) (Maine law); *In re Coventry Commons Assocs.*, 143 B.R. 837, 838 (E.D. Mich.1992) (Michigan law); *New York Life Ins. Co. v. Bremer Towers*, 714 F.Supp. 414, 418 (D. Minn.1989) (Minnesota law); *Midlantic Nat'l Bank v. Sourlis*, 141 B.R. 826, 834 (D.N.J.1992) (New Jersey law); *641 Avenue of the Americas, L.P. v. 641 Assocs., Ltd.*, 189 B.R. 583, 590 (S.D.N.Y.1995) (New York law); *In re KNM Roswell L.P.*, 126 B.R. 548, 554 (Bankr. N.D. Ill.1991) (New Mexico law); *SLC Ltd. V v. Bradford Group West, Inc.* (In re *SLC Ltd. V*), 152 B.R. 755, 761 (Bankr. D. Utah 1993) (Utah law)). See also *Vienna Park Properties v. United Postal Savings Ass'n* (In re *Vienna Park Properties*), 976 F.2d 106, 112-13 (2d Cir. 1992) (security interest in rents was inchoate under Virginia law but still perfected)

<sup>45</sup>See *supra* notes 38-39 and accompanying text.

<sup>46</sup>See *Millette*, 186 F.3d at 642.

<sup>47</sup>*Id.*

<sup>48</sup>See *id.*

<sup>49</sup>Pub. L. No. 103-394, 108 Stat. 4106 (1994) (codified in scattered sections of 11 U.S.C.)

<sup>50</sup>See Forrester, *supra* note 1, at 354-55 n.21 (“The author found more than 300 cases reported from 1980 to [1993] involving the issue of rents.”)

<sup>51</sup>See 11 U.S.C. § 544(a) (2004).

including a mortgage lender's rights to rents.<sup>52</sup> Thus, depending on state law or a federal court's interpretation of state law, courts in bankruptcy cases had 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.<sup>53</sup> Some courts determined that the trustee could avoid the lender's interest in rents if state law required enforcement for perfection.<sup>54</sup> Other courts permitted the 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.<sup>55</sup> A third group of courts found a properly recorded assignment of rents was perfected and thus would not permit the trustee to avoid the lender's interest in rents.<sup>56</sup>

Congress addressed this issue in the Bankruptcy Reform Act of 1994<sup>57</sup> by amending section 552(b) of the Bankruptcy Code.<sup>58</sup> According to legislative

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<sup>52</sup>See *Butner v. United States*, 440 U.S. 48, 54-55 (1979). In *Butner*, the United States 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." *Lewis v. Manufacturers National Bank*, 364 U.S. 603, 609 . . . . 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. The Court has continued to follow its mandate set forth *Butner* under the current Bankruptcy Code. See *Raleigh v. Illinois Dept. of Revenue*, 530 U.S. 15, 16 (2000); *Nobelman v. American Sav. Bank*, 508 U.S. 324, 324 (1993).

<sup>53</sup>See Forrester, *supra* note 1, at 386-92.

<sup>54</sup>See, e.g., *Glessner v. Union Nat'l Bank & Trust Co.* (*In re Glessner*), 140 B.R. 556 (Bankr. D. Kan. 1992), *overruled by* KAN. STAT. ANN. § 58-2343 (West 2003); *Drummond v. Farm Credit Bank* (*In re Kurth Ranch*), 110 B.R. 501 (Bankr. D. Mont. 1990); *In re Multi-Group III Ltd. Partnership*, 99 B.R. 5 (Bankr. D. Ariz. 1989); *In re TM Carlton House Partners, Ltd.*, 91 B.R. 349 (Bankr. E.D. Pa. 1988); *In re Ass'n Center Ltd. Partnership*, 87 B.R. 142 (Bankr. W.D. Wash. 1988), *overruled by* WASH. REV. CODE § 7.28.230(3) (West Supp. 2006); *In re Hamlin's Landing Joint Venture*, 77 B.R. 916 (Bankr. D. Fla. 1987), *overruled by* FLA. STAT. ANN. § 697.07 (West 2006); *Exchange Nat'l Bank v. Gotta* (*In re Gotta*), 47 B.R. 198 (Bankr. W.D. Wis. 1985).

<sup>55</sup>See, e.g., *Casbeer v. State Fed. Sav. & Loan Ass'n* (*In re Casbeer*), 793 F.2d 1436 (5th Cir. 1986); *Walters Village, Ltd. v. Village Properties, Ltd.* (*In re Village Properties, Ltd.*), 723 F.2d 441 (5th Cir.), *cert. denied*, 466 U.S. 974 (1984); *Consol. Capital Income Trust v. Colter, Inc.* (*In re Consol. Capital Income Trust*), 47 B.R. 1008 (D. Colo. 1985); *McCombs Properties VI, Ltd. v. First Texas Sav. Ass'n* (*In re McCombs Properties VI, Ltd.*), 88 B.R. 261 (Bankr. C.D. Cal. 1988); *In re Mears*, 88 B.R. 419 (Bankr. S.D. Fla. 1988); *In re Gelwicks*, 81 B.R. 445 (Bankr. N.D. Ill. 1987); *FDIC v. Lancaster* (*In re Sampson*), 57 B.R. 304 (Bankr. E.D. Tenn. 1986); *United States v. Farrell* (*In re Fluge*), 57 B.R. 451 (Bankr. D.N.D. 1985).

<sup>56</sup>See, e.g., *Steinberg v. Crossland Mortgage Corp.* (*In re Park at Dash Point L.P.*), 985 F.2d 1008 (9th Cir. 1993); *Vienna Park Properties v. United Postal Savings Ass'n* (*In re Vienna Park Properties*), 976 F.2d 106 (2d Cir. 1992); *J.H. Streiker & Co. v. SeSide Co.* (*In re SeSide Co.*), 152 B.R. 878 (E.D. Pa. 1993); *In re Northport Marina Assocs.*, 136 B.R. 911 (E.D.N.Y. 1992); *In re White Plains Development Corp.*, 136 B.R. 93 (S.D.N.Y. 1992); *In re Raleigh/Spring Forest Apartments Assocs.*, 118 B.R. 42 (E.D.N.C. 1990); *Northwestern Nat'l Life Ins. Co. v. Metro Square* (*In re Metro Square*), 106 B.R. 584 (D. Minn. 1989); *In re Rancourt*, 123 B.R. 143 (Bankr. D.N.H. 1991); *In re Somero*, 122 B.R. 634 (Bankr. D. Me. 1991).

<sup>57</sup>Pub. L. No. 103-394, 108 Stat. 4106 (1994) (codified in scattered sections of 11 U.S.C.)

<sup>58</sup>11 U.S.C. § 552(b)(2) (2004). 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

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.”<sup>59</sup> 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,<sup>60</sup> but the spate of litigation over this issue has subsided.

Under state 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.<sup>61</sup> 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.<sup>62</sup> Therefore, 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 borrower<sup>63</sup> or the tenants.<sup>64</sup> Other states may require somewhat more onerous action such as filing a request for a receiver,<sup>65</sup> or initiating a foreclosure proceeding.<sup>66</sup> 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.<sup>67</sup>

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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 non-bankruptcy law” after “security agreement” and added “and notwithstanding section 546(b) of this title” as shown above. Pub. L. No. 103-394, §214(a), 108 Stat. 4106, 4126 (1994) (codified in 11 U.S.C. §552(b)).

<sup>59</sup>140 CONG. REC. 27,678, 27,695 (1994) (statement of Rep. Brooks).

<sup>60</sup>See Carlson, *supra* note 4, at 1145; Freyermuth, *The New UARA*, *supra* note 4, 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).

<sup>61</sup>See Millette, 186 F.3d at 643.

<sup>62</sup>See *id.*; *In re Geary's Bottled Liquors Co., Inc.*, 184 B.R. 408 (Bankr. D.Mass. 1995).

<sup>63</sup>See 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); *Hawaii Nat'l Bank v. Cook*, 58 P.3d 60, 67-68 (Haw. 2002).

<sup>64</sup>See CAL. CIV. CODE § 2938(c)(3); *Imperial Gardens Liquidating Trust v. Northwest Commons, Inc. (In re Northwest Commons)*, 136 B.R. 215, 218 (Bankr. E.D. Mo. 1991), *criticized in In re Mews Assocs.*, 144 B.R. 867 (Bankr. W.D. Mo. 1992); *Fluge*, 57 B.R. at 454; *Hawaii Nat'l Bank*, 58 P.3d at 67-68.

<sup>65</sup>See, e.g., *In re Century Inv. Fund VIII Ltd. Partnership*, 937 F.2d 371, 377 (7th Cir. 1991); *In re Flower City Nursing Home, Inc.*, 38 B.R. 642, 645 (Bankr. W.D.N.Y. 1984).

<sup>66</sup>See *Martinez v. Continental Enterprises*, 730 P.2d 308, 316 (Colo. 1986).

<sup>67</sup>See *Freedman's Sav. & Trust Co. v. Shepard*, 127 U.S. 494, 502-03 (1888) (requiring that the

Requiring that a lender 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, and, unless the borrower is willing to relinquish possession of the property voluntarily, obtaining possession of the mortgaged property requires judicial intervention as well.<sup>68</sup> The delay can give a borrower time to collect and misapply rents.<sup>69</sup> 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 can have liability for environmental problems on the property.<sup>70</sup> Second, the lender can be held liable to the 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."<sup>71</sup> A mortgagee in possession is held to the standard of a "prudent" or "provident" owner.<sup>72</sup> Finally, the lender may have liability to third parties for injuries caused by dangerous conditions on the property.<sup>73</sup> For these reasons lenders are generally hesitant to become mortgagees in possession.<sup>74</sup>

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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.)*, 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).

<sup>68</sup>Obtaining the appointment of a receiver requires a court order, and 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.

<sup>69</sup>A lender with a collateral assignment of rents cannot reach rents collected by the borrower during this period. *See infra* Part II.C.

<sup>70</sup>The Comprehensive Environmental Response, Compensation, and Liability Act, 42 U.S.C. §§ 9601-9657 (2005) [hereinafter CERCLA], 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 "decision-making control over the environmental compliance related to 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.

<sup>71</sup>*Myers-Macomber Engineers v. M.L.W. Constr. Corp.*, 414 A.2d 357, 360 (Pa. Super. Ct. 1979).

<sup>72</sup>*See also* *Whitley v. Barnett*, 131 N.W. 704, 705 (Iowa 1911); *United Nat'l Bank v. Parish*, 750 A.2d 238, 241 (N.J. Super. Ct. 1999); *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 PROPERTY—MORTGAGES, § 4.1 cmt. c (1997).

<sup>73</sup>*See* *Daniels v. Hart*, 118 Mass. 543, 544 (1875); *Barter v. Wheeler*, 49 N.H. 9, 34 (1869); *First Nat'l Bank v. Motor Club of Am. Ins. Co.*, 708 A.2d 69, 71 (N.J. Super. Ct. App. Div. 1997); *Rogers v. Wheeler*, 2 Lans. 486, 489 (N.Y. 1870), *aff'd* 43 N.Y. 598 (1870); *Zisman v. City of Duquesne*, 18 A.2d 95, 97 (Pa. Super. 1941); *Sprague v. Smith*, 29 Vt. 421 (1857); *Coleman*, 64 P.3d at 68; NELSON & WHITMAN, *supra* note 18, § 4.26.

<sup>74</sup>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 (E.D. Pa. 1993) (classifying a lender's service of demand notices on tenants as taking constructive possession); *Imperial Gardens Liquidating Trust v. Northwest Commons, Inc. (In re Northwest Commons)*, 136 B.R. 215, 218 (Bankr. E.D. Mo. 1991) (finding that lender's giving of notices to

There are also disadvantages to the receivership remedy. First, a lender may 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 not by themselves sufficient to cause a court to appoint a receiver. Some additional equitable ground for the receivership “such as danger of loss, waste, destruction, or serious impairment of the property” must exist.<sup>75</sup> The effectiveness of a provision in loan documents that a lender is entitled to the appointment of a receiver varies from jurisdiction to jurisdiction.<sup>76</sup> 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. 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.<sup>77</sup> 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.<sup>78</sup> Therefore, the lender can take control of rents upon default without taking any burdensome action.

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tenants was equivalent to taking possession), *criticized in In re Mews Assocs.*, 144 B.R. 867 (Bankr. W.D. Mo. 1992); *Spiotta v. Nat'l Grocery Co.*, 168 A. 159, 160 (N.J. 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 (N.J. Super. 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 *Prince v. Brown*, 856 P.2d 589, 590 (Okla. Civ. App. 1993); *Coleman v. Hoffman*, 64 P.3d 65, 69-70 (Wash. Ct. App. 2003); NELSON & WHITMAN, *supra* note 18, § 4.25. See also *Strutt v. Ontario Sav. & Loan Ass'n*, 105 Cal. Rptr. 395, 405 (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 Schools*, 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 the estate.”); *Ireland v. U.S. Mortgage & Trust Co.*, 76 N.Y.S. 177 (1902) (finding that a lender’s receipt of rents does not make the lender a mortgagee in possession), *aff'd* 67 N.E. 1083 (1902).

<sup>75</sup>*Grether v. Nick*, 213 N.W. 304, 306, *aff'd on reh'g*, 215 N.W. 571 (Wis. 1927). See also *Totten v. Harlowe*, 90 F.2d 377, 380 (D.C. Cir.), *cert. denied*, 301 U.S. 711 (1937); *Atco Constr. & Dev. Corp. v. Beneficial Sav. Bank*, F.S.B., 523 So. 2d 747 (Fla. App. 1988); *First Nat'l Bank v. Illinois Steel Co.*, 51 N.E. 200, 204 (Ill. 1898); *Crowley v. Valley W. Water Co.*, 882 P.2d 1022, 1026 (Mont. 1994); *Cortelyou v. Hathaway*, 11 N.J. Eq. 39, 43 (1855). See generally NELSON & WHITMAN, *supra* note 18, § 4.34.

<sup>76</sup>The presence of a receivership clause in the mortgage has virtually no effect in some states. See *Gage v. First Fed. Sav. & Loan Ass'n*, 717 F.Supp. 745, 750-51 (D. Kan. 1989); *Dart v. Western Sav. & Loan Ass'n*, 438 P.2d 407 (Ariz. 1968); *ANJ Future Invs., Inc. v. Alter*, 756 So.2d 153, 154 (Fla. Dist. Ct. App. 2000); *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 v. Superior Court*, 137 Cal. Rptr. 743, 748 (Cal. Ct. App. 1977); *Fleet Bank v. Zimelman*, 575 A.2d 731, 734 (Me. 1990); *Riverside Properties 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. ANN. § 559.17 (West Supp. 2006); *Febbraro v. Febbraro*, 416 N.Y.S.2d 59, 60 (N.Y. App. Div. 1979).

<sup>77</sup>See *First Southern Properties, Inc. v. Vallone*, 533 S.W.2d 339 (Tex. 1976).

<sup>78</sup>See *Equitable Mortgage Co. v. Fishman (In re Charles D. Stapp of Nevada, Inc.)*, 641 F.2d 737, 740 (9th Cir. 1981); *Vector Realty Group v. 711 Fourteenth St., Inc.*, 711 A.2d 1265, 1267 (D.C. 1998); *Hawaii Nat'l Bank v. Cook*, 58 P.3d 60, 67 (Hawaii 2002); *Metlife Capital Fin. Corp. v. Wash. Ave Assocs. L.P.*, 732 A.2d 493, 503 (N.J. 1999); *Taylor v. Brennan*, 621 S.W.2d 592, 594 (Tex. 1981).

### C. THE RIGHT TO PREVIOUSLY COLLECTED RENTS

Another problem with the collateral assignment of rents from a lender's point of view 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.<sup>79</sup> An agreement of the parties to the contrary is not effective.<sup>80</sup> 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.<sup>81</sup> Therefore, the lender's inability to reach rents collected by the borrower after default pursuant to a collateral assignment of rents gives the lender another incentive to require an absolute assignment of rents.

The absolute assignment of rents is not a recent development. Borrower, lenders, and courts have been struggling 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 over 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 treatise on mortgage law that "rents may be mortgaged."<sup>82</sup> The earliest corporate deed of trust found, 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

<sup>79</sup>See *Park at Dash Point*, 121 B.R. at 855. 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. 850, 855 (Bankr. W.D. Wash. 1990), *aff'd sub nom.* *Steinberg v. Crossland Mortgage Corp. (In re Park at Dash Point L.P.)*, 985 F.2d 1008 (9th Cir. 1993); *In re Prichard Plaza Assocs. Ltd. Partnership*, 84 B.R. 289, 297 (Bankr. D. Mass. 1988); *Martinez v. Continental Enterprises*, 730 P.2d 308, 316 (Colo. 1986); *Taylor v. Brennan*, 621 S.W.2d 592 (Tex. 1981). *But cf.* *Fed. Land Bank v. Lower*, 421 N.W.2d 126 (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).

<sup>80</sup>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 (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.").

<sup>81</sup>See *FDIC v. Int'l Property Management, Inc.*, 929 F.2d at 1034; *In re O'Neill Enterprises, Inc.*, 506 F.2d at 1244; *In re Ventura-Louise Properties*, 490 F.2d at 1145.

<sup>82</sup>JOHN J. POWELL, A TREATISE ON THE LAW OF MORTGAGES 25 (1<sup>st</sup> Am. ed. 1807). The first American edition was adapted from the fourth English edition.

collect rents and profits therefrom.<sup>83</sup> The problem for early attorneys, as for attorneys today, was in drafting the 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.<sup>84</sup> 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 agreement of the parties was 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.<sup>85</sup> In these cases, courts properly held that the mortgagor was entitled to the rents until the lender took possession or obtained 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.<sup>86</sup>

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.<sup>87</sup> Typical of these cases is *Harris v. Taylor*<sup>88</sup> decided in 1889 in which a first mortgage lender was assigned “the sum of \$200 of the rents collected for each month.”<sup>89</sup> A second lienholder had brought suit for foreclosure and appointment of a receiver, and the first lienholder was seeking to have rents paid over to him by the receiver. In 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.”<sup>90</sup> 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 that the lender 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*<sup>91</sup> the United States Supreme Court stated:

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<sup>83</sup>See *Israels & Kramer, supra* note 4, 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).

<sup>84</sup>See *Freedman’s Savings & Trust Co. v. Shepherd*, 127 U.S. 494, 502 (1888); *In re. Banner*, 149 F. 936, 937 (S.D.N.Y. 1907); *Sullivan v. Rosson*, 19 N.E. 405, 408 (N.Y. 1918).

<sup>85</sup>See, e.g., *Myers v. Brown*, 112 A. 844 (N.J. Ch. 1921).

<sup>86</sup>See *infra* notes 114-122 and accompanying text.

<sup>87</sup>See *Cargill v. Thompson*, 59 N.W. 638 (Minn. 1894); *Harris v. Taylor*, 54 N.Y.S. 864 (N.Y. App. Div. 1898). See also *Kelly v. Bowerman*, 71 N.W. 836 (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 (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).

<sup>88</sup>54 N.Y.S. 864 (N.Y. App. Div. 1898).

<sup>89</sup>*Id.* at 866.

<sup>90</sup>*Id.*

<sup>91</sup>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. (16 Pet.) 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.

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.<sup>92</sup>

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 to or quoted in over one hundred subsequent cases,<sup>93</sup> so the case clearly influenced 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.<sup>94</sup> For example, in *Thomson v. Erskine*, 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.<sup>95</sup> The assignment of rents “by its terms was to become operative upon default.”<sup>96</sup> 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 mortgaged property in the event of his default.”<sup>97</sup> In

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*Id.* 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. 41 U.S. at 18. 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 93.

<sup>92</sup>*Id.* at 502.

<sup>93</sup>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.

<sup>94</sup>See *State Bank v. Cohen*, 123 N.Y.S. 747 (N.Y. Sup. Ct. 1910); *Thomson v. Erskine*, 73 N.Y.S. 166, 166 (N.Y. App. Term 1901); *Grannis-Blair Audit Co. v. Maddux*, 69 S.W.2d 238 (Tenn. 1934); *Franzen v. G.R. Kinney Co.*, 259 N.W. 850 (Wis. 1935). See also *Cullen v. Foote*, 61 N.W. 818 (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 Fidelity-Philadelphia Trust Co. v. West*, 226 N.W. 406 (Minn. 1929).

<sup>95</sup>73 N.Y.S. at 166.

<sup>96</sup>*Id.*

<sup>97</sup>*Id.* at 167.

Several courts followed the decision in *Thomson*, including *State Bank v. Cohen*, 123 N.Y.S. 747 (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 (N.Y. 1918), and *In re Jarmulowsky*, 224 F. 141 (S.D.N.Y. 1915) (following *Sullivan v. Rosson*, prior to its reversal, in an opinion written by then District Judge Learned Hand). *Sullivan v. Rosson*, however, was reversed on appeal. 119 N.E. at 408. See *infra* notes 114-117 and accompanying text.

In a subsequent New York case, an assignment of rents upon default was again enforced

Grannis-Blair Audit Co. v. Maddux,<sup>98</sup> 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.<sup>99</sup>

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*,<sup>100</sup> 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.<sup>101</sup> The court found that the clause required the lender to take possession in order to collect rents.<sup>102</sup> In *Simpson v. Ferguson*,<sup>103</sup> the court quoted Jones on Mortgages, stating, “*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.*”<sup>104</sup> 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.<sup>105</sup>

The pledge was one of several common law security devices that were for the most part superceded by Article 9 of the UCC.<sup>106</sup> The requirements of a

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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 made demand on the borrower for possession. 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.*

<sup>98</sup>69 S.W.2d 238 (Tenn. 1934).

<sup>99</sup>*Id.* at 238-39. The California Supreme Court in *Kinnison v. Guaranty Liquidating Corp.*, discussed *infra* at notes 131-132, cited *Grannis-Blair* as being an “absolute assignment of rents” case. See *Kinnison*, 115 P.2d 450, 453 (Cal. 1941).

<sup>100</sup>210 N.Y.S. 400 (N.Y. App. Term. 1925).

<sup>101</sup>*Id.* at 401.

<sup>102</sup>*Id.* at 405.

<sup>103</sup>44 P. 484 (Cal. 1896).

<sup>104</sup>*Id.* at 484 (quoting LEONARD A. JONES, A TREATISE ON THE LAW OF MORTGAGES OF REAL PROPERTY § 670 (5th ed. 1894))(emphasis added by court).

<sup>105</sup>See *In re. Banner*, 149 F. 936, 937 (S.D.N.Y. 1907); *Sullivan v. Rosson*, 19 N.E. 405, 408 (N.Y. 1918).

<sup>106</sup>See *WHITE & SUMMERS*, *supra* note 34, §§ 30-1(a), 30-2. 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

common law pledge are a debt, an offer of property as security for the debt, and delivery of possession of the property from the pledgor to the pledgee.<sup>107</sup> The possession element is essential in order to make the pledge effective,<sup>108</sup> and possession must continue in order for the pledge to remain in effect.<sup>109</sup> Possession can be actual or constructive, such as the delivery of a key to a warehouse holding the pledged property.<sup>110</sup> 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 action, and thus explain the roots of the perfection problem.

In order to avoid the possession requirement of a “pledge” of rents, lenders attempted the “absolute assignment” argument very early. In *Armour Packing Company v. Wolff & Company*,<sup>111</sup> 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.”<sup>112</sup> 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. 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.”<sup>113</sup> In *Sullivan v. Rosson*,<sup>114</sup> rents were “assigned to the holder of this mortgage as further security for the payment of said indebtedness.”<sup>115</sup> The lender claimed that this language made him the “unqualified owner of the rents . . . to an amount sufficient to pay said mortgage.”<sup>116</sup> The court held that the assignment of rents was not an absolute transfer, but a pledge of the rents as security for the debt.<sup>117</sup> *In re Banner*<sup>118</sup> 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.”<sup>119</sup> The lender argued that assignment clause gave the lender title to the rents upon the occurrence of a default.<sup>120</sup> The court found that the language created a pledge, distinguishing the earlier *Harris* case<sup>121</sup> on the basis that the assignment of rents in that case was in a separate document.<sup>122</sup>

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were not covered by earlier versions of Article 9. See UCC § 9-104 (l) (1972), (1978). Article 9 no longer excludes deposit accounts from its scope. See UCC § 9-109 cmt. 16 (2001).

<sup>107</sup>*Mechanic’s & Traders Ins. Co. v. Kiger*, 103 U.S. 352, 356 (1880); *Alabama Land & Mineral Corp. v. Toffel*, 292 F.3d 1319, 1325 (11th Cir. 2002).

<sup>108</sup>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).

<sup>109</sup>See *Casey*, 96 U.S. at 477; *Thurber*, 26 F. At 227.

<sup>110</sup>See *Casey*, 96 U.S. at 477.

<sup>111</sup>59 Mo. App. 665 (1894).

<sup>112</sup>*Id.* at 665 (emphasis added by court).

<sup>113</sup>*Id.*

<sup>114</sup>119 N.E. 405 (N.Y. 1918)

<sup>115</sup>*Id.* at 406.

<sup>116</sup>*Id.* at 407.

<sup>117</sup>*Id.* at 408.

<sup>118</sup>149 F. 936, 937 (S.D.N.Y. 1907).

<sup>119</sup>*Id.* at 937.

<sup>120</sup>*Id.* at 938.

<sup>121</sup>See *supra* notes 88-90 and accompanying text.

<sup>122</sup>149 F. at 938-39.

Lenders were eventually successful in making the “absolute assignment” argument.<sup>123</sup> In *Paramount Building & Loan Association v. Sacks*,<sup>124</sup> three mortgagees claimed rents collected by a receiver after default and before foreclosure by the first lienholder. 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.<sup>125</sup> 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. In so holding, the court, citing *Freedman’s Saving & Trust Company v. Shepard*, distinguished between a pledge of the rents that would require possession and an assignment of the rents.<sup>126</sup> In *Stanton v. Metropolitan Lumber Co.*,<sup>127</sup> decided at 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. 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.”<sup>128</sup>

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, Justice Augustus Hand in *Prudential Insurance Co. v. Liberdar Holding Corp.*<sup>129</sup> distinguished between an assignment for security and “a transfer of outright ownership.”<sup>130</sup> The California Supreme Court in the frequently cited case of *Kinnison v. Guaranty Liquidating Corp.*<sup>131</sup> stated, “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.”<sup>132</sup> This distinction is probably a result of the language of Justice Harlan’s opinion in *Freedman’s*

<sup>123</sup>See *Paramount Building & Loan Association v. Sacks*, 152 A. 457 (N.J. Ch. 1930); *Stanton v. Metropolitan Lumber Co.*, 152 A. 653 (N.J. Eq. 1930); *Kinnison v. Guaranty Liquidating Corp.*, 115 P.2d 450, 453 (Cal. 1941). Some early cases did not necessarily use the “absolute” assignment terminology, but distinguished between a pledge and an assignment.

<sup>124</sup>152 A. 457, 457 (N.J. Ch. 1930).

<sup>125</sup>*Id.*

<sup>126</sup>*Id.* at 458 (citing *Freedman’s*, 127 U.S. 494 (1888)).

<sup>127</sup>152 A. 653 (N.J. Eq. 1930).

<sup>128</sup>*Id.* at 654-55.

<sup>129</sup>74 F.2d 50 (2d Cir. 1934)

<sup>130</sup>*Id.* at 51. Justice 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 probably intention should premetn 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 to their own business.

*Id.* at 51.

<sup>131</sup>115 P.2d 450, 453 (Cal. 1941).

<sup>132</sup>*Id.* at 453. *Kinnison* involved an assignment of rents that was executed by the borrower after the borrower’s default. The agreement required that the borrower collect rents for the account of the lender. *Id.* at 451-52.

*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 that agreement from a “pledge” of the rents.<sup>133</sup> Regardless of the reasons for its development, the movement towards the concept of the absolute assignment of rents was unfortunate.

#### 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.<sup>134</sup> 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 criticized by commentators writing on the subject.<sup>135</sup>

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 the rents.<sup>136</sup> 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.”<sup>137</sup> 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 . . . .”<sup>138</sup>

<sup>133</sup>See *Freedman’s Savings & Trust Co. v. Shepherd*, 127 U.S. 494, 502 (1888), quoted, *supra*, in text accompanying note 92.

<sup>134</sup>See, e.g., *Great West Life Assurance Co. v. Rothman (In re Ventura Louise Properties)*, 490 F.2d 1141, 1144 (9th Cir. 1974) (“by assignment, title is transferred”) (quoting *Paramount Bldg. & Loan Ass’n v. Sacks*, 152 A. 457, 458 (N.J. Super Ct. Ch. Div. 1930)); *In re Salem Plaza Assocs.*, 135 B.R. 753, 756 (Bankr. S.D.N.Y. 1992) (absolute assignment “upon default, divests the [borrower] of every interest in the rents”); *Taylor v. Brennan*, 621 S.W.2d 592, 594 (Tex. 1981) (absolute assignment “passes title to the rents”).

<sup>135</sup>See RESTATEMENT (THIRD) OF PROPERTY–MORTGAGES § 4.2, Reporter’s Note at 214 (1997); *Averch et al. supra* note 4, at 709; *Carlson, supra* note 4, at 1105-07; *Forrester, supra* note 1, at 379-80; *Freyermuth, The New UARA, supra* note 4, at 29-35; *Randolph, supra* note 4, at 290.

<sup>136</sup>See, e.g., *FDIC v. Int’l Property Management, 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. Partnership*, 117 B.R. 202, 206 (Bankr. D. Md. 1990); *Provident Mutual Life Ins. Co. v. Winslow Center Assocs. (In re Winslow Center Assocs.)*, 50 B.R. 679, 681 n.2 (Bankr. E.D. Penn. 1985); *National Operating, L.P. v. Mutual Life Ins. Co.*, 630 N.W.2d 116 (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.

*In re Charles D. Stapp*, 641 F.2d 737, 740 (9th Cir. 1981).

<sup>137</sup>See *FDIC v. Int’l Property Management, Inc.*, 929 F.2d 1033, 1035 (5th Cir. 1991) (citing *Randolph, supra* note 4, at 290).

<sup>138</sup>*Foundry of Barrington Partnership v. Barrett (In re Foundry of Barrington Partnership)*, 129 B.R. 550 (Bankr. N.D. Ill. 1991).

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 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 as and 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.<sup>139</sup>

Other types of receivables are commonly sold. The business of factoring involves the sale of accounts at a discount to a factor who collects the accounts.<sup>140</sup> The modern practice of asset securitization involve 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.<sup>141</sup> The transfer is structured as a "true sale" in order to remove the assets from the originator's bankruptcy estate.<sup>142</sup>

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 incentive to perform the landlord's duties under the lease. If the landlord stops performing, the tenants are likely to stop paying rent. Thus, rents are not a particularly

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<sup>139</sup>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.

<sup>140</sup>See WHITE & SUMMERS, *supra* note 34, § 30-7. Traditionally, the factor purchased the accounts on a non-recourse basis, meaning that the factor took the entire risk of collecting the accounts. *Id.* Article 9 covers sales of accounts. U.C.C. § 9-109(a)(3).

<sup>141</sup>See WHITE & SUMMERS, *supra* note 34, § 30-7, 30-7 n.2.; Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J.L. BUS. & FIN. 133, 135 (1994).

<sup>142</sup>See Schwarcz, *supra* note 141, 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.

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 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 the absolute assignment 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. Courts have been reluctant in most cases to find that a borrower and lender intended an absolute assignment and therefore have required that the intent of the parties to create an absolute assignment be very clearly expressed.<sup>143</sup> 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 that the lender must take some action after default in order to collect rents may be fatal to the finding of an absolute assignment.<sup>144</sup> 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.<sup>145</sup> This elevation 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 over a century and has caused a substantial amount of litigation.

*Armour Packing Co. v. Wolff & Co.*, 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.<sup>146</sup> An assignment of rents executed after the mortgage provided that the mortgagor did “hereby transfer, assign and make over to the said company (the mortgagee) any and all

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<sup>143</sup>See *FDIC v. Int'l Property Management, Inc.*, 929 F.2d 1033, 1036 (5th Cir. 1991); *Prudential Ins. Co. V. Liberdar Holding Corp.*, 74 F.2d 50, 51 (1934); *In re 5877 Poplar, L.P.*, 268 B.R. 140, 146 (Bankr. W.D. Tenn. 2001).

<sup>144</sup>See, e.g., *In re 1301 Connecticut 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).

<sup>145</sup>See, e.g., *In re 5877 Poplar, L.P.*, 268 B.R. 140, 146-47 (Bankr. W.D. Tenn. 2001); *In re 1301 Connecticut Ave. Assocs.*, 117 B.R. 2, 7 (Bankr. D.D.C. 1990), *aff'd* 126 B.R. 1 (D.D.C. 1991); *In re Ass'n Center Ltd. Partnership*, 87 B.R. 142, 145 (Bankr. W.D. Wash. 1988); *Taylor v. Brennan*, 621 S.W.2d 592, 594-95 (Tex. 1981). *But see In re Carretta*, 220 B.R. 203 (D.N.J. 1998) (finding an absolute assignment despite language in assignment of rents that it was given “as further security”); *In re Galvin*, 120 B.R. 767, 771 (Bankr. D. Vt. 1990) (finding an absolute assignment based on intent of the parties despite language in assignment that it was given to secure the debt). In *FDIC v. International Property Management, Inc.*, the Fifth Circuit recognized that all assignments of 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).

<sup>146</sup>59 Mo. App. 665 (1894).

rents . . . as additional security for the payment of said notes.”<sup>147</sup> The mortgagee argued that he was entitled to rents because the assignment was an absolute assignment. The court rejected this argument on the basis of the “security” language in the assignment, 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.”<sup>148</sup>

Through the twentieth century and into the twenty-first, courts have continued to struggle with the same issues.<sup>149</sup> In *Condor One, Inc. v. Turtle Creek, Ltd. (In re Turtle Creek, Ltd.)*, 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.”<sup>150</sup> The lender argued that the assignment of rents was absolute, but the court held that it was only intended as security based on the language in the document.<sup>151</sup> 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 and other income of the premises . . . .”<sup>152</sup> The court concluded based on the “inconsistent and contradictory language contained in the deed of trust” and based on a “presumption that an assignment operates as security for a debt” that the parties intended a pledge rather than an absolute assignment.<sup>153</sup> 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 persisted for over a century.

A 1894 case, *Cargill v. Thompson*, involved an assignment of rents that on its face was an absolute assignment.<sup>154</sup> 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

<sup>147</sup>*Id.* at 665 (emphasis added by the court).

<sup>148</sup>*Id.*

<sup>149</sup>*See, e.g., In re. Banner*, 149 F. 936, 937 (S.D.N.Y. 1907); *Sullivan v. Rosson*, 19 N.E. 405, 408 (N.Y. 1918).

<sup>150</sup>194 B.R. 267, 278 (Bankr. N.D. Ala. 1996).

<sup>151</sup>*Id.*

<sup>152</sup>*In re 5877 Poplar, L.P.*, 268 B.R. 140, 146-47 (Bankr. W.D. Tenn. 2001) (emphasis added by court).

<sup>153</sup>*Id.* at 147-48 (emphasis in original).

<sup>154</sup>59 N.W. 638 (Minn. 1894).

of said property.”<sup>155</sup> 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, interest on the debt, repairs, and principal on the debt with surplus eventually being returned to the borrower.<sup>156</sup> The lessees sued the lender claiming that the transaction was a conditional sale which put the lender in privity with lessees and that the absolute assignment of rents brought the lender into privity with lessees, making the lender liable under the lease covenants.<sup>157</sup> 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.”<sup>158</sup>

In a similar lawsuit in 1990, a tenant sued a lender for breaches under a lease occurring prior to the lender’s foreclosure.<sup>159</sup> The tenant claimed that the lender’s absolute assignment of rents placed the lender in privity of estate with the tenant and therefore made the lender liable for lease covenants. The court did not decide whether the assignment of rents created “only a pledge or an absolute assignment.”<sup>160</sup> Instead, the court looked to a provision in the assignment of rents that the assignee was undertaking no obligation under the lease. Based on that provision, the court held that the lender was not liable.<sup>161</sup> 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.<sup>162</sup> The court looked to the provisions of the assignment of rents giving the borrower the right to collect rents until the lender gave notice of default. Because the lender 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.<sup>163</sup> 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

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<sup>155</sup>*Id.* at 638.

<sup>156</sup>*Id.* at 638-39.

<sup>157</sup>*Id.* at 639-40. 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. The court did not decide the issue of 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.  
*Id.* at 640.

<sup>158</sup>*Id.*

<sup>159</sup>*See Naficy v. Woodmen of the World Life Ins. Soc.*, 1990 WL 122128 (Tex. App.). 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.

<sup>160</sup>*Id.* at \*6-7.

<sup>161</sup>*Id.*

<sup>162</sup>*See Leon’s Fine Foods v. Merit Investment Partners, Ltd.*, 2000 WL 1048491 (Tex. App.).

<sup>163</sup>*Id.* \*2-3.

rents gave the lender an interest in property that made the lender an “owner” under the mechanic’s lien statute.<sup>164</sup> The court held for the lender based on Illinois law that does not recognize an absolute assignment. The court said that an assignment of rents in Illinois grants an equitable lien as security for a mortgage.<sup>165</sup> 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 mechanics’ 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 holding as they did. 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. 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 over whether an absolute assignment of rents is 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 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.<sup>166</sup> 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.<sup>167</sup>

Some federal courts have treated an absolute assignment of rents as giving the lender an absolute ownership interest in rents.<sup>168</sup> These courts have held that

<sup>164</sup>See *Ecker & Co. v. LaSalle Nat’l Bank*, 645 N.E.2d 335, 339 (Ill. App. 1994).

<sup>165</sup>*Id.* at 340.

<sup>166</sup>See, e.g., *In re Cavros*, 262 B.R. 206 (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 (Bankr. D.D.C. 1997); *In re Lyons*, 193 B.R. 637, 644 (Bankr. D. Mass. 1996); *500 Ygnacio Assocs., Ltd. v. Aetna Life Ins. Co. (In re 500 Ygnacio Assocs., Ltd.)*, 141 B.R. 191 (Bankr. N.D. Cal. 1992); *Foundry of Barrington Partnership v. Barrett (In re Foundry of Barrington Partnership)*, 129 B.R. 550 (Bankr. N.D. Ill. 1991); *In re Rollingwood Apartments, Ltd.*, 133 B.R. 906 (Bankr. S.D. Ohio 1991); *In re Bethesda Air Rights Ltd. Partnership*, 117 B.R. 202 (Bankr. D. Md. 1990). See also *FDIC v. Int’l Property Management, 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 Mutual Life Ins. Co. v. Winslow Center Assocs. (In re Winslow Center Assocs.)*, 50 B.R. 679, 681 (Bankr. E.D. Penn. 1985).

<sup>167</sup>See *Rollingwood*, 133 B.R. at 913; *Princeton Overlook*, 143 B.R. at 633; *Bethesda*, 117 B.R. at 211.

<sup>168</sup>See, e.g., *First Fidelity Bank v. Jason Realty, L.P. (In re Jason Realty, L.P.)*, 59 F.3d 423 (3d Cir.1995); *First Fidelity Bank v. Eleven Hundred Metroplex Assocs.*, 190 B.R. 510 (S.D.N.Y. 1995); *MacArthur Executive Assocs. v. State Farm Ins. Co.*, 190 B.R. 189 (D.N.J. 1995); *In re Kingsport Ventures, L.P.*, 251 B.R. 841 (Bankr. E.D. Tenn. 2000); *In re Robin Associates*, 275 B.R. 218 (Bankr. W.D. Pa. 2001); *In re Carretta*, 220 B.R. 203 (D.N.J. 1998); *In re Turtle Creek*, 194 B.R. 267 (Bankr. N.D. Ala. 1996); *In re Carter*, 126 B.R. 811 (Bankr. M.D. Fla. 1991); *In re Galvin*, 120 B.R. 767 (Bankr. D. Vt. 1990); *In re Gould*, 78 B.R. 590 (D. Idaho 1987); *In re Fry Road Assocs.*, 64 B.R. 808 (Bankr. W.D. Tex. 1986); *In re P.M.G. Properties*, 55 B.R. 864 (E.D.

because the lender owns the rents absolutely as a matter of state law, the bankruptcy estate has no interest in the rents.<sup>169</sup> Therefore, the bankruptcy trustee or debtor in possession has not right to use the rents to operate and maintain the property in a reorganization.

Similar to decisions under state law as to the character of an absolute assignment of rents, bankruptcy courts holding that an absolute assignment of rents gives a lender ownership of rents rather than a security interest are simply incorrect. Although the form of the transaction may indicate a transfer of title to rents, the substance 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.<sup>170</sup> They should, however, “look to the substance of state law rights, not merely the label that state law places on them.”<sup>171</sup>

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.<sup>172</sup> If the borrower has any remaining property rights in the rental stream under state law, then bankruptcy law dictates that the rental stream be treated as part of the bankruptcy estate.<sup>173</sup>

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.<sup>174</sup> If rents are unavailable for operation and maintenance of the property, almost no hope of reorganization exists for a borrower in Chapter 11.<sup>175</sup> If the debtor has no equity in the property and there is not “a reasonable possibility of a successful reorganization within a reasonable time,”<sup>176</sup> the lender is entitled to relief from the automatic stay.<sup>177</sup> 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

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Mich. 1985).

<sup>169</sup>See *In re Carter*, 126 B.R. at 813; *In re Galvin*, 120 B.R. at 772; *In re Fry Road Assocs.*, 64 B.R. at 809; *In re P.M.G. Properties*, 55 B.R. at 870.

<sup>170</sup>See *First Fidelity Bank v. Jason Realty, L.P.* (*In re Jason Realty, L.P.*), 59 F.3d 423, 427 (3d Cir.1995) (citing *Butner v. United States*, 440 U.S. 48, 55 (1979)).

<sup>171</sup>See *In re Guardian Realty Group, L.L.C.*, 205 B.R. at 4 (citing *United States v. National Bank of Commerce*, 472 U.S. 713, 727 (1985)).

<sup>172</sup>See *Guardian*, 205 B.R. at 4-5, 500 *Ygnacio Assocs., Ltd. v. Aetna Life Ins. Co.* (*In re 500 Ygnacio Assocs., Ltd.*), 141 B.R. 191, 195 (Bankr. N.D. Cal. 1992); *In re Bethesda Air Rights Ltd. Partnership*, 117 B.R. 202, 206-08 (Bankr. D. Md. 1990); *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).

<sup>173</sup>See 11 U.S.C. § 541 (2004); *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 208-09 (1983).

<sup>174</sup>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. 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 1, at 387-88.

<sup>175</sup>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 COMM. L.J. 516, 519 (1988); *Carlson*, *supra* note 4, at 1109. In a single asset bankruptcy the borrower will have no income available to continue operation and maintenance of the mortgaged property.

<sup>176</sup>*United Sav. Ass'n v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 376 (1988).

<sup>177</sup>11 U.S.C. § 362(d)(2) (2004).

have been successful.<sup>178</sup> This result defeats the policies behind the Bankruptcy Code and Chapter 11 and can only be classified as an injustice.

#### E. ANALOGOUS “ABSOLUTE” TRANSFERS FOR SECURITY

Many types of transactions create in substance a security interest 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. 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.<sup>179</sup> 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,<sup>180</sup> 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.<sup>181</sup> 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.”<sup>182</sup> 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 a mortgage. Under some circumstances, usually involving an unsophisticated borrower in desperate need of credit, the borrower will give a lender an absolute deed to property to secure a loan. The parties have typically agreed that the lender will return the deed unrecorded upon repayment of the debt. In determining the substance of the transaction, courts look at a number of factors including the existence of a debt, whether the grantor retained possession of the property, a disparity between the value of the property and the consideration, and whether there is an agreement for a reconveyance.<sup>183</sup> Courts permit the introduction of parol evidence to prove the true nature of the transaction.<sup>184</sup> 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.

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<sup>178</sup>If 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 Fidelity Bank v. Jason Realty, L.P.* (*In re Jason Realty, L.P.*), 59 F.3d 423, 430 (3d Cir.1995); *In re Fry Road Assocs.*, 66 B.R. 602 (Bankr. W.D. Tex. 1986).

<sup>179</sup>*State v. Stonybrook*, 181 A.2d 601, 604 (Conn. 1962).

<sup>180</sup>*Id.* at 604-05.

<sup>181</sup>*Block Island Land Trust v. Washington Trust Co.*, 713 A.2d 119 (R.I. 1998).

<sup>182</sup>*Id.* at 201.

<sup>183</sup>See *Flack v. McClure*, 565 N.E.2d 131, 136 (Ill. App. 1990); *Johnson v. Cherry*, 726 S.W.2d 4, 7 (Tex. 1987); *Sannerud v. Brantz*, 928 P.2d 477, 481 (Wyo. 1996); RESTATEMENT (THIRD) OF PROPERTY—MORTGAGES § 3.2, 3.3 (1997); NELSON & WHITMAN, *supra* note 18, § 3.8.

<sup>184</sup>See NELSON & WHITMAN, *supra* note 18, § 3.6.

With regard to personal property secured transactions, the scope provision of Article 9 of the UCC provides that it applies to “a transaction, regardless of its form, that creates a security interest in personal property or fixtures by contract.”<sup>185</sup> The purpose of this provision is to look at the substance of a transaction rather than its form.<sup>186</sup> Therefore, courts are often called upon 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.<sup>187</sup>

Courts must also distinguish in some cases between a true sale of personal property and a transfer which creates a security interest. Although Article 9 covers sales of accounts, chattel paper, payment intangibles, and promissory notes,<sup>188</sup> 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,<sup>189</sup> just as with real property recording acts. At the same time, however, the seller “does not retain a legal or equitable interest in the collateral sold.”<sup>190</sup> Sales of these intangibles have raised some of the same issues in bankruptcy that absolute assignments of rents have raised.<sup>191</sup> 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 more successfully navigated these issues, however, 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 in all likelihood raises 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 a workable solution to the problems it solves is put in its place. Therefore, comprehensive change is necessary. This change has occurred gradually in some states through the judicial process, but a faster and more comprehensive solution is legislative.

### A. THE JUDICIAL SOLUTION

The Restatement (Third) of Property–Mortgages provides a workable system for lenders to take a security interest in rents, making the absolute assignment unnecessary.<sup>192</sup> The Restatement takes the position that “[t]he use of ‘absolute

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<sup>185</sup>UCC § 9-109 (a)(1). 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).

<sup>186</sup>*See* WHITE & SUMMERS, *supra* note 34, § 30-2.

<sup>187</sup>*See id.* § 30-3.

<sup>188</sup>UCC § 9-109 (a)(3).

<sup>189</sup>UCC § 9-318(b).

<sup>190</sup>*Id.* § 9-318(a).

<sup>191</sup>*See, e.g.*, Octagon Gas Systems, Inc. v. Rimmer, 995 F.2d 948 (10<sup>th</sup> Cir. 1993), *cert. denied*, 510 U.S. 993 (1993); *In re LTV Steel, Inc.*, 274 B.R. 278 (Bankr. N.D. Ohio 2001).

<sup>192</sup>RESTATEMENT (THIRD) OF PROPERTY–MORTGAGES § 4.2 (1997).

assignment' terminology . . . creates needless confusion and is rejected."<sup>193</sup> In fact, the Restatement uses the terminology that rents are "mortgaged" rather than assigned to avoid the confusion that the absolute assignment doctrine has engendered.<sup>194</sup>

Because the Restatement resolves the problems 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 of the operation of the recording act, as against third parties, upon execution and delivery."<sup>195</sup> Therefore, a recorded mortgage of rents would have priority over a creditor garnishing rents and 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."<sup>196</sup> 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 face with collateral assignments of rents. With a workable scheme for mortgaging rents, the absolute assignment of rents becomes unnecessary.

#### 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.<sup>197</sup> 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.<sup>198</sup> 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 assignment of rents.

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<sup>193</sup>*Id.* § 4.2 reporter's note p. 214.

<sup>194</sup>*Id.* § 4.2 cmt. b.

<sup>195</sup>*Id.* § 4.2 (b).

<sup>196</sup>*Id.* § 4.2 (c)(2). In addition to the demand, the lender must satisfy any additional conditions imposed by the mortgage, *id.* § 4.2(c)(1), and the demand must also be delivered to the owner of the property and other lienholders, *id.* § 4.2(c)(2).

<sup>197</sup>*Id.* § 4(b).

<sup>198</sup>The comments to section 4 provide:

Nothing 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.

The UARA resolves the problems that lenders have encountered with collateral assignments of rents. First, the Act provides that an assignment of rent is fully perfected upon recordation.<sup>199</sup> 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.<sup>200</sup> With state law made clear 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 used the absolute assignment to avoid.

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,<sup>201</sup> by sending notice to the mortgagor,<sup>202</sup> by sending notice to the tenants,<sup>203</sup> or by any other method permitted under the particular state's law.<sup>204</sup> 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.<sup>205</sup>

The Act makes the borrower personally liable for collecting rents that the lender is entitled to collect and provides for attorneys' fees and costs if the borrower fails to turn over collected rents.<sup>206</sup> This provision is particularly important for lender if the borrower does not have personal liability on the debt because the debt is non-recourse or because the mortgaged property has been conveyed to a non-assuming grantee.<sup>207</sup> Although most courts hold that the borrower's misapplication of rents is waste,<sup>208</sup> the Act makes clear the liability of the borrower who wrongfully collects rents.

Third, the UARA addresses the issue of the lender's security interest in proceeds of rents collected by the borrower before or 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 rents and that the security interest in proceeds is perfected if the security interest in rents is perfected.<sup>209</sup> The Act deals with priority issues relating to cash proceeds in the same manner as Article 9 of the UCC. 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

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<sup>199</sup>*Id.* § 5(b).

<sup>200</sup>*Id.* § 5(c).

<sup>201</sup>*Id.* § 7. This provision also lays out the requirements for a lender to obtain the appointment of a receiver. *Id.*

<sup>202</sup>*Id.* § 8. The notice must also be sent to the holders of other recorded assignments of rents. *Id.* § 8(a).

<sup>203</sup>*Id.* § 9.

<sup>204</sup>*Id.* § 6(a).

<sup>205</sup>*Id.* § 6(b).

<sup>206</sup>*Id.* § 14(b), (d).

<sup>207</sup>A grantee of mortgaged property not personally liable on the debt should nevertheless be liable for misapplying rents.

<sup>208</sup>*See* Taylor v. Brennan, 621 S.W.2d 592 (Tex. 1981); Ginsberg v. Lennar Florida Holdings, 645 So.2d 490 (Fla. App. 1994); UARA § 14 cmt. 1; RESTATEMENT (THIRD) OF PROPERTY-MORTGAGES § 4.6 (a)(5) (1997).

<sup>209</sup>UARA §15(b). “[C]ash proceeds are identifiable if the are maintained in a segregated account or . . . to the extent the assignee can identify them by a method of tracing . . .” *Id.* §14(c).

“make the assignee a mortgagee in possession of the real property.”<sup>210</sup> 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.<sup>211</sup> Lenders tend to avoid taking possession of mortgaged property prior to foreclosure to avoid these liabilities, and, therefore, lenders do not want the liability of a mortgagee in possession to arise 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. The Act provides further that the lender is not obligated by virtue of collecting rents to pay “expenses of protecting or maintaining the real property.”<sup>212</sup> 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.<sup>213</sup> 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.<sup>214</sup> Furthermore, tenants may be entitled to the appointment of a receiver to protect and maintain the property.<sup>215</sup> So the concerns of tenants as well as borrowers and lenders are considered in the Act.

The Act 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.<sup>216</sup> 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.<sup>217</sup> 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 sending 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 tenant’s concerns. Overall, the Act provides a clear and comprehensive scheme for the creation of security interests in rents.

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<sup>210</sup>*Id.* § 11 (1).

<sup>211</sup>*See supra* note 74.

<sup>212</sup>UARA § 13(a).

<sup>213</sup>*See* Freyermuth, *The New UARA*, *supra* note 4, at 56.

<sup>214</sup>UARA §13(b).

<sup>215</sup>*Id.* §13(c).

<sup>216</sup>*Id.* § 9(c)-(d).

<sup>217</sup>*Id.* § 9(d), cmt. 5.

## VI. CONCLUSION

The law regarding assignments of rents has been in great disarray for over 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 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 a reasonable security interest under a collateral assignment and lenders' use of absolute assignments to overcome the deficiencies of the collateral assignment 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.