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A UNIFORM AND MORE RATIONAL APPROACH TO RENTS AS SECURITY FOR THE MORTGAGE LOAN

Julia Patterson Forrester

I. INTRODUCTION

For a lender making a loan secured by a mortgage\(^1\) on an office building, shopping center, apartment complex, or other income-producing property,\(^2\) rents are an important aspect of

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\(^1\) The term "mortgage" as used in this Article is intended to encompass mortgages, deeds of trust and other similar instruments used in the various states to create an interest in real estate to secure a loan. The terms "borrower" and "lender" will generally be used rather than the traditional terms "mortgagor" and "mortgagee," and in the bankruptcy context the borrower may be referred to as the "debtor" or "debtor in possession." With regard to pronouns, the lender will be referred to as "it" since most commercial real estate loans are made by institutional lenders, and the borrower will be referred to as "he" although most commercial real estate developers own property and borrow through entities.

\(^2\) Shopping centers, office buildings, and apartment complexes are typical examples of income-producing properties that generate rents because these types of improvements are occupied by tenants who pay rent to the landlord pursuant to a lease. Other types of income-producing real property, including hotels, parking lots, student dormitories, and nursing homes, do not involve a landlord/tenant relationship in its strict sense and raise special issues which are not within the primary scope of this Article. See infra note 271 and accompanying text.
the security for the loan. During the term of a loan secured by an income-producing property, the interests of both borrower and lender are usually best served by the use of rents to pay costs of operation and maintenance of the property and interest on and principal of the loan. In the event of a default, the interests of the borrower and the lender may become antagonistic with regard to the use of rents accruing from the property. The borrower, facing the possibility of losing the property by foreclosure sale, may find it to his advantage to "milk" the property of its rents by applying rents for purposes unrelated to the property or the mortgage loan. The lender's interest, on the other hand, is best served if rents collected during the time period between default and foreclosure continue to be applied to operation, maintenance, and loan payments. Therefore, the lender will typically require the borrower at the time of the closing of the loan to execute an assignment of rents which the lender hopes will give it the ability to control rents from the mortgaged property in the event of a default.

3. The borrower may use the rents to benefit other properties he owns, to build a "war chest" of funds to pay fees involved in a bankruptcy filing or protracted litigation with the lender, or simply to line his pockets.

4. "Assignment of rents" is the most commonly used name for the instrument or mortgage provision by which a lender attempts to take a security interest in rents, and the author will use the term "assignment of rents" in discussing current law. The author will use the term "security interest" in discussing proposed changes in the law because of the widespread understanding of that term as used in the Uniform Commercial Code. Whether a mortgage lender's interest in rents is described as a security interest, a pledge, a mortgage, an assignment, or an absolute assignment, it is in fact an interest granted for the purpose of providing security for the loan. See infra notes 109-13 and accompanying text.

5. Loan documents may also contain restrictions on the ability of the borrower to enter into, modify, or terminate leases or accept prepayments of rent without the consent of the lender. Furthermore, the documents may require that rents collected by the borrower be applied to payment of expenses of operation and maintenance of the property and payment of amounts due the lender. Finally, tenants may be required to acknowledge the assignment of rents and the restrictions on modification or termination of leases or on prepayments of rent. Where a loan is nonrecourse with no personal liability for repayment imposed upon the borrower, the lender is particularly interested in the disposition of rents of the property, and the application of rents for purposes other than operation, main-
While the antagonistic positions of the borrower and lender in the event of default are not surprising, what is noteworthy is the confusion surrounding the law which relates to assignments of rents. In many cases the rules governing assignments of rents are based on ancient real property concepts, and the policies behind the rules bear very little relation to the realities of the modern commercial real estate loan. Furthermore, there is a wide variation in treatment of the assignment of rents among jurisdictions, with some jurisdictions honoring the contractual terms of the agreement between borrower and lender, and other jurisdictions imposing onerous restrictions on the enforcement of the agreement despite its contractual terms. Both the Uniform Land Security Interest Act (ULSIA)
and the new Restatement (Third) of Property-Security (Mortgages) address the issue of rents as security for the mortgage loan, and both would make it easier for a lender to control rents after default. However, reform in this area and movement towards uniformity among the states have been slow to come.

The complexity of the law and lack of uniformity among the states make assignments of rents difficult for practitioners to draft, for borrowers to operate under, for lenders to enforce, and for courts to interpret. Furthermore, this complexity and lack of uniformity impose unnecessary costs on lenders and make it difficult for lenders to make underwriting decisions on commercial real estate loans. If a lender is unable to take control of rents after default and the borrower misapplies rents, the value of the mortgaged property may be impaired by neglect, and the total indebtedness may increase substantially due to unpaid interest accruing on the loan. Both of these factors increase the likelihood of a deficiency upon foreclosure, and if the deficiency is not collected from the borrower,
it will be a loss to the lender. Additionally, tenants of mortgaged property may be affected adversely if rents are diverted by the borrower rather than being used for operation and maintenance of the property.12

The confusion in the law governing assignments of rents affects not only the parties directly involved, but in significant ways has implications for the national economy, citizens in general, and the efficacy of the federal bankruptcy system. Loans secured by commercial real estate make up a substantial percentage of the loan portfolios of our nation's banks, savings and loans, and insurance companies.13 Given the general decrease in real estate values across the country14 and the increase in the number of defaults,15 the treatment of rents in the period between default and foreclosure has become a more significant issue. Of utmost concern is the extent to

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15. See id.
which confusion over the treatment of rents during this period makes lenders more reluctant to loan money.\textsuperscript{16} A negative impact on lenders' willingness to do business has serious economic consequences nationwide. Furthermore, because the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC) now own a significant number of real estate loans,\textsuperscript{17} taxpayers may ultimately absorb the losses of uncollected deficiencies resulting from misapplication of rents by borrowers.

In bankruptcy the problem is compounded. Once a borrower has filed for protection under the Bankruptcy Code, the lender is delayed in the exercise of its remedies,\textsuperscript{18} and if the lender's interest in rents is not protected during the pendency of bankruptcy, the borrower, as debtor in possession, may misapply rents for a longer period.\textsuperscript{19} In addition, inconsistent treatment of assignments of rents by the bankruptcy courts\textsuperscript{20} has resulted in a massive amount of litigation in the bankruptcy arena between borrowers and lenders.\textsuperscript{21} Not only is this litigation an


\textsuperscript{18} See infra notes 127-33 and accompanying text.


\textsuperscript{21} See 1992 House Subcomm. Hearing, supra note 12, at 135 (statement of Lawrence P. King on behalf of the National Bankruptcy Conference) (classifying the treatment of rents in bankruptcy as "a very much litigated problem"). The author found more than 300 bankruptcy
inefficient use of the funds of bankruptcy estates and our nation's lenders, but the additional costs imposed on lenders may reduce the availability of real estate loans.22

Controversy surrounding the treatment of rents as security for the mortgage loan has recently caught the attention of the reporters for the new Restatement23 and the committee


23. The reporters for the Restatement, Grant Nelson and Dale Whit-
charged with recommending revisions to Article 9 of the Uniform Commercial Code (UCC), as well as lawmakers on Capitol Hill. Congress recently came quite close to passing a bankruptcy reform bill that would have addressed the issue of perfection of an assignment of rents in bankruptcy, and a similar bill has now been reintroduced in the Senate. Even if a bankruptcy reform bill does eventually pass, it will not solve the underlying problems with assignments of rents because the issues arising in bankruptcy are not caused by deficiencies in bankruptcy law but by problems at the state law level. Neither a discussion of how rents covered by an assignment of rents should be treated under existing bankruptcy law nor a discussion of how bankruptcy law should be reformed is within the scope of this Article. Rather, the focus of this Article is on changes that should be made in state law to provide a more rational treatment of the assignment of rents both in and outside of bankruptcy.

The author proposes that rents be integrated into Article 9 of the UCC and treated essentially the same as accounts are treated under Article 9.


25. See infra notes 173-74 and accompanying text.


28. Other commentators have recommended that rents be included within the scope of Article 9. See R. Wilson Freyermuth, Of Hotel Reve-
Rents as Security

A security interest in rents to a lender in much the same manner that a borrower may now grant a security interest in accounts. This proposal would provide a workable solution to the problems arising under both state law and bankruptcy law with regard to security interests in rents and would provide for uniformity among the states. Furthermore, the proposal would be easy to implement because of existing statutory and case law relating to security interests in accounts.

In 1990 the Permanent Editorial Board for the UCC established a study committee to recommend revisions to Article 9, and the study committee has recently recommended that a drafting committee be formed to revise Article 9 in accordance with its report. Although the study committee did not recommend that rents be included within the scope of Article 9, it did recommend that the drafting committee "give serious consideration to the reports of the advisory group on real estate-related collateral," and among the reports of the advisory group is a minority position report recommending amendment of Article 9 to encompass rents. The author believes that the drafting committee should give serious consideration to this important issue.

In this Article the author will provide an introduction to the problems associated with assignments of rents by discussing the nature of rents and their treatment in the absence of an assignment. Next, the author will examine in detail the issues arising with regard to assignments of rents under current law both in and outside of the bankruptcy context. Finally, the author will discuss the proposal that rents be integrated into

nues, Rents and Formalism in the Bankruptcy Courts: Implications for Reforming Commercial Real Estate Finance, 40 UCLA L. Rev. 1461, 1536-41 (1993); Alexander Rostocki, Jr., Perfecting Security Interests in Rents: Article 9 Must be Amended, 24 UCC L.J. 151 (1991); Note, An Article Nine Scope Problem—Mortgages, Leases, and Rents as Collateral, 47 U. COLO. L. Rev. 449, 459-60 (1976). In addition, a minority of the members of the PEB Study Group's Advisory Group on Real Estate-Related Collateral recommended that rents be incorporated into Article 9. See PEB STUDY GROUP REPORT, supra note 24, app. at 196.
29. PEB STUDY GROUP REPORT, supra note 24, at 1.
30. Id. at 6.
31. Id. at 66.
32. Id. app. at 196.
Article 9 of the UCC.

II. THE NATURE OF RENTS AND THEIR TREATMENT IN THE ABSENCE OF AN ASSIGNMENT OF RENTS

Before beginning a detailed discussion of the treatment of assignments of rents, it is instructive to examine the character of rents and the treatment of rents in a mortgage loan transaction in the absence of an assignment of rents. The right to unaccrued rents from real property is an interest in land which is incident to the landlord's reversion, but rents may be severed from real property. Severance occurs when rents accrue or are collected, or when the right to unaccrued rents is assigned to a third party, reserved in a transfer of the reversion, or pledged. Because unsevered rents are a part


34. See Brack v. Coburn, 196 S.W.2d 230, 234 (Ark. 1946); Valley Nat'l Bank, 480 P.2d at 674; Marine Nat'l Bank, 454 A.2d at 70; Schmid, 37 S.W.2d at 108; Treetop Apartments Gen. Partnership v. Oyster, 800 S.W.2d 628, 629 (Tex. Ct. App. 1990).

35. See White v. Irvine Kentucky State Medical Ass'n, 22 S.W.2d 778, 778 (Mo. 1929); Marine Nat'l Bank, 454 A.2d at 70; 2 CASNER, supra note 33, § 9.41.

36. See In re Park at Dash Point L.P., 121 B.R. 850, 855 (Bankr. W.D. Wash. 1990), aff'd sub nom. Steinberg v. CrossLand Mortgage Corp. (In re Park at Dash Point L.P.), 152 B.R. 300 (W.D. Wash. 1991), aff'd, 985 F.2d 1008 (9th Cir. 1993); Treetop, 800 S.W.2d at 629. There appears to be a split in authority as to whether severance of rents occurs upon accrual or collection. See infra note 57 for a discussion of a related split in authority.

37. See Brack, 196 S.W.2d at 234; Valley Nat'l Bank, 480 P.2d at 674; Winnisimmet, 122 N.E. at 576; Schmid, 37 S.W.2d at 108.

of the real property to which they relate, they are covered by a mortgage of that real property, and a foreclosure sale purchaser is entitled to rents accruing after the date of foreclosure. However, because the right to unaccrued rents is incident to the possession of the property, the borrower has the right to rents collected from the property until the lender takes possession of the property either as a mortgagee in possession or as a foreclosure sale purchaser, or until a receiver takes possession of the property.

A mortgage lender's ultimate remedy is foreclosure of the mortgaged property, but the time period required for the completion of a foreclosure varies significantly from state to state. During the interim period between a borrower's de-

property will convey the right to unaccrued rents unless the right to unaccrued rents is expressly reserved. Jim Davis & Co., 536 So. 2d at 58 (quoting Walsh, 132 So. at 53); Winnisimmet, 122 N.E. at 576; Tinnon, 408 S.W.2d at 105; CASNER, supra note 33, § 9.45.

39. See Treetop, 800 S.W.2d at 629 (citing Standridge v. Vines, 81 S.W.2d 289, 290 (Tex. Civ. App. 1935)).

40. See Jim Davis & Co., 536 So. 2d at 58 (quoting Walsh, 132 So. at 53); Security Sav. & Loan Soc. v. Dudley, 26 P.2d 384, 385 (Wash. 1933). Because the foreclosure will cut off leases that are junior to the mortgage, the foreclosure sale purchaser will not be able to require junior tenants to stay in possession and pay rent in the absence of an agreement to that effect. See Grant S. Nelson & Dale A. Whitman, Real Estate Finance Law § 4.22-23 (2d ed. 1985).


42. See Teal v. Walker, 111 U.S. 242, 248 (1884); Simpson v. Ferguson, 44 P. 484, 485 (Cal. 1896) (en banc); Mid-Continent Supply Co. v. Hauser, 269 P.2d 453, 458 (Kan. 1954); Grafeman Dairy, 241 S.W. at 927 (Mo. 1922); Wyckoff v. Scofield, 98 N.Y. 475, 477 (1885); Metropolitan Life, 16 N.E.2d at 1016; Treetop, 800 S.W.2d at 629.

43. Prior to the consummation of a foreclosure, the borrower has the equity of redemption which gives him the right after default to pay the debt with interest and thereby to redeem the property from the encumbrance of the mortgage. See Nelson & Whitman, supra note 40, § 7.1.

44. See 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). 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
fault and the completion of a foreclosure, a lender may have available certain provisional remedies such as securing the appointment of a receiver for the property, taking possession of the property and collecting rents, or collecting rents without taking possession of the property. Whether these provisional remedies are available and whether they require special mortgage provisions in order to be available, depend upon the law of the state where the mortgaged property is located and the effect given in that state to the mortgage instrument itself.45

& WHITMAN, supra note 40, § 8.4.

45. In some states, called “title theory” states, a mortgage lender is treated as having legal title, in a sense, to the mortgaged property. Robert Kratovil, Mortgages—Problems in Possession, Rents, and Mortgagee Liability, 11 DEPAUL L. REV. 1, 4 (1961). 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 to collect the rents therefrom. Id. at 5. In other states, called “lien theory” states, a mortgage lender is treated as having only a lien on the mortgaged property, id. at 4, and the borrower retains the right to possession of the property and rents until the lien has been foreclosed by the lender or until the statutory redemption period has expired, id. at 5-6. Finally, in a few states, called “intermediate” or “intermediate theory” states, a mortgage lender has a hybrid interest which gives the lender the right to take possession of the property and collect rents after a default under the mortgage. Id. at 4-5. See generally NELSON & WHITMAN, supra note 40, § 4.1-4.3. The majority of the states are lien theory states. RESTATEMENT (THIRD) OF PROPERTY-SECURITY (MORTGAGES) § 4.1 cmt. a (Tentative Draft No. 2, 1992).

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 where there is a mortgage provision to that effect. 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). In a title theory state a borrower and lender will generally agree to permit the borrower to remain in possession of the property at least until default, see ME. REV. STAT. ANN. tit. 33, § 502 (West 1988) (giving a mortgage lender the right to take possession before or after breach which implies the borrower generally has possession at the outset), and at least one so-called “title theory” state gives the borrower a statutory right to remain in possession until default in the absence of an agreement to the contrary, see MASS. ANN. LAWS ch. 183, § 26 (Law. Co-op. 1987). In fact,
In many jurisdictions a lender has the right to take possession of the mortgaged property upon default of the borrower and collect rents from the property. Rents collected by a lender in possession of mortgaged property must be applied to the operation and maintenance of the property and to the payment of the indebtedness secured by the mortgage. Even in those jurisdictions that do not permit a lender to take possession of mortgaged property, a 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. The remedies of possession by a lender or receivership are appropriate where the borrower is wasting or mismanaging the mortgaged property. However, a lender may want the ability upon a default to control rents without taking possession of the property or obtaining the appointment of a receiver and may therefore require the execution by the borrower of an assignment of rents in an attempt to make this remedy available.

III. STATE LAW TREATMENT OF THE ASSIGNMENT OF RENTS

Although the purpose of an assignment of rents executed by a borrower to a mortgage lender is to permit the lender to control rents from the mortgaged property in the event of a default, different jurisdictions give varying degrees of effect to the intent of the borrower and lender to accomplish this pur-
Some jurisdictions recognize the "absolute" assignment of rents whereby the borrower and lender agree that the lender will be entitled to rents immediately upon default by the borrower without any action necessary on the part of the lender, but other jurisdictions do not. Some jurisdictions that purport to recognize the absolute assignment have a strong policy against finding that a borrower and lender intended an absolute assignment and make it virtually impossible to implement the absolute assignment. In those jurisdictions which do not recognize the absolute assignment or where a borrower and lender have not successfully implemented one, a lender must take some type of affirmative action in order to render an assignment of rents operative or "activated" after a default by the borrower. Some states require that a lender take possession of the property, obtain the appointment of a receiver, or take some other onerous action in order to activate an assignment of rents. Other states permit a lender to activate an assignment of rents by taking some nominal action such as notifying tenants that subsequent rent payments should be made directly to the lender.

Regardless of whether the action required for activation of an assignment of rents is nominal or onerous, a borrower has the right to collect rents after default until the lender activates its assignment of rents, and the lender has no rights whatsoever.

50. See infra notes 51-60 and accompanying text.
51. See infra notes 100-03 and accompanying text.
52. See infra note 101.
53. See infra notes 114-16 and accompanying text.
55. See, e.g., In re Park at Dash Point L.P., 121 B.R. 850, 855 (Bankr. W.D. Wash. 1990) (discussing Washington statute which requires that the lender take possession of the property or obtain the appointment of a receiver), aff'd sub nom. Steinberg v. CrossLand Mortgage Corp. (In re Park at Dash Point L.P.), 152 B.R. 300 (W.D. Wash. 1991), aff'd, 985 F.2d 1008 (9th Cir. 1993); Martinez, 730 P.2d at 316 (requiring the lender to gain actual possession or file a foreclosure action); Taylor, 621 S.W.2d at 594 (requiring the lender to obtain possession, impound the rents, secure appointment of a receiver, or take some similar action).
56. See infra notes 87-90 and accompanying text.
er to those rents collected by the borrower prior to activation. The terminology often used to describe this concept is that the security interest created by an assignment of rents is "inchoate" until the lender has activated the assignment of rents making the security interest "choate." Some courts equate activation, which makes an assignment of rents choate, with perfection, while other courts equate activation with

57. See Prudential Ins. Co. v. Liberdar Holding Corp., 74 F.2d 50, 51 (2d Cir. 1934); Dash Point, 121 B.R. at 855; In re Prichard Plaza Assocs. Ltd. Partnership, 84 B.R. 289, 297 (Bankr. D. Mass. 1988); Martinez, 730 P.2d at 316; Taylor, 621 S.W.2d at 595. But see In re Polo Club Apartments Assocs. Ltd. Partnership, 150 B.R. 840, 854 (Bankr. N.D. Ga. 1993) (interpreting Georgia law to give a lender with an activated assignment of rents the right to rents collected by the borrower but not spent at the time of activation as well as future rents).

There is a split in authority over whether a lender is entitled to rents that are accrued but uncollected at the time of activation. Childs Real Estate Co. v. Shelburne Realty Co., 143 P.2d 697, 700 (Cal. 1943). Some courts hold that the lender is entitled to accrued but uncollected rents, see Stowers v. Wheat, 78 F.2d 25, 32 (5th Cir. 1935); New York Life Ins. Co. v. Fulton Dev. Corp., 193 N.E. 169, 171 (N.Y. 1934), while other courts hold that the lender is not entitled to the rents, see Hartford Realization Co. v. Travelers' Ins. Co., 167 A. 728, 732 (Conn. 1933); Paramount Bldg. & Loan Ass'n v. Sacks, 152 A. 457, 458 (N.J. Ch. Ct. 1930).


Although the terms "choate" and "perfected" have essentially the same meaning, see BLACK'S LAW DICTIONARY 241, 1137 (6th ed. 1990) (defining "choate" as "[t]hat which has become perfected"), the term "perfected" has become a term of art under Article 9 of the UCC. See infra
enforcement. This distinction, which becomes important if there is a priority contest between creditors of the borrower or if the borrower is in bankruptcy, will be discussed in part IV of this Article. Regardless of whether activation is likened to perfection or enforcement, the borrower has the right to accruing rents until the security interest in the rents is activated. Rents collected by the borrower are severed from the realty, and the lender’s interest under an assignment of rents does not extend to these personal property “proceeds” of rents. This is the case in some jurisdictions despite an agreement of the parties to the contrary.

A. The Possession Requirement

For a lender to activate an assignment of rents in many states, the lender must take possession of the mortgaged property or take some other action, such as obtaining the appointment of a receiver, that is considered the equivalent of taking possession of the property. Several arguments have been

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61. See Dash Point, 121 B.R. at 855.

62. See, e.g., 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.”); Hall v. Goldsworthy, 14 P.2d 659, 661 (Kan. 1932) (“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.”).

63. Butner v. United States, 440 U.S. 48, 52-53 (1979). See also Freedman’s Sav. & Trust Co. v. Shepard, 127 U.S. 494, 502-03 (1888) (requiring that the lender take actual possession, that a receiver take possession, or that the lender’s demand for possession be refused); Dash Point, 121 B.R. at 856; Bevins v. Peoples Bank & Trust Co., 671 P.2d 875, 879 (Alaska 1983) (requiring the lender to take possession of the property or the rents); Martinez v. Continental Enters., 730 P.2d 308, 316 (Colo. 1986) (requiring the lender to gain actual possession or file a
made in support of the requirement that a lender take possession of the property or some equivalent action in order to collect rents. Some courts have used the rationale that, because an assignment of rents clause imposes no duty on the lender to collect rents, to give the clause effect without requiring a lender to take possession would deprive the borrower of the rents while giving no assurance that the lender would actually collect the rents and apply them to the debt. A second argument in support of the requirement that a lender take possession of the mortgaged property is that without such a requirement it would be necessary to impose a constructive trust on any rents collected by the borrower after default. Another reason for the requirement of possession by a lender in order to collect rents may lie in the treatment of the assignment of rents in some jurisdictions as a "pledge" of the rents. The pledge was a common law means of creating a security interest in personal property and required delivery of actual or constructive possession to be effective. Where a lender's interest

foreclosure action); 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).

64. See Taylor, 621 S.W.2d at 594; In re Kidd's Estate, 292 N.Y.S. 888, 893 (Sur. Ct. 1936); Comment, The Mortgagee's Right to Rents After Default, 50 YALE L.J. 1424, 1427 (1941); NELSON & WHITMAN, supra note 40, § 4.35. A lender in possession has a duty to manage the property in a reasonably prudent manner and therefore must make reasonable efforts to collect the rents. See infra note 78 and accompanying text.

65. See Prudential Ins. Co. v. Liberdar Holding Corp., 74 F.2d 50, 51 (2d Cir. 1934); Taylor, 621 S.W.2d at 594; Kidd's Estate, 292 N.Y.S. at 893; Comment, supra note 64, at 1427; NELSON & WHITMAN, supra note 40, § 4.35. The court in Prudential said that to hold that "mere words of assignment can entitle a mortgagee to claim rentals which have been collected by a mortgagor and mingled with its other property... would... impose unworkable restrictions upon the industry in cases where mortgagors have been led to suppose that they might rightfully apply the rentals to their own business." 74 F.2d at 51.


67. See Colonial Trust Co. v. Stone Harbor Elec. Light & Power Co., 280 F. 245 (D.N.J. 1922); Myers v. Brown, 112 A. 844 (N.J. Ch.), aff'd, 115 A. 926 (N.J. 1921). In fact, the common law pledge required that the lender have the right to take possession of the pledged property before
in rents is treated as a pledge, the lender must take possession of the rents by taking possession of the property to make the pledge effective.

All of these arguments are easily refuted. First, it is unlikely that a lender entitled to collect rents for application to the mortgage debt would fail to do so, and if the lender did fail to collect rents, the borrower could continue to collect them. Where rents are collected by a borrower after default, the imposition of a constructive trust is unnecessary since there are other means of dealing with the problem of rents collected and spent by a borrower. For example, a lender might be permitted to reach only those proceeds of rents that it could trace and identify. Finally, where a borrower and lender do not intend to create a common law pledge of rents or to require that the lender take possession of the real property in order to collect rents, it does not make sense to treat an assignment of rents as a pledge of the rents.

A more legitimate reason for the requirement of activation of an assignment of rents by possession or some equivalent action may be based on the concern that the mortgaged property will not be properly maintained if the lender takes the income of the property but has no obligation to operate and maintain it. A lender in possession of property has an obligation to main-

default, and "any arrangement under which the debtor had the right to retain the collateral until default could not be a pledge." 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 1.1 (1965). Therefore, a "pledge" of rents giving a lender the right to take possession of the mortgaged property and to collect rents after the occurrence of a default would not be a common law pledge of the rents.

68. See Comment, supra note 64, at 1426-27.
69. Where a lender has a perfected security interest in accounts, the same issue can arise. Article 9 of the UCC deals with this problem by providing that the security interest continues in proceeds of the accounts and is perfected as to identifiable cash proceeds. U.C.C. § 9-306(3)(b) (1990). A secured creditor's right to cash proceeds under Article 9 therefore depends upon its ability to trace and identify the funds. See JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 23-7 (3d ed. 1988). At least one court has analogized the tracing problem that can arise when a borrower spends rents collected after default to the tracing of proceeds of personal property security under Article 9. See In re GOCO Realty Fund I, 151 B.R. 241, 250 n.8 (Bankr. N.D. Cal. 1993).
tain the property, but a lender collecting rents without taking possession of the property may apply all of the rents to pay the debt secured by the property. Because the borrower still in possession of his property is unlikely to have funds available for continued operation and maintenance, it is possible that giving the lender control of rents without requiring the lender to take possession or some equivalent action could lead to the waste of the mortgaged property. It is doubtful, however, that such a scenario would occur with sufficient frequency to justify the current state of the law. In fact, where a borrower is able to retain control of rents after default because of the lender's unwillingness to take onerous actions required for the lender to gain control of rents, waste of the property is more likely to occur. Since the lender in most cases is relying on the mortgaged property as the primary source of security for the loan, the lender has incentive to ensure that the property continues to be well operated and maintained. To this end, the lender is likely to release some portion of the rents to the borrower for operation and maintenance of the property, and if the borrower refuses to maintain the property, the lender will take possession or seek the appointment of a receiver as a means of preventing the waste of the property.

From a lender's viewpoint, the requirement that the lender take possession of the property or obtain the appointment of a receiver in order to have access to rents after default is undesirable. If the possession requirement is intended to protect the lender against the problem of the borrower's misapplication of rents, it fails to do so. Unless the borrower is willing to relin-

70. See infra note 78 and accompanying text.
71. The lender must account to the borrower for rents and apply net rentals against the indebtedness. Teachers Ins. & Annuity Ass'n v. Oklahoma Tower Assocs. Ltd. Partnership, 798 P.2d 618, 622 (Okla. 1990); Randal v. Jersey Mortgage Inv. Co., 158 A. 865, 866 (Pa. 1932). There is always some risk that a lender could misapply rents, but this risk exists whether or not the lender is in possession of the property. In addition, a lender is more likely to have assets available to satisfy a judgment for misapplied rents than is a borrower in default.
quish possession of the property voluntarily, both taking possession of property and securing the appointment of a receiver require judicial intervention which can cause a substantial delay and provide time for the borrower to collect and misapply additional rents.\textsuperscript{73} Judicial action should not be necessary for activation of an assignment of rents since a breach of the peace is unlikely.\textsuperscript{74} If the lender is attempting to enforce its security interest in rents wrongfully, then the borrower would have recourse to the courts just as with the wrongful enforcement of any other non-judicial remedy.\textsuperscript{75} Because the ultimate remedy of foreclosure is permitted without court action in many states,\textsuperscript{76} it is difficult to justify a requirement of judicial action for collection of rents.

When a lender becomes a mortgagee in possession, the lender faces potential liability that can exceed even the amount of the mortgage debt. First, and most significantly, the lender in possession can have liability for environmental problems on the property.\textsuperscript{77} Second, the lender can be held liable to the

\begin{footnotesize}
\textsuperscript{73} Obtaining the appointment of a receiver requires a court order. The mortgagee in possession remedy is designed to take effect without judicial intervention, but if a borrower refuses to give up possession of the mortgaged property, the lender may not resort to the use of force. At best the lender might be able to use a summary eviction proceeding to dispossess the borrower.

\textsuperscript{74} Because the lender need only notify tenants by mail that rents should be paid to the lender, a breach of the peace would be less likely in connection with the collection of rents by a lender than in connection with a secured party’s attempts to gain possession of tangible collateral as is permitted under Article 9. U.C.C. § 9-503 (1990).

\textsuperscript{75} This shift of the burden to sue cannot be taken lightly. If a lender can take rents without judicial interference, then some lenders will take control of rents wrongfully. However, it is doubtful that this scenario would occur with sufficient frequency to justify the current state of the law.


\textsuperscript{77} The Comprehensive Environmental Response, Compensation, and Liability Act, 42 U.S.C. §§ 9601-9657 (1988) [hereinafter CERCLA], imposes liability upon owners and operators of hazardous waste sites. \textit{Id.} § 9607(a). “Owner or operator” does not include “a person who without participating in the management of a . . . facility, holds indicia of ownership primarily to protect his security interest in the . . . facility.” \textit{Id.} §
\end{footnotesize}
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," and third, the lender may have liability to third parties for injuries caused by dangerous conditions on the property. For these reasons lenders are generally hesitant to become mortgagees in possession.

There are also disadvantages to the lender of the receivership remedy. First, a lender may find it difficult to make the necessary showing to a court that a receiver should be appointed. Generally, insolvency of the borrower and inadequacy of the security are not by themselves sufficient to cause a court to appoint a receiver; there must be some additional equitable

9601(20)(A). However, a mortgagee in possession may be participating in the management of a facility and therefore may not fit within this exemption from liability.

A new Environmental Protection Agency (EPA) rule defines the scope of the concept of "participation in management." 40 C.F.R. § 300.1100 (1992). The rule provides that participation in management means "actual participation in the management or operational affairs of the . . . facility." Id. § 300.1100(c)(1). The rule expressly includes within the meaning of the term the exercise of "decisionmaking control over the borrower's environmental compliance" or the exercise of "control at a level comparable to that of a manager of the borrower's enterprise" under circumstances where 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."

It is interesting to note that the EPA rule protects a lender in possession of and operating the borrower's facility after foreclosure where the lender is attempting to sell the property using certain means prescribed by the rule, id. § 300.1100(d), but the rule provides no similar safe harbor for a lender in possession prior to foreclosure.


ground for the receivership "such as danger of loss, waste, destruction, or serious impairment of the property." The effectiveness of a provision in loan documents that a lender is entitled to the appointment of a receiver varies from jurisdiction to jurisdiction, and even if the lender is able to procure the appointment of a receiver, there is a risk that the receiver will mismanage the property. Finally, in those states where non-judicial foreclosure is permitted, there may be a risk that a lender, by going to court to obtain the appointment of a receiver, will have elected a judicial foreclosure.

Even from the borrower's viewpoint, requiring a lender to take possession of property or obtain the appointment of a receiver may be undesirable. The borrower generally wants to retain possession and control of the property until foreclosure, and even a borrower in default may feel that his own management of the property will be better than that of the


82. See First S. Properties, Inc. v. Vallone, 533 S.W.2d 339, 343 (Tex. 1976).

83. A borrower would prefer to impose these onerous requirements on a lender only because the lender may be unwilling to exercise its rights under an assignment of rents leaving the borrower in control of rents and the property.
lender or of a receiver unfamiliar with the property and its leases. If a borrower is better able to manage the property, he will be able to generate more income than would a lender or receiver in possession; therefore, a borrower would prefer that a lender not take possession of property or secure the appointment of a receiver in order to activate its assignment of rents. On the other hand, if a lender is collecting all of the income from the property and applying it to payment of the debt, the borrower may be unable to operate or maintain the property. Nevertheless, borrowers are in most cases willing to agree at the time of the closing of the loan to give the lender control over rents in the event of default.

Tenants of the property arguably have reason to favor the requirement of activation of an assignment of rents by possession or some equivalent action. Tenants are concerned with the general condition of the mortgaged property and with performance of specific lease covenants, and a lender in possession has an obligation to operate and maintain the property and may have liability for breaches of lease covenants. A lender collecting rents without taking possession of mortgaged property has no obligation to operate and maintain the property and has no liability for breaches of lease covenants. However, this arrangement may be advantageous to the lender if he is collecting rents and may be able to act as a substitute lessor for the property in the event of default. This arrangement allows the lender to take possession of the property in the event of default and to act as a substitute lessor for the property.

84. See supra note 78 and accompanying text.
85. There is little authority on this issue, and most of the cases which do address the issue deal with the liability of a mortgagee in possession under a leasehold mortgage for payment of rent. There is a split in the authority that does exist with some courts holding the lender liable for covenants that run with the land, see, e.g., Williams v. Safe Deposit & Trust Co., 175 A. 331, 334 (Md. 1934); Astor v. Hoyt, 5 Wend. 605, 617 (N.Y. 1830), and others finding the lender not liable, see, e.g., Johnson v. Sherman, 15 Cal. 287, 293 (1860), Cargill v. Thompson, 59 N.W. 638 (Minn. 1894). See also Patrick A. Randolph, Jr., The Mortgagee’s Interest in Rents: Some Policy Considerations and Proposals, 29 Kan. L. Rev. 1, 20-22 (1980).
86. Where a mortgage lender is collecting rents under an assignment of rents, the lender is receiving the benefits of the leases on the mortgaged property, but the lender is not deemed to have assumed any of the obligations under the leases. Kratovil, supra note 45, at 21-22. Because an assignment of rents is not a transfer of the landlord’s reversion, id. at 21 (citing Orman v. Burgess [sic], 217 Ill. App. 311 (1920); Winnisimmet Trust Inc. v. Libby, 122 N.E. 575, 576 (Mass. 1919)), an assignee of rents is not liable for the breach of lease covenants, Kratovil,
er, where requirements imposed on lenders for taking control of rents are so onerous that they are rarely exercised, tenants are not protected because the borrower, facing loss of the property through foreclosure, has little incentive to maintain the property and comply with lease covenants. On balance, the lender's interest in seeing that the mortgaged property is operated and maintained and that tenants do not abandon the premises should provide the most protection to tenants.

Use of either the mortgagee in possession or the receivership remedy when the lender's only goal is to collect rents is simply overkill. These remedies are suitable where the value of the property itself is at risk because of the borrower's destruction or waste of the property but not where the borrower is simply milking the property of its rents. Neither remedy is desirable.

supra note 45, at 21 (citing S.H. Cohn Co. v. Simon, 17 Ohio C.C. (n.s.) 371 (1916)).

At least one commentator has suggested that this result is unfair to the tenant who will have to pay rents to the lender but will not be able to look to the lender for performance of the landlord's obligations under the lease. Randolph, supra note 85, at 25-26. Because of the doctrine of independence of lease covenants, a tenant will generally not be entitled to withhold rents based on a default in the landlord's obligations. Id. at 26. The tenant's remedy is to sue its landlord, the borrower, for damages based on breach of the lease covenant unless the landlord's breach is so serious that it effectively evicts the tenant, in which case the doctrine of constructive eviction permits the tenant to vacate the premises and stop paying rent.

This argument overlooks the fact that a lender has more interest than a borrower after default in seeing that the property is maintained and that tenants do not abandon the property. Although the lender is not liable for breaches of lease covenants, the tenant may be better off than if the borrower is milking the property. Furthermore, the doctrine of independence of lease covenants has been significantly eroded in the area of residential tenancies, see Roger A. Cunningham, The New Implied and Statutory Warranties of Habitability in Residential Leases: From Contract to Status, 16 URB. L. ANN. 3 (1979), and may be eroding in the area of commercial tenancies, see Davidow v. Inwood N. Professional Group—Phase I, 747 S.W.2d 373, 377 (Tex. 1988) (finding an implied warranty by a commercial landlord that leased premises are suitable for their intended commercial purpose, which warranty was mutually dependant with the tenant's obligation to pay rent). With regard to those lease covenants that are mutually dependant, a tenant would be able to withhold rent as a result of breaches by the landlord.
from the viewpoint of either lender or borrower, and even the interests of a tenant are not better protected if requirements for activation of an assignment of rents are so onerous that a lender would rather see rents misapplied than take the risks attendant with becoming a mortgagee in possession.

B. Less Onerous Requirements

Actions less onerous than taking possession of mortgaged property or obtaining the appointment of a receiver have in some states been held sufficient to activate an assignment of rents. For example, in some states a refused demand for possession has been considered sufficient action to permit a lender access to rents. In a few states the mere filing of a request for a receiver, as opposed to the appointment of one, suffices to activate an assignment of rents. Some states require only that the lender make demand on the borrower for rents, and in other states a demand made on tenants to begin paying rents to the lender has been held sufficient. The rationale of


some of the courts permitting activation of an assignment of rents by these less onerous means is that the required action is considered the equivalent of the lender's taking possession of the mortgaged property, and if the lender is considered to be in possession of the property, then the lender might face liability as a mortgagee in possession.

The Restatement has adopted the view that delivery of a demand for rents to the borrower is the only action required for a lender to begin collecting rents. Comments to the rele-

parties obligated for payment"). This is particularly true in title and intermediate theory states. See Kratovil, supra note 45, at 12.

91. See Northwest Commons, 136 B.R. at 218 (finding that lender's giving of notices to tenants was equivalent to taking possession); Spiotta, 168 A. at 160 (finding constructive possession where lender had served notice on tenant demanding payment of rent to lender). See also 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).

92. But see Strutt v. Ontario Sav. & Loan Ass'n, 105 Cal. Rptr. 395, 405 (Cal. Ct. App. 1973) ("[A lender] who, after default, does no more than collect rents by means of a letter request to the tenants and who does not undertake management of the property is [not] a 'mortgagee in possession.'"); Luther P. Stephens Inv. Co. v. Berry Schs., 3 S.E.2d 68, 71 (Ga. 1939) ("[T]he mere fact that the mortgagee receives the rents and profits does not constitute him a mortgagee in possession, unless he takes the rent in such a way as to take out of the hands of the mortgagor the management and control of the estate.") (quoting 41 C.J. 612, § 580); Ireland v. U.S. Mortgage & Trust Co., 76 N.Y.S. 177, 181-82 (N.Y. App. Div. 1902) ("[T]he mere fact that the mortgagee receives the rents and proceeds does not constitute him chargeable as a mortgagee in possession.") (quoting 20 AM. & ENG. ENC. LAW 1010 (2d ed.), aff'd 67 N.E. 1083 (1902). Where property is occupied by tenants, a lender's possession is not physical possession but the exercise of control over the property; however, mere collection of rents without otherwise taking over management and control of the property should not constitute a lender a mortgagee in possession. See Strutt, 105 Cal. Rptr. at 405; Luther P. Stephens Inv. Co., 3 S.E.2d at 71. See also NELSON & WHITMAN, supra note 40, §§ 4.25, 4.27, 4.29.

93. RESTATEMENT (THIRD) OF PROPERTY-SECURITY (MORTGAGES) § 4.2(c) (Tentative Draft No. 2, 1992). Section 4.2(c) provides:

The mortgage may provide that the mortgagee may commence collection of the rents at any time or, in any event, upon mortgagor default. The mortgagee's right to actual possession of the rents arises upon:
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vant section provide that collection of rents by a lender in itself "does not constitute the [lender] a 'mortgagee in possession,' with the duties and liabilities attendant to that status."9 Therefore, under the Restatement a lender is able to collect rents from the property without taking possession of the property, obtaining the appointment of a receiver, or taking other onerous action and without taking on the duties and liabilities of a mortgagee in possession.

ULSIA provides that a lender with an assignment of rents may, after the borrower's default, give notice to tenants to make rent payments to the lender without taking possession of the mortgaged property, and the lender is entitled to those rents accruing after a tenant's receipt of the notice.95 The

(1) Satisfaction of any conditions in the mortgage; and
(2) Delivery of a demand for the rents to the mortgagor, the holder of the equity of redemption, and each person who holds a mortgage on the real property or on its rents of which the mortgagee has notice.

Id. This approach is adopted in conjunction with the adoption of the lien theory view that a lender may not take possession of the mortgaged property prior to foreclosure unless the borrower voluntarily relinquishes possession or abandons the property. Id. § 4.1. A mortgage provision giving the lender the right to take possession upon default is unenforceable, id. § 4.1(b), and receivership is the remedy available to the lender for prevention waste of the property, id. § 4.1 cmt. b.

94. Id. § 4.2 cmt. b.
95. U.L.S.I.A. § 505(a), 7A U.L.A. 222 (Supp. 1993). Section 505(a) provides:

After a debtor's default, a secured creditor in possession of the real estate and any creditor who has an assignment of rents, even though not in possession, may notify a lessee to make payment of the rents to that creditor and, subject to the priority among creditors specified in this subsection, is entitled to the rents accruing after the receipt of the notice, except to the extent that the rents have been paid in good faith either to the debtor or to a secured creditor entitled thereto under a previous notice. If more than one secured creditor entitled to rents has notified the lessee to make payment, the secured creditor in possession has priority or, if no creditor is in possession, the secured creditor having priority of security interest has priority as to rents. If requested in writing by the lessee, the secured creditor, within ten days after the request is received, shall furnish reasonable proof as to the secured creditor's right to rents. The lessee need not perform to the secured creditor until the
comments to this section provide that a lender collecting rents is not considered to be in constructive possession of the property and therefore has no obligation to operate or maintain the property. The lender must apply rents collected to reduce the debt but may release all or part of the rents to the borrower to be applied to operating expenses. Therefore, ULSIA provides a method whereby the lender can collect rents without taking possession of the property or obtaining the appointment of a receiver and also provides guidance as to a means for allowing the continued operation and maintenance by the borrower.

The ULSIA and Restatement approaches to the treatment of the assignment of rents give the lender a realistic means of enforcing a security interest in rents. If the borrower agrees to grant a security interest in rents, there should be some reasonable means of enforcing it in the absence of specific document provisions requiring more onerous action. Requiring that a lender take possession of the mortgaged property or obtain the appointment of a receiver in order to collect rents from the property is simply unnecessary where there is no waste of the property. Because of the lender's interest in the continued operation and maintenance of the property, a lender in control of rents will in many cases release some portion of the rents to the borrower for the borrower's use in operating and maintain-

proof is furnished. The lessee need not perform to the debtor or any secured creditor who had previously given notice until the time for furnishing the proof has expired.

Id. § 505(a) cmt. 2.

97. Id. Even this, however, might be sufficient participation in management by a lender to leave the lender open to liability under CERCLA. See supra note 77.

98. ULSIA encourages use of the mortgagee in possession remedy by protecting lenders to some extent from liabilities to which they would otherwise be subject, U.L.S.I.A. § 505, but permits a lender to collect rents without taking possession, id. § 505(a). ULSIA attempts to confine the remedy of appointment of a receiver to the unusual case where possession by the lender would not adequately protect the property. See id. § 504 cmt. 1. This can be contrasted with the Restatement approach which prohibits the mortgagee in possession remedy and provides for receivership as the primary means for protecting a lender against waste. See supra note 93.
ing the property.99 This scenario may provide the best of both worlds for borrower and lender since the lender may control rents without the risks of receivership or liability as a mortgagee in possession and the borrower may retain control over the property and its management.

C. The Absolute Assignment of Rents

A borrower and lender may agree that an assignment of rents should give the lender access to rents immediately upon default by the borrower without the requirement of prior activation. To achieve this goal the borrower may execute an absolute assignment of rents,100 which some courts have recognized as being effective.101 Where the activation requirement


100. An absolute assignment may take on any number of forms ranging from an assignment which by its terms permits the lender access to rents immediately upon default without any other action on the part of the lender, to an assignment which purports to be an outright transfer to the lender of the right to rents with a license back to, or other right in, the borrower to collect rents until the occurrence of a default. In some cases a borrower will execute an absolute assignment that gives the lender the right to collect rents for application to the indebtedness from the date of execution of the assignment forward. This last type of assignment is generally enforced in accordance with its terms but is rare since most borrowers want to retain control over the collection of rents at least until the occurrence of a default.


is eliminated, the lender may begin collecting rents upon the borrower's default without first taking any onerous action which would otherwise be required.\textsuperscript{102} Further, the lender has the right to rents collected by the borrower or other parties after default.\textsuperscript{103}

The case traditionally cited for the concept of the absolute assignment is \textit{Kinnison v. Guaranty Liquidating Corporation}.\textsuperscript{104} Because the borrower in \textit{Kinnison} was to collect rental income for the account of the lender from the date of the execution of the agreement forward,\textsuperscript{105} the case did not involve an absolute assignment of rents to take effect upon default. However, the court did discuss the validity of an assignment of rents which provides "that in the event of default the rents are assigned absolutely to the mortgagee."\textsuperscript{106} The court

\textsuperscript{102} \textit{See} Equitable Mortgage Co. v. Fishman (\textit{In re Charles D. Stapp of Nev., Inc.}), 641 F.2d 737, 740 (9th Cir. 1981); \textit{Kinnison}, 115 P.2d at 453; \textit{Taylor}, 621 S.W.2d at 594. But see \textit{In re GOCO Realty Fund I}, 151 B.R. 241 (Bankr. N.D. Cal. 1993), in which a bankruptcy court addressed the issue of a lender's right to retainers held by law firms paid out of post-default rents where the lender held an absolute assignment of rents. The court held that the lender did not have an interest in the rents because the lender had not taken any action to enforce its assignment of rents after the borrower's default. \textit{Id.} at 249. The court interpreted Cal. Civ. Code § 2938, the California statute governing absolute assignments, to require a lender to take an "enforcement step" in order to be entitled to rents on the basis that "[a]ny other interpretation will only lead to confusion in the market place by leaving open to question entitlement to monies commingled or transferred to third parties." \textit{Id.} at 248. This result may be wrong since it would mean no difference at all under California law in treatment of an absolute assignment of rents and a collateral assignment of rents although California statute provides explicitly for both. \textit{CAL. CIV. CODE} § 2938 (West Supp. 1993). As an alternative basis for its holding, the court found that the lender had "failed to meet its burden of tracing the proceeds" of the rents to the retainers. \textit{In re GOCO Realty Fund I}, 151 B.R. at 250.

\textsuperscript{103} \textit{See} International Property Management, 929 F.2d at 1034; \textit{O'Neill Enters.}, 506 F.2d at 1244; Ventura-Louise Properties, 490 F.2d at 1145.

\textsuperscript{104} 115 P.2d 450 (Cal. 1941). Although California cases are often cited for the common law doctrine of the absolute assignment, California has recently codified its recognition of the absolute assignment. \textit{See} \textit{CAL. CIV. CODE} § 2938(a) (West 1993).

\textsuperscript{105} \textit{Kinnison}, 115 P.2d at 452.

\textsuperscript{106} \textit{Id.} at 453.
in Kinnison distinguished between a provision "pledging the rents as additional security" and a provision which "operates to transfer to the mortgagee the mortgagor's right to the rentals upon the happening of the specified condition."\textsuperscript{107} The court held that the assignment of rents involved in that case did not transfer a security interest in rents but was a "complete transfer of [the borrower's] interest in rentals."\textsuperscript{108}

A number of courts have stated that an absolute assignment of rents is one which transfers title to or ownership of the rents to the lender,\textsuperscript{109} while other courts have recognized that an absolute assignment is intended merely for security.\textsuperscript{110} Treating an absolute assignment as a transfer of title to rents is a legal fiction\textsuperscript{111} because a mortgage lender has not pur-

chased the rents but is merely attempting to get a security interest with attributes different from the traditional collateral assignment of rents. If the lender were truly purchasing the rents, then 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. In addition, it is the borrower who retains the risk of default by the tenants under their leases, and this would not generally be the case if the rents were sold. Finally, a true purchase of the rents would not terminate on the final repayment of the indebtedness as does an assignment of rents made in connection with a mortgage loan.

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. Language in an assignment of rents that the lender must take some action after default in order to collect rents has been held fatal to the finding of an absolute assignment. More importantly, if an assignment of rents provides that it is given as security for the mortgage debt, courts generally hold that it is not an absolute assignment. This elevation of form over substance

112. The author will use the term "collateral assignment of rents" to distinguish the traditional assignment of rents from the "absolute assignment" where that distinction is necessary.

113. See 500 Ygnacio Assocs., 141 B.R. at 195. 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.


116. See, e.g., 1301 Connecticut Ave. Assocs., 117 B.R. at 7; In re Association Ctr. Ltd. Partnership, 87 B.R. 142, 145 (Bankr. W.D. Wash. 1988); Taylor, 621 S.W.2d at 594-95. But see In re Galvin, 120 B.R. 767,
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.

Lenders persist in their attempts to create absolute assignments because the advantages to a lender of an absolute assignment are clear. First, the lender is entitled to collect rents without activating the assignment of rents.\(^1\) In states where some minimal action such as serving notice on the borrower or on the tenants is all that is required for activation, this advantage is not so important, but in states requiring more onerous actions such as taking possession of the property or obtaining the appointment of a receiver, the advantage is great.\(^2\) Second, under an absolute assignment the lender is entitled to rents collected by the borrower or another party after the occurrence of a default.\(^3\) This is in contrast to the traditional

\(^{771-72}\) (Bankr. D. Vt. 1990) (finding an absolute assignment based on intent of the parties despite language in the assignment that it was given to secure the debt). Even in FDIC v. International Property Management, Inc., where the Fifth Circuit recognized that all assignments of rents made in connection with a mortgage loan are undoubtedly made to secure the debt, the court 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 at 1038.


118. See supra notes 73-82 and accompanying text for a discussion of the disadvantages to a lender of taking possession of property or seeking the appointment of a receiver.

119. See FDIC v. International Property Management, Inc., 929 F.2d 1033, 1034 (5th Cir. 1991); Fidelity Bankers Life Ins. Co. v. Williams (In re O'Neill Enters.), 506 F.2d 1242, 1244 (4th Cir. 1974); Great W. Life Assurance Co. v. Rothman (In re Ventura-Louise Properties), 490 F.2d 1141, 1145 (9th Cir. 1974). A number of cases involving assignments of rents have been contests between the lender holding the assignment and another creditor of the borrower. See, e.g., Jim Davis & Co. v. Albuquerque Fed. Sav. & Loan Ass'n, 536 So. 2d 55, 57 (Ala. 1988) (involving contest between mortgage lender and judgment creditor with writ of garnishment over rents accruing after lender purchased at foreclosure
assignment of rents which gives a lender the right only to those rents accruing after activation. Finally, the advantages to a lender of the absolute assignment arising in the bankruptcy context will be discussed below.

Where a lender has succeeded in drafting an assignment of rents that a court will construe as an absolute assignment, there may be some problems caused by the finding of an absolute assignment. Several courts have focused unduly on the discussion of an absolute assignment as a transfer of ownership of the rents, and the logical extension of treating an absolute assignment as a sale of the rents is the assumption that the lender must have paid a purchase price in the form of a reduction in the amount of the debt owed by the borrower by an amount equal to the present value of the rental stream.

sale); Kinnison, 115 P.2d at 452 (involving contest between mortgage lender and execution creditor over rents collected by the borrower and deposited in a bank account in the borrower's name). Where the assignment of rents is absolute, the lender wins the contest. See id. at 454.

120. See supra notes 57-62 and accompanying text.

121. See infra notes 192-95 and accompanying text.

122. In the case of In re Fry Road Assocs., 64 B.R. 808 (Bankr. W.D. Tex. 1986), a bankruptcy court held that a lender owned the rents covered by an absolute assignment, and the borrower no longer had any interest in them. The court said that an absolute assignment "operates to transfer the right to rentals automatically upon the happening of a specified condition such as default... The assignment does not create a security interest but instead passes title to the rents...." Id. at 809 (quoting Taylor v. Brennan, 621 S.W.2d 592, 594 (Tex. 1981)) (citations omitted).

It should be noted that the Fifth Circuit later recognized that an absolute assignment is in fact made for security purposes and is only a legal fiction intended to circumvent the requirement of activation of an assignment of rents. See FDIC v. International Property Management, Inc., 929 F.2d 1033, 1035 (5th Cir. 1991).

123. The court in Fry Road stated that "[i]t title was transferred, a portion of the debt... has obviously been discharged or paid pro tanto." Fry Road, 64 B.R. at 809 n.1 (citing Taylor, 621 S.W.2d at 594) (citations omitted). The court apparently was confused by the meaning of the term "pro tanto" as it had been used by courts in discussing the absolute assignment of rents. See, e.g., Malsman v. Brandler, 41 Cal. Rptr. 438, 440 (Cal. Dist. Ct. App. 1964), cited in Taylor, 621 S.W.2d at 594. The term means "for so much" or "as far as it goes." BLACK'S LAW DICTIONARY 1222 (6th ed. 1990); BRYAN A. GARNER, A DICTIONARY OF MODERN LEGAL USAGE 444-45 (1987). See also Donley v. Hays, 17 Serg. & Rawle
However, because the borrower and lender would not have intended a sale of the rents and would not therefore have agreed to the amount of the debt reduction, a court or a jury might have to determine that amount. Furthermore, if a lender charges or collects interest on the "pre-reduction" principal amount after rents have been assigned, the lender risks the imposition of usury penalties. Finally, the absolute assignment has caused confusion in bankruptcy as will be discussed below.

The fictional transfer of rents by absolute assignment was an unfortunate step taken by lenders and courts in order to avoid some of the pitfalls of the collateral assignment of rents. The undue focus on the absolute assignment as passing title to rents has made drafting such an assignment all but impossible and has led to confusion over whether the absolute assignment effects a sale of the rental stream or merely creates a security interest. For these reasons, the concept of the absolute assignment should be eliminated, but the parties' intent that the lender have control over rents without activation should be attainable by a more straightforward method as would be the case if rents were covered by Article 9 of the UCC.

400 (Pa. 1828) (contrasting the terms "pro tanto" and "pro rata"). In the context of assignments of rents, the term should mean that rents collected by a lender are applied to reduce the debt as, and to the extent, actually received by the lender. This interpretation of the term would be consistent with the fact that an assignment of rents, even an absolute assignment, is truly a security interest in the rents rather than a sale of the rents.

124. See Richard E. Danley & Andrew E. Jillson, Absolute Assignments of Leases and Rents: Has the Unicorn Been Found or Is It Still Myth, 30 REAL EST., PROB. & TR. L. REP., Apr. 1992, at 28, 32.

125. See infra notes 192-97 and accompanying text.

126. The Taylor court, for example, could have adopted the straightforward approach that the right to rents would pass to the lender automatically upon a default where the parties had sufficiently manifested their intent to that effect. See International Property Management, 929 F.2d at 1035.
IV. ASSIGNMENTS OF RENTS IN THE BANKRUPTCY CONTEXT

A. The Effect of Bankruptcy in General

Most of the recent cases involving assignments of rents, both collateral and absolute, have been bankruptcy cases, so it is important to review the treatment of assignments of rents in the bankruptcy context. The bankruptcy of a borrower will materially affect a mortgage lender's rights under its mortgage and assignment of rents, one of the primary effects being delay.127 Once a borrower has filed a petition in bankruptcy, the lender is stayed from foreclosing on the mortgaged property despite any pre-petition default or the continuing failure of the borrower to make payments on the loan.128 In a Chapter 7 bankruptcy the trustee will ultimately liquidate the mortgaged property to pay the mortgage lender and other creditors29 or if there is no equity in the property, may abandon it so that the mortgage lender can foreclose.130 In a Chapter 11 bankruptcy131 the borrower hopes that a plan of reorganization will ultimately be confirmed,132 at which time the mortgage lender will begin receiving payments on its debt under the terms of the plan. However, the time period between filing of a petition under Chapter 11 and confirmation of a plan can be substantial.133

127. See 1991 Senate Subcomm. Hearing, supra note 12, at 88-89 (statement of Mary Jane Flaherty on behalf of the American Council of Life Insurance), 186-87 (statement of James W. Nelson on behalf of the Mortgage Bankers Association of America). Mr. Nelson estimated annual losses to mortgage lenders caused by delays resulting from bankruptcies of single asset real estate entities at $1.7 billion. Id. at 187.

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129. Id. §§ 704(1), 726.

130. Id. § 554.

131. Issues regarding rents could theoretically arise in a Chapter 13 bankruptcy also. Most often, however, the issues arise in Chapter 11 and involve a single-asset entity. See 1991 Senate Subcomm. Hearing, supra note 12, at 88-89 (statement of Mary Jane Flaherty on behalf of the American Council of Life Insurance), 185-87 (statement of James W. Nelson on behalf of the Mortgage Bankers Association of America).

132. If a plan is not ultimately confirmed, the bankruptcy will be dismissed or converted to a Chapter 7. 11 U.S.C. § 1112 (b)(2) (1988).

133. The debtor has the exclusive right to file a plan of reorganization for 120 days. Id. § 1121(b). That period may be extended at the request
During the period of time between the filing of bankruptcy and the ultimate foreclosure or liquidation of the property in Chapter 7 or commencement of payments under a Chapter 11 plan, rents continue to accrue from the mortgaged property. The bankruptcy trustee or borrower, as debtor in possession, and the lender have conflicting interests in the treatment of the rents collected during the pendency of the bankruptcy. The bankruptcy trustee is charged with collecting and liquidating property of the estate and therefore wants the accrued rents to remain in the estate for payment of unsecured claims. The borrower in Chapter 11 wants to use rents in furtherance of his anticipated plan of reorganization because a reorganization will be impossible unless rents are available for the continued operation of the property and because excess rents may be used for payment of other expenses including attorneys' fees. The lender, on the other hand, wants rents to be applied only to operation and maintenance of the property and to payment of interest accruing on the debt. If excess rents are not applied to accruing interest, the increasing loan balance caused by unpaid interest can, in the case of an oversecured lender, quickly overtake any equity cushion that the lender may have in the property. Similarly, in the case of an undersecured lender, it can increase the unsecured portion of the loan, only a small percentage of which may ever be paid. These parties' conflicting interests in the application of rents in the bankruptcy have led to the litigation of a number of cases on the effect of an assignment of rents in bankruptcy.

The United States Supreme Court addressed the issue of the treatment of an assignment of rents in bankruptcy in *Butner v. United States.* The Court held in *Butner* that state law governs "property rights in the assets of a bankrupt's estate," including the rights of a lender under an assignment of rents. The Court rejected the view that had been adopted of the debtor. See id. § 1121(d). Confirmation of a plan occurs after notice and a hearing. Id. § 1128(a).

134. Id. § 704(1).
135. See supra note 21.
137. *Butner,* 440 U.S. at 54-55. The Court reasoned as follows:

Property interests are created and defined by state law.
by the Third and Seventh Circuits that "federal law affords mortgagees an automatic security interest in rents and profits when state law would deny such an automatic benefit and require the mortgagee to take some affirmative action before his rights are recognized." Instead, the Court decided that bankruptcy courts should "take whatever steps are necessary to ensure that the mortgagee is afforded in federal bankruptcy court the same protection he would have under state law if no bankruptcy had ensued." The difficulty has come in implementing the Court's pronouncement that the lender be given the same protection in bankruptcy that it would have under state law because state law is so confusing.

B. Bankruptcy Treatment of the Unactivated Collateral Assignment of Rents

Where a lender has not activated its assignment of rents prior to the borrower's bankruptcy filing, it is clear that the lender may not take steps outside of the bankruptcy court to begin collecting rents without seeking relief from the automatic stay. Any action such as taking possession of the mortgaged property, seeking the appointment of a receiver in state court, or even sending notices to tenants to begin making rent payments to the lender would violate the automatic stay.

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.

Butner, 440 U.S. at 54-55.
138. Id. at 56.
139. Id.
141. Id. See also In re Multi-Group III Ltd. Partnership, 99 B.R. 5, 8 (Bankr. D. Ariz. 1989) (actions taken to collect rents pursuant to Arizona
Therefore, the borrower, as debtor in possession, or the bankruptcy trustee is entitled to continue collecting rents. The respective rights of the borrower and the lender to rents collected from the mortgaged property depend upon whether rents covered by an unactivated collateral assignment of rents are considered cash collateral. Cash collateral is defined by the Bankruptcy Code as "cash . . . in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property subject to a security interest as provided in section 552(b) of this title."142

If rents are not considered cash collateral, they are available for distribution to unsecured creditors in the case of a Chapter 7 bankruptcy or for use by the debtor in possession in the case of a Chapter 11 bankruptcy.143 Where rents are treated as

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142. 11 U.S.C. § 363(a). Section 552(b) provides:

Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 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 proceeds, product, offspring, rents, or profits of such property, then such security interest extends to such proceeds, product, offspring, rents, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable non-bankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

*Id.* § 552(b).

Under § 552(a), property acquired by the bankruptcy estate after the commencement of the bankruptcy proceeding is not subject to any pre-petition lien; therefore, after-acquired property provisions of a security agreement are not enforced in bankruptcy. *Id.* § 552(a). Section 552(b) provides an exception to the lien avoidance mechanism of section 552(a) for "proceeds, product, offspring, rents, or profits" of property covered by a pre-petition security interest. *Id.* § 552(b).

143. Rents may be used by the borrower in Chapter 11 "to fund his
cash collateral, the debtor is not entitled to use them without consent of the lender or authorization of the bankruptcy court.\footnote{144} The bankruptcy court may not authorize the use of cash collateral unless the lender is adequately protected,\footnote{146} but courts usually permit the borrower to use rents for the operation and maintenance of the mortgaged property because such use provides adequate protection to the lender by preserving the value of the property.\footnote{147} The court may require that excess rents be sequestered or paid to the lender for application against the indebtedness. In fact, the borrower and lender often will enter into an agreed order, the effect of which is to permit the borrower to use some portion of the rents for operation and maintenance of the property and to give the lender the remainder of the rents for application against the indebtedness.

The courts are split on the issue of whether rents covered by an unactivated collateral assignment of rents should be treated as cash collateral. Some courts have held that such rents are not cash collateral.\footnote{148} The reasoning of most of these courts is

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\footnotetext[144]{legal bill, continue his lifestyle, or for other purposes.\textsuperscript{144} \textit{1991 Senate Subcomm. Hearing}, supra note 12, at 218 (statement of William L. Norton III on behalf of the American Bankers Association). But see \textit{In re Association Ctr. Ltd. Partnership}, 87 B.R. 142, 147 (Bankr. W.D. Wash. 1988), in which the court said the following with regard to the use of rents collected by the borrower:

The debtor-in-possession which has fiduciary and accounting responsibilities to all of its creditors . . . is now collecting the rents. It is obviously to the best interest of all parties that the rents be properly utilized to pay for the operation of the building, overhead, maintenance, insurance, taxes and the like . . . . If the rents are being dissipated and/or used for improper purposes, the situation can always be brought before the Court . . . .

\textit{Id.}}

\footnotetext[145]{14. 11 U.S.C. § 363(c)(2).}

\footnotetext[146]{145. \textit{Id.} § 363(e).}


\textit{Id.}}

based upon their equating the activation required by state law with "perfection." The Bankruptcy Code permits a trustee in bankruptcy to avoid unperfected security interests, and

148. See Glessner, 140 B.R. at 558; Kurth Ranch, 110 B.R. at 506; Multi-Group, 99 B.R. at 8; Association Ctr., 87 B.R. at 145; Hamlin's Landing, 77 B.R. at 920-21. The court in Prichard Plaza used a slightly different rationale. The court recognized that the assignment of rents had been perfected by recordation but held that the rents were not cash collateral because the lender's security interest in the rents was inchoate since the lender had not activated its assignment of rents by taking possession of the mortgaged property. Prichard Plaza, 84 B.R. at 298, 301-02.

149. The power to avoid unperfected security interests arises pursuant to § 544(a) of the Bankruptcy Code which provides:

The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by —

(1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists;

(2) a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists; or

(3) a bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such a purchaser exists.

these courts have reasoned that an unactivated assignment of rents is an unperfected security interest in rents that can be avoided by the trustee in bankruptcy. 150 If the trustee can avoid a lender's interest in the rents because it is unperfected, then only the bankruptcy estate has an interest in the rents, and they are not cash collateral. 151

Other courts have held that a lender with an unactivated assignment of rents can take actions in the bankruptcy court that are the equivalent of the actions required for activation under state law. 152 Most of these courts, like those espousing the view discussed above, equate activation of an assignment with perfection. These courts, however, find that an unactivated assignment of rents falls within a narrow exception to the trustee's avoidance power that permits post-petition perfection. 153 The equivalent action which can be taken in the bankruptcy court is the filing by the lender of a notice under section 546(b) of the Bankruptcy Code. 154 The filing of such a

150. See Glessner, 140 B.R. at 561; Kurth Ranch, 110 B.R. at 507-08; Association Ctr., 87 B.R. at 146.

151. The definition of cash collateral includes "rents . . . subject to a security interest as provided in § 552(b) . . . ." 11 U.S.C. § 363(a). Section 552(b) is expressly made subject to § 554 which gives the trustee the power to avoid unperfected security interests. Id. §§ 554, 552(b).


153. See Casbeer, 793 F.2d at 1443; McCombs, 88 B.R. at 264; Mears, 88 B.R. at 421; Gelwicks, 81 B.R. at 448; Sampson, 57 B.R. at 307; Fluge, 57 B.R. at 457; Consolidated Capital, 47 B.R. at 1011.

154. Section 546(b) provides:

The rights and powers of a trustee under sections 544, 545, and 549 of this title are subject to any generally applicable law
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notice constitutes a post-petition perfection of the interest in rents.\textsuperscript{155} If the interest in rents is perfected, it cannot be avoided by the bankruptcy trustee; therefore, any rents collected after the filing of the section 546(b) notice are considered cash collateral.\textsuperscript{156}

Finally, a recent trend in a number of courts has been to recognize that a properly recorded assignment of rents is perfected and is therefore not subject to avoidance by the trustee in bankruptcy.\textsuperscript{157} These courts have treated the activation re-

that permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of such perfection. If such law requires seizure of such property or commencement of an action to accomplish such perfection, and such property has not been seized or such action has not been commenced before the date of the filing of the petition, such interest in such property shall be perfected by notice within the time fixed by such law for such seizure or commencement.


155. See Casbeer, 793 F.2d at 1443; McCombs, 88 B.R. at 264; Mears, 88 B.R. at 421; Gellwicks, 81 B.R. at 448; Sampson, 57 B.R. at 307, 309; Fluge, 57 B.R. at 454, 456-57; Consolidated Capital, 47 B.R. at 1011.

156. See Casbeer, 793 F.2d at 1443-44; McCombs, 88 B.R. at 264; Sampson, 57 B.R. at 309; Consolidated Capital, 47 B.R. at 1011-12. A student may have first suggested the approach taken by these courts in his comment in THE HASTINGS LAW JOURNAL. See Randy Rogers, Comment, Assignment of Rents Clauses under California Law and in Bankruptcy: Strategy for the Secured Creditor, 31 HASTINGS L.J. 1433 (1980). Courts and commentators have since criticized this approach on the basis that legislative history indicates § 546(b) was intended to apply only where a particular statute authorizes relation back to the time of perfection. See In re Association Ctr. Ltd. Partnership, 87 B.R. 142, 146 (Bankr. W.D. Wash. 1988); In re Prichard Plaza Assocs. Ltd. Partnership, 84 B.R. 289, 300-01 (Bankr. D. Mass. 1988); Averch, supra note 27, at 523; McCafferty, supra note 27, at 464. For example, § 546(b) would clearly apply to the post-petition perfection of a purchase money security interest which is perfected within ten days after the purchaser receives possession of the collateral under UCC § 9-301(2). See McCafferty, supra note 27, at 463 n.148.

quired under state law as being more akin to enforcement of
the security interest in rents than to perfection and have held
that an assignment of rents is perfected by recordation in the
real property records.\(^{158}\) Therefore, if a lender has a properly
recorded assignment of rents, rents collected by the debtor are
cash collateral.\(^{159}\)

The different treatments given assignments of rents by the
various federal courts are dependant to some extent on their
different interpretations of bankruptcy law and to some extent
on their interpretations of the law of the applicable state. Os-
tensibly, differences in state law account for the fact that some
courts have treated activation as being equivalent to perfection
while others have treated a properly recorded but unactivated
assignment of rents as being perfected. Very few state courts
have used the term "perfection" in reference to the activation
of an assignment of rents,\(^{160}\) but where the term has been so
used, it probably has a different meaning from that used in
Article 9 of the UCC and likely contemplated by bankruptcy
law. The essence of perfection as used in Article 9, and proba-
bly in the Bankruptcy Code, is that it gives constructive notice
to third parties of a security interest or lien and thus is the
event that makes a security interest good as against third
parties.\(^{161}\) With regard to an assignment of rents, the recor-

Plains Dev. Corp., 136 B.R. 93, 95 (Bankr. S.D.N.Y. 1992); In re
Rancourt, 123 B.R. 143, 147 (Bankr. D.N.H. 1991); In re Somero, 122
Assocs., 118 B.R. 42, 45 (Bankr. E.D.N.C. 1990); Northwestern Nat'l Life
Ins. Co. v. Metro Square (In re Metro Square), 106 B.R. 584, 587 (D.
Minn. 1989).

158. See Steinberg, 985 F.2d at 1011; Vienna Park, 976 F.2d at 112-13;
SeSide, 152 B.R. at 884-85; White Plains, 136 B.R. at 95; Metro Square,
106 B.R. at 587-88.

159. See Vienna Park, 976 F.2d at 114; SeSide, 152 B.R. at 885; Metro
Square, 106 B.R. at 588.

160. See, e.g., Kinnison v. Guaranty Liquidating Corp., 115 P.2d 450,
Loan Ass'n, 536 So. 2d 55, 60 (Ala. 1988) (notice to tenants was not
necessary to perfect a lender's right to rents).

161. See SeSide, 152 B.R. at 884-85. Depending upon the type of collat-
eral and which state's law governs the transaction, perfection of an Arti-
icle 9 security interest may be accomplished automatically, by filing a
financing statement with the Secretary of State, by filing locally, by
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dation of the instrument gives notice to third parties of the lender's interest in rents. 162

Section 544 of the Bankruptcy Code permits the trustee in bankruptcy to avoid those transfers (including liens and security interests) that could be avoided by a bona fide purchaser of real property or a lien creditor. 163 A bona fide purchaser of real property on which a lender had a properly recorded mortgage and assignment of rents would take the property subject to that mortgage and assignment. 164 The purchaser, like the borrower, could collect the rents accruing before the lender's activation of its assignment of rents, but once the lender had activated its assignment of rents, the lender would be entitled to collect rents. 165 Similarly, a judgment creditor of the borrower with a writ of garnishment on rents would have a right to rents accrued or collected up to the point of activation by the lender of its assignment of rents, 166 but the lender would have the right to rents accrued or collected after the activation of its assignment. 167 Since neither a bona fide purchaser nor a judgment creditor could avoid the lender's interest in rents, a court should not hold that a trustee in bankruptcy may avoid the assignment of rents pursuant to section 544, and the filing in the real property records, or by the secured party's taking possession of the collateral. U.C.C. §§ 9-302, 9-304, 9-305, 9-306, 9-401 (1990). Except for automatic perfection, each type of perfection gives notice to third parties of the security interest. A lien on real property is perfected by recordation in the real property records of the county in which the property is located, thereby providing notice.

162. See SeSide, 152 B.R. at 885.


165. See Dash Point, 121 B.R. at 855.


courts which find that a properly recorded assignment of rents is perfected are correct in their analysis with regard to perfection.

The nature of the security interest created by a collateral assignment of rents is probably the root of the problem. Since the interest is inchoate, the lender has no rights in those rents collected by the borrower prior to activation. The collected rents are severed from the real property, and the lender has no right to these personal property "proceeds" of the rents.\(^{168}\) If the borrower is in bankruptcy, an argument can be made that the lender has no interest in the rents once they are collected and become cash, and if the lender has no interest in this cash, then it should not be treated as cash collateral.\(^{169}\) Nevertheless, most courts have found a way to protect a mortgage lender's interest in rents in bankruptcy either by finding that the rents are cash collateral because the lender's assignment of rents was perfected by recordation, or by permitting the lender to file a notice with the bankruptcy court and thereby perfect the lender's interest.\(^{170}\) Most commentators on the subject have advocated that duly recorded assignments of rents be treated as perfected\(^{171}\) and have criticized the view that rents covered by a duly recorded but unactivated assignment of rents are not cash collateral.\(^{172}\)

Apparently Congress also agreed that rents covered by a duly recorded but unactivated assignment of rents should be treated as cash collateral, for in 1992 both the Senate and the House of Representatives passed bankruptcy reform bills that

\begin{itemize}
  \item 168. See supra notes 57-61 and accompanying text.
  \item 169. This is similar to the argument made in In re Prichard Plaza Assocs. Ltd. Partnership, 84 B.R. 289 (Bankr. D. Mass. 1988). See supra note 148.
  \item 170. See supra notes 152-59 and accompanying text.
  \item 171. See Averch, supra note 27, at 528; John Collen & Douglas Rosner, Protecting Assignments of Rents in Bankruptcy: The Case for Following In re KNM Roswell, 20 CAL. BANKR. J. 197, 206 (1992); Sally A. Conti, Assignments of Rent in Bankruptcy: There is Hope For Secured Creditors, NORTON BANKR. L. ADVISOR, May 1991, at 7, 11; McCafferty, supra note 27, at 477; Schmitt, supra note 27, at 55.
  \item 172. See Collen & Rosner, supra note 171, at 37; McCafferty, supra note 27, at 469-70; Randolph, supra note 27, at 308-13; Schmitt, supra note 27, at 37.
\end{itemize}
dealt with this problem.\textsuperscript{173} A compromise bill died in the House at the end of the congressional session as a result of opposition from banks to a provision unrelated to the assignment of rents provision.\textsuperscript{174} A new bankruptcy reform bill addressing the assignment of rents issue has been introduced in the Senate,\textsuperscript{176} and it is likely that some form of the bill will

\textsuperscript{173} In November of 1991, Senators Howell Heflin (Democrat, Alabama) and Charles Grassley (Republican, Iowa) introduced a comprehensive bankruptcy reform bill, S. 1985, 102d Cong., 1st Sess. (1991), and a version of the bill passed the Senate by a vote of 97-0 in June of 1992, 138 CONG. REC. S8359 (daily ed. June 17, 1992). The bill provided for amendment of Bankruptcy Code § 363(a) to add: "If the cash collateral includes an interest in rents or leases, in real property, held by a creditor and duly recorded in the public records, such interest shall be deemed perfected for purposes of this title . . . ." S. 1985, 102d Cong., 1st Sess. § 203 (1991).


\textsuperscript{174} See Kenneth H. Bacon, Bankruptcy Bill Dies as Some Big Banks Oppose Provision on Priority of Creditors, WALL STREET J., Oct. 9, 1992, at B12. The controversial provision causing the demise of the bill would have given greater protection to retirement benefits under collective bargaining agreements. Id.

\textsuperscript{175} S. 540, 103d Cong., 1st Sess. § 205 (1993). The most recent version of the bill after revision in committee would amend Bankruptcy Code § 552(b) to add:

(2)(A) Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548, if —

(i) the debtor and an entity entered into a security agreement that was duly recorded in the public records before the commencement of the case; and

(ii) the security interest created by the security agreement extends to —

(I) property of the debtor acquired before the commencement of the case; and

(II)(aa) to amounts paid as rents of such property; . . .

the security interest extends to such amounts paid to the estate
eventually pass. If Congress passes a bankruptcy reform bill, the bill will probably contain a provision that treats a duly recorded assignment of rents as being perfected for bankruptcy purposes, since the proposal is supported by a number of groups and seems to have no organized opposition.

Finally, state legislatures in a number of states have recently passed statutes designed to clarify the rights of a lender under an assignment of rents. Most of these statutes have

as rents . . . after the commencement of the case to the extent provided in the security agreement, whether or not the security interest in such rents . . . is perfected under applicable nonbankruptcy law, except to the extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

(B) If a security interest extends under subparagraph (A) to rents acquired by the estate after the commencement of the case, the security interest in such rents shall be deemed to be perfected for the purpose of section 544(a).

Id.

176. The Senate Judiciary Committee ordered the bill favorably reported "with an amendment in the nature of a substitute" on September 15, 1993. 139 CONG. REC. D989 (daily ed. Sept. 15, 1993).

177. See 1992 House Subcomm. Hearing, supra note 12, at 9-11 (statement of Ronald DeKoven on behalf of the American Bankers Association), 135-36 (statement of Lawrence P. King on behalf of the National Bankruptcy Conference), 190-92 (statement of Philip J. Hendel on behalf of the Commercial Law League of America); 1991 Senate Subcomm. Hearing, supra note 12, at 89-90 (statement of Mary Jane Flaherty on behalf of the American Council of Life Insurance), 186 (statement of James W. Nelson on behalf of the Mortgage Bankers Association of America), 214 (statement of William L. Norton III on behalf of the American Bankers Association). Of particular significance is the support of the National Bankruptcy Conference, which is perceived as a neutral or possibly pro-debtor group. The National Bankruptcy Conference had originally opposed the provision as premature but changed its position because of the amount of litigation in the bankruptcy courts on the issue of perfection of an assignment of rents. See 1992 House Subcomm. Hearing, supra note 12, at 135-36 (statement of Lawrence P. King on behalf of the National Bankruptcy Conference).

178. Although the author proposes changes in state law to correct existing problems in treatment of the assignment of rents under state and bankruptcy law, the author advocates amendment of the Bankruptcy Code as an interim measure to resolve the cash collateral issue.

179. See CAL. CIV. CODE § 2938-2938.1 (West 1993); FLA. STAT. ANN. § 697.07 (West Supp. 1993); KAN. STAT. ANN. § 58-2343 (Supp. 1992); MD.
provisions to the effect that a duly recorded assignment of
rents is perfected, therefore, the statutes seem to be aimed
at resolving the cash collateral issue in bankruptcy. Although
the statutes do apparently resolve the cash collateral issue in
the states where they have been enacted, they may produce
other problems.181

C. The Activated or Absolute Assignment of Rents in
Bankruptcy

Where a collateral assignment of rents is found to have been
activated by the lender prior to the borrower's bankruptcy
filing, some courts have treated rents collected after the bank-
rupcy filing as cash collateral—property in which both the
estate and the lender have an interest. These courts have
found that the lender has only a security interest in the rents

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180. See CAL. CIV. CODE § 2938(b), 2938.1(a) (West 1993); KAN. STAT.
ANN. § 58-2343 (Supp. 1992); MD. CODE ANN., REAL PROP. § 3-204 (Supp.
1992); N.C. GEN. STAT. § 47-20(b)-(d) (Supp. 1992); OR. REV. STAT. § 93.806 (Supp. 1992); TENN. CODE

Atrium Dev. Co.), 159 B.R. 464 (Bankr. E.D. Va. 1993); In re Willows of
Coventry, Ltd. Partnership, 154 B.R. 959 (Bankr. N.D. Ind. 1993); In re
Mews Assocs., 144 B.R. 867 (Bankr. W.D. Mo. 1992); Bryn Athyn Invest-
tors, Ltd. v. Hutton/Conam Realty Pension Investors (In re Bryn Athyn
even after activation and that the bankruptcy estate has an ownership interest. The holdings of these courts are based on the respective property interests of the parties under state law as mandated by the Supreme Court in Butner. In Willows, for example, the court found that the assignment of rents was merely a security device under Indiana law and that the lender's exercise of its rights thereunder did not change the character of the assignment. In holding that the assignment of rents created only a security interest even after activation, the court relied on the intent of the parties and the fact that the assignment, by its terms, would become void upon full payment of the mortgage debt. Where a lender is collecting rents pursuant to an activated assignment of rents, the debtor in possession is entitled to a "turnover order" requiring the lender to return any previously collected but unapplied rents and permitting the debtor in possession to collect future rents.

Other courts have held that a lender is the owner of rents covered by an assignment of rents that was activated prior to the filing of the bankruptcy petition. The Northwest Commons case was decided on the basis that a lender "foreclosed" its interest in rents under Missouri law by activating its assignment of rents and therefore owned the rents. The court held that the rents were not property of the estate and therefore could not be cash collateral. Similarly, other courts

183. See Principal Mut., 159 B.R. at 470; Willows, 154 B.R. at 965; Mews Assocs., 144 B.R. at 870; Bryn Athyn Investors, 69 B.R. at 457.
185. 154 B.R. at 965.
186. Id. at 964.
189. Northwest Commons, 136 B.R. at 220.
190. Id.
have found that rents covered by an activated assignment of rents are not property of the bankruptcy estate.\textsuperscript{191}

A similar issue may arise where an assignment of rents is found to be an absolute assignment because an absolute assignment does not require activation.\textsuperscript{192} Most courts addressing the issue in the bankruptcy context have treated an absolute assignment as giving a lender only a security interest in rents.\textsuperscript{193} These courts recognize the continuing interest of the bankruptcy estate in rents covered by an absolute assignment and have held that the rents are cash collateral.\textsuperscript{194} This is a clear advantage to the lender of having an absolute rather than a collateral assignment of rents because the lender does not have to litigate the issue of whether activation has occurred or be concerned about which of the three approaches the court will follow in treatment of an unactivated assignment of rents.\textsuperscript{195}

A few courts have treated an absolute assignment of rents as giving the lender an absolute ownership interest in rents.\textsuperscript{196} These courts have held that because the lender owns

\begin{footnotes}
\footnote{191. See Commerce Bank, 5 F.3d at 39; Century Inv. Fund, 937 F.2d at 375; VIII S. Michigan Assocs., 145 B.R. at 915; Mount Pleasant, 144 B.R. at 737.}
\footnote{192. See supra note 102.}
\footnote{194. See Rollingwood, 133 B.R. at 913; Princeton Overlook, 143 B.R. at 633; Bethesda, 117 B.R. at 211.}
\footnote{195. For a discussion of the other advantages to the lender of the absolute assignment, see supra notes 117-20 and accompanying text.}
\footnote{The Florida legislature recently enacted a statute providing that an assignment of rents "shall be absolute upon the mortgagor's default." FLA.}
the rents absolutely as a matter of state law, the bankruptcy estate has no interest in the rents, and the rents are not cash collateral.¹⁹⁷

Bankruptcy courts holding that either an activated collateral assignment of rents or an absolute assignment of rents gives a lender ownership of rents rather than just a security interest are probably incorrect as a matter of state law. The better reasoned opinions, in holding that the lender has only a security interest in rents under an activated or absolute assignment, discuss factors such as who would be entitled to the rental stream in the event the loan were paid in full.¹⁹⁸ If the borrower has any interest remaining in the rental stream under state law, then bankruptcy law dictates that the rental stream be treated as part of the bankruptcy estate.¹⁹⁹ The fact that the


¹⁹⁷. See Carter, 126 B.R. at 813; Galvin, 120 B.R. at 772; Fry Road Assocs., 64 B.R. at 809; P.M.G. Properties, 55 B.R. at 870. See also In re Salem Plaza Assocs., 135 B.R. 753 (Bankr. S.D.N.Y. 1992) (The court did not find an absolute assignment but said that rent covered by an absolute assignment would not be property of the estate and therefore would not be cash collateral.). This result might at first be appealing to a lender, but there are risks to a lender who is treated as owning rents. See supra notes 122-25 and accompanying text.


lender may have taken possession of the rental stream prior to
the bankruptcy petition is irrelevant if the borrower still has
an interest in it.200 As with the bankruptcy problems associat-
ed with the unactivated collateral assignment of rents, this
issue in bankruptcy is probably the result of the convoluted
nature of the state law treatment of rents as security for the
mortgage loan. Courts are not accustomed to dealing with
inchoate security interests which are made choate by activa-
tion or with absolute assignments which purport to give title to
a lender when they are in fact intended as security.

Where a court finds that rents covered by an activated or
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 he would if rents
were treated as cash collateral. If rents are unavailable for
operation and maintenance of the property, there is almost no
hope of reorganization for a debtor in Chapter 11.201 If the
debtor has no equity in the property and there is not "a rea-
sonable possibility of a successful reorganization within a rea-
sonable time,"202 the lender is entitled to relief from the auto-
matic stay.203 Therefore, the debtor's efforts to reorganize un-
der the protection of Chapter 11 will be frustrated even in
those cases where a reorganization might otherwise have been
successful.204

200. See Whiting Pools, 462 U.S. at 208-09. But see In re Mount Pleas-
201. See Averch, supra note 27, at 519 (citing In re Tripplet, 84 B.R.
84 (Bankr. W.D. Tex. 1988); In re Fry Road Assocs., 66 B.R. 602, 604-05
(Bankr. W.D. Tex. 1986)). In a single asset bankruptcy the borrower will
have no income available to continue operation and maintenance of the
mortgaged property.
204. In at least two cases where a court has treated a lender as the
owner of rents under an activated or absolute assignment of rents, In re
1992); In re Fry Road Assocs., 64 B.R. 808 (Bankr. W.D. Tex. 1986),
there is a later reported decision in which the lender is granted relief
from the stay and permitted to foreclose, Grand Traverse Dev. Co. v.
Board of Trustees (In re Grand Traverse Dev. Co.), 150 B.R. 176 (Bankr.
V. A PROPOSAL

As a means to solve the problems with respect to treatment of rents as security for the mortgage loan both in and outside of bankruptcy, Article 9 of the UCC should be amended to cover rents, treating them in substantially the same manner as accounts. In the remainder of this Article the author will discuss the rationale behind this proposal, the details of the proposal, and its advantages.

A. Rationale for the Proposal

1. Similarity Between Rents and Accounts

"Accounts" are covered by Article 9 and provide a useful analogy to rents. An account is defined under section 9-106 of Article 9 as "any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper, whether or not it has been earned by performance." The right to rent under a real property lease is not an account under this definition, and in fact Article 9 expressly provides that it is not applicable to leases of, or rents from, real estate. However, because the Article 9 definition of

W.D. Mich. 1993); In re Fry Road Assocs., 66 B.R. 602 (Bankr. W.D. Tex. 1986). In Fry Road, one of the reasons given by the court for lifting the stay was the lender's ownership of rents and the borrower's resulting inability to operate and maintain the mortgaged property.


207. Id. § 9-104(j). See also FDIC v. International Property Management, Inc., 929 F.2d 1033, 1035 (5th Cir. 1991); In re Bristol Assocs., 505 F.2d 1056 (3d Cir. 1974); In re Carley Capital Group, 128 B.R. 652, 658 n.6 (Bankr. W.D. Wis. 1991); Hollinrake v. Fed. Land Bank (In re Hollinrake), 93 B.R. 183, 188 (Bankr. S.D. Iowa 1988); First Fed. Sav. v. City Nat'l Bank, 87 B.R. 565, 568 (W.D. Ark. 1988); Rostocki, supra note 28, at 151; Note, supra note 28, at 456-57. "General intangibles" is the catchall category of intangible personal property not otherwise categorized, and if rents were not specifically excluded from Article 9, they would be general intangibles. See U.C.C. § 9-106.
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accounts does include accounts that are to be paid periodically over some fixed period of time, an account can constitute a valuable income stream similar to the right to rent under a lease. In addition, the definition of an account under Article 9 includes not only those rights to payment that have been fully earned by performance, but also rights under an executory contract for goods or services or under a personal property lease where performance has not yet been earned. Those accounts not yet fully earned by performance, which were formerly classified under Article 9 as "contract rights," are the accounts with the most similarity to rents because a real property lease also contains continuing obligations of the landlord.

Although a lease was traditionally treated as a conveyance of land, courts now recognize to a greater extent the contractual nature of a lease. It is the contractual nature of a

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208. An example would be an account resulting from a lease of personal property.
209. U.C.C. § 9-106.
210. The 1972 Amendments to Article 9 eliminated the distinction between accounts, defined as rights to payment already earned by performance, and contract rights, defined as rights to payment not yet earned by performance, because the distinction was unnecessary and created some problems. U.C.C. § 9-106, Official Reasons for 1972 Change, 3 U.L.A. 236 (1992).
211. A similar analogy could be made between real property leases and chattel paper. Chattel paper is defined in Article 9 as "a writing or writings which evidence both a monetary obligation and a security interest in or a lease of specific goods." U.C.C. § 9-106(b). A lender can take an Article 9 security interest in a lease of personal property in addition to the stream of rent created by the lease. Similarly, a mortgage lender can take an assignment of leases of, as well as rents from, mortgaged property.
212. See 2 WILLIAM BLACKSTONE, COMMENTARIES *316; 2 RICHARD R. POWELL, REAL PROPERTY ¶ 221[1][a] (1993). The lease for a term of years first developed at a time when agricultural use of land was predominant and most leases conveyed unimproved property for agricultural purposes. John F. Hicks, THE CONTRACTUAL NATURE OF REAL PROPERTY LEASES, 24 BAYLOR L. REV. 443, 450 (1972). At that time there were rarely structural improvements on the land and, where there were improvements, they were relatively unimportant as compared to the land. Id. The landlord's obligation under the lease was merely to deliver possession, and the tenant, unless ousted from possession, was required to pay rent. Id.
213. See 2 POWELL, supra note 212, ¶ 221[1][a]; Hicks, supra note 212,
lease that makes the right to the payment of rent under a lease so similar to the right to receive payment pursuant to an account. A modern lease is likely to cover improved property and to have a profusion of covenants between landlord and tenant. A landlord may have obligations to provide utilities, maintenance, security, and numerous other services, and the tenant's payment of rent is in exchange for these services as well as for possession of the real property. Despite the profusion of covenants in the modern lease, contract principles are not always applied to leases because of the continued perception of the lease as both conveyance and contract. Nevertheless, Article 9 covers certain types of accounts that are quite similar in nature to the right of a landlord to receive rent under a lease.

2. Treatment of Accounts Under Article 9

Article 9 provides a comprehensive scheme for the treatment of security interests in accounts, which can be compared to the law governing assignments of rents. A security interest in accounts attaches under Article 9 when the debtor has signed

214. Hicks, supra note 212, at 451. In some instances the lease covers nothing but improvements, as would be the case with the lease of space on an upper floor of a multi-story building.

215. Id. at 451-52.

216. Nevertheless, the law has traditionally treated rent as being paid solely for the right of possession because the lease was primarily a conveyance with covenants being merely incidental. Id. at 461. Only a breach by the landlord which is so serious as to constitute an actual or constructive eviction of the tenant or which otherwise goes to the total consideration for the lease excuses the tenant from the obligation to pay rent. Id. at 542. Other covenants breached by the landlord are generally considered independent of the tenant's obligation to pay rent. Id.

217. For example, the doctrine of independent lease covenants still applies to a great extent. See supra note 216. In addition, the requirement that a landlord mitigate damages by trying to relet upon the tenant's abandonment of the premises has been adopted by less than a majority of the states. See Hicks, supra note 212, at 543.

a security agreement, value has been given, and the debtor has rights in the accounts. The security interest is perfected by filing a financing statement in the office of the Secretary of State, and perfection and the effect thereof are governed by the law of the state in which the debtor is located. Part 3 of Article 9 provides the rules for priority of a security interest in accounts as against other interests in the accounts.

With regard to enforcement, Article 9 provides that a secured party with a security interest in accounts is entitled "[w]hen so agreed and in any event on default . . . to notify an account debtor . . . to make payment to him whether or not the assignor was theretofore making collections on the collateral, and also to take control of any proceeds to which he is entitled." Therefore, the only action that a secured party need take in order to begin collecting accounts covered by the security interest is to give notice to the account debtors. The secured party's security interest in amounts previously collected by the debtor is recognized in that the secured party is entitled to take control of identifiable proceeds of the accounts. This can be contrasted with the collateral assignment of rents which requires activation by onerous action in many states and which only extends to those rents collected after the assignment of rents has been activated. Article 9 provides protection for a secured party against a debtor's collection of accounts and application of the proceeds to pay debts unrelated to the business being financed by the secured party. This scenario is comparable to the milking of real property, and the Article 9 approach is preferable to the cumbersome requirements that a mortgage lender must meet prior to collecting rents pursuant to a collateral assignment of rents.

219. Id. § 9-203(1).
220. Id. §§ 9-302, 9-401(1).
221. Id. § 9-103(3)(b).
222. Id. §§ 9-301 - 9-318.
223. Id. § 9-502(1). Article 9 provides other remedies to a secured party with a security interest in accounts. The secured party may sell the accounts in a commercially reasonable manner, id. § 9-504, or may give notice to the debtor that the secured party intends to keep the accounts in full satisfaction of the indebtedness, id. § 9-505.
224. See supra notes 54-57 and accompanying text.
Article 9 applies not only to security interests in accounts but also, with some exceptions, to sales of accounts. Article 9 does, however, distinguish between a security interest in accounts and a true sale of accounts where that distinction is necessary. Section 9-502 gives the secured party the right to notify account debtors to make payments directly to the secured party but requires the secured party to act in a commercially reasonable manner in collecting the accounts. Furthermore, the secured party must account to the debtor for any surplus in funds collected over the amount of the debt, and the debtor is liable for any deficiency where the collection of the accounts by the secured party is based on a security interest. If the underlying transaction is a sale of accounts, however, the secured party has no duty of commercial reasonableness, and the debtor is entitled to surplus or is liable for deficiency only if the agreement between the parties so provides.


226. Id. § 9-102(1)(b). The reason for including sales of accounts within the scope of Article 9 is that "commercial financing on the basis of accounts and chattel paper is often so conducted that the distinction between a security transfer and a sale is blurred." Id. § 9-102 cmt. 2. Article 9 does not apply to sales of accounts as a part of a sale of an entire business, assignments of accounts for the purpose of collection only, transfers of accounts made with an assumption by the assignee of obligations under the related contract, or sales of a single account in whole or partial satisfaction of a preexisting indebtedness. Id. § 9-104(f).

227. Id. § 9-502(2). This section provides:

A secured party who by agreement is entitled to charge back uncollected collateral or otherwise to full or limited recourse against the debtor and who undertakes to collect from the account debtors or obligors must proceed in a commercially reasonable manner and may deduct his reasonable expenses of realization from the collections. If the security agreement secures an indebtedness, the secured party must account to the debtor for any surplus, and unless otherwise agreed, the debtor is liable for any deficiency. But, if the underlying transaction was a sale of accounts or chattel paper, the debtor is entitled to any surplus or is liable for any deficiency only if the security agreement so provides.

Id.

228. Id.

229. Id. Of course, the fact that the debtor is entitled to surplus or
In the context of the Article 9 security interest in accounts, no device similar to the absolute assignment is necessary because the enforcement of the security interest requires only that notice be given to account debtors and because the security interest covers proceeds of the accounts.\textsuperscript{230} A security interest in accounts is treated as a security interest, and a sale of accounts is treated as a sale.\textsuperscript{231} Several courts have discussed factors to be considered in determining whether a transfer of accounts creates a security interest or constitutes a sale of the accounts,\textsuperscript{232} and the issue of whether a transfer of accounts is liable for a deficiency will be evidence tending to show that a security interest rather than a sale was intended. \textit{See In re Evergreen Valley Resort, 23 B.R. 659, 661 (Bankr. D. Me. 1982).}

\textsuperscript{230} U.C.C. § 9-502(1).


\textsuperscript{232} \textit{See} Major's Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538 (3d Cir. 1979); Levin v. City Trust Co. \textit{(In re Joseph Kanner Hat Co.),} 482 F.2d 937, 940-41 (2d Cir. 1973); \textit{Evergreen Valley Resort, 23 B.R. at 661}; Gold Coast Leasing Co. v. California Carrots, Inc., 155 Cal. Rptr. 511, 514-15 (Cal. Ct. App. 1979); \textit{Georgia-Pacific,} 590 P.2d at 664-65. The \textit{Evergreen} court discussed the factors involved in the determination as follows:

Several factors have emerged through court interpretation of [U.C.C. § 9-102] which indicate when an assignment operates to create a security interest only. A security interest is indicated where the assignee retains a right to a deficiency on the debt if the assignment does not provide sufficient funds to satisfy the amount of debt. A security interest is also indicated when the assignee acknowledges that his rights in the assigned property would be extinguished if the debt owed were to be paid through some other source. Likewise, a security interest is indicated if the assignee must account to the assignor for any surplus received from the assignment over the amount of the debt. Evidence that the assignor's debt is not reduced on account of the assignment is also evidence that the assignment is intended as security. Finally, the contract language itself may express the intent that the assignment is for security only. In contrast, assignments have been found to be absolute transfers where the assignment operates to discharge the underlying debt. \textit{Evergreen Valley Resort, 23 B.R. at 661-62 (citations omitted).} In determining whether a transaction is a financing arrangement or a sale, the question for a court "is whether the nature of the recourse, and the true
for security or is a sale seems not to have posed the problems it has in the context of the assignment of rents.

Where the treatment of the assignment of rents is inconsistent among the various states, Article 9 provides a model of consistency since some version of Article 9 has now been adopted in all fifty states. In fact, one purpose of the UCC was to make the law uniform among the various jurisdictions. Another purpose of the UCC was "to simplify, clarify and modernize the law governing commercial transactions." Because the UCC was drafted with the modern commercial transaction in mind, the policies it promotes are likely to be rational in modern times, unlike the law relating to assignments of rents.

3. Bankruptcy Treatment of a Security Interest in Accounts

The bankruptcy treatment of Article 9 security interests in accounts, unlike the bankruptcy treatment of assignments of rents, has been rather straightforward. Amounts collected by a debtor in bankruptcy on accounts covered by a perfected Article 9 security interest have been treated as cash collateral. nature of the transaction, are such that the legal rights and economic consequences of the agreement bear a greater similarity to a financing transaction or to a sale." Major's Furniture Mart, 602 F.2d at 544 (footnote omitted).

233. See supra notes 7-9 and 50-60 and accompanying text.


235. U.C.C. § 1-102(2)(c).

236. Id. at § 1-102(2)(a).

237. See Dewhirst v. Citibank (In re Contractors Equipment Supply Co.), 861 F.2d 241, 245 (9th Cir. 1988); see also In re Park at Dash Point L.P., 121 B.R. 850, 859-60 (Bankr. W.D. Wash. 1990) (comparing treatment of an assignment of rents with treatment of a security interest in accounts in bankruptcy), aff'd sub nom. Steinberg v. CrossLand Mortgage Corp. (In re Park at Dash Point L.P.), 152 B.R. 300 (W.D. Wash. 1991), aff'd, 985 F.2d 1008 (9th Cir. 1993). Perfection of an Article 9 security interest in accounts has caused no confusion. It is accomplished by filing a financing statement in the office of the Secretary of State. U.C.C. §§ 9-302, 9-401(1). The perfected security interest extends to amounts collected by the debtor which are proceeds of the accounts, provided that the proper steps are taken for perfection of the security interest in the cash proceeds and to the extent that a perfected security in-
Where a secured party has notified account debtors to make payments to the secured party prior to the filing of the bankruptcy petition, the issue arises as to whether accounts collected, or to be collected, by the secured party are property of the estate. One court held that amounts collected by the secured party became property of the secured party (and not of the estate) only when the secured party had made an accounting to the debtor as required by section 9-502(2). Amounts accruing after the bankruptcy filing and not yet collected by a secured party are clearly property of the estate and are to be treated as cash collateral. It is only where accounts have actually been sold to a secured party that the bankruptcy estate would have no interest in the accounts accruing after the bankruptcy filing.

4. Similarity Between Rents and Crops

Like accounts, crops are covered by Article 9 and are in some ways analogous to rents. Just as unsevered rents are treated as real property, growing crops have traditionally been considered a part of the real property on which they are growing unless they had been severed. Actual severance occurs in cash proceeds is available. Id. §§ 9-502, 9-306. Since a perfected Article 9 security interest in accounts cannot be avoided by a trustee in bankruptcy under section 544(a) of the Bankruptcy Code, both the debtor and the secured party have an interest in these funds making them cash collateral. 11 U.S.C. § 363(a) (1988).

240. See In re Evergreen Valley Resort, Inc., 23 B.R. 659, 661 (Bankr. D. Me. 1982) ("The estate would have an interest in these funds only if the assignment . . . was intended to be a security transaction as opposed to an absolute transfer.").
241. See In re Bunting, 60 F.2d 605, 607 (E.D. Ill. 1932); Silveira v. Ohm, 201 P.2d 387, 389 (Cal. 1949); Womach v. Thomas, 486 A.2d 15, 17 (Del. Ch. 1984); Bornstein v. Somerson, 341 So. 2d 1043, 1046 (Fla. Dist. Ct. App. 1977); Kroh v. Dobson, 37 N.W.2d 144, 145 (Mich. 1949); Farmers' Bank v. Bradley, 288 S.W. 774, 775 (Mo. 1926). In some states unharvested crops which are fully matured are treated as personal property. See Tolland Co. v. First State Bank, 35 P.2d 867, 869 (Colo. 1934); Goldstein v. Mundon, 210 N.W. 444 (Iowa 1926); Kettering v. Barber, 159 N.W. 133, 134 (S.D. 1916); Willis v. Moore, 59 Tex. 628, 637 (1883).
when crops are harvested,242 and constructive severance occurs when an interest in the crops is reserved in a sale of the land243 or when growing crops are sold or mortgaged separate from the land.244 As with rents, a sale of real property will convey unsevered crops growing on the land unless there has been an express reservation by the seller of the right to the crops.245 Many pre-Code cases and even some modern ones discuss crops and rents together and treat them in the same manner with regard to the rights of a mortgage lender.246

Growing crops are subject to execution as personal property. See Tolland, 35 P.2d at 869; Womach, 486 A.2d at 17; Kroh, 37 N.W.2d at 145; Hayward v. Poindexter, 229 S.W. 256, 258 (Mo. Ct. App. 1921); Langford v. Hudson, 241 S.W. 393, 394 (Tenn. 1922).

242. See Womach, 486 A.2d at 18; Kroh, 37 N.W.2d at 145; Hayward, 229 S.W. at 258; Gulf Stream Realty Co. v. Monte Alto Citrus Ass'n, 253 S.W.2d 933, 936 (Tex. Civ. App. 1952).

243. See Kroh, 37 N.W.2d at 145; Hayward, 229 S.W. at 258; Langford, 241 S.W. at 394.

244. See Tolland, 35 P.2d at 868-69; Bornstein, 341 So. 2d at 1046; Kroh, 37 N.W.2d at 145; Farmers’ Bank, 288 S.W. at 775; Gulf Stream, 253 S.W.2d at 936.

245. See Silveira, 201 P.2d at 389; Womach, 486 A.2d at 17; Kroh, 37 N.W.2d at 145; Hayward, 229 S.W. at 258; Langford, 241 S.W. at 394; Willis, 59 Tex. at 638. This is true whether the conveyance is voluntary or involuntary, as in the case of a foreclosure sale. Womach, 486 A.2d at 17.

246. See, e.g., Federal Land Bank v. Terpstra (In re Porter), 90 B.R. 399, 403 (N.D. Iowa 1988) (discussing pre-Code Iowa law); Hill v. Earthman (In re Hill), 83 B.R. 522, 528 (Bankr. E.D. Tenn. 1988) (Pre-Code Tennessee law “treated rent and crops essentially the same in determining the rights of a creditor with a mortgage on the land.”); Lake County Tr. Co. v. Two Bar B, Inc., 606 N.E.2d 258, 263 (Ill. App. Ct. 1992) (“[T]he mortgagor is entitled to the rents, profits and crops of the mortgaged property as long as he lawfully remains in possession of the premises.”); Farmers’ Bank, 288 S.W. at 775 (“[Mortgagor] has the right to sever growing crops from the ground, or collect rents and profits ... until possession taken or foreclosure under the deed of trust.”); Treetop Apartments Gen. Partnership v. Oyster, 800 S.W.2d 628, 629 (Tex. Ct. App. 1990) (“A purchaser at foreclosure does not acquire title to rents or crops that the landowner has severed from the land prior to the foreclosure.”); Security Mortgage & Trust Co. v. Gill; 27 S.W. 835, 836 (Tex. Civ. App. 1894) (treating rents in the same manner as crops under pre-Code Texas law). Both pre-Code and modern cases hold that crops are covered by a “rents and profits” clause in a mortgage. See, e.g., Bunting,
Growing crops, however, unlike rents, are treated under Article 9 as personal property for purposes of the creation of a security interest in them.\textsuperscript{247}

It is difficult to explain why crops were included within the scope of Article 9 while rents were excluded. Since one means of severing rents is the granting of a security interest in them apart from the real estate,\textsuperscript{248} treating rents as personal property for purposes of the creation of a security interest in them is not novel or extraordinary.\textsuperscript{249} Rents may have been excluded from Article 9 because security interests in rents are usually created in conjunction with a real estate mortgage and thus not in the type of commercial transaction which Article 9 was intended to cover, or the exclusion may have been based more on politics than on reason.\textsuperscript{250}

\begin{itemize}
\item 247. This could be explained on the basis that the creation of a security interest in the crops severs the crops from the real property. \textit{See Northwestern Mut. Life Ins. Co.,} 703 P.2d at 1318. Under this reasoning a lien on crops could still be created and perfected pursuant to real property law, and some courts so hold. \textit{See id.; Anna Nat'l Bank,} 506 N.E.2d at 776; \textit{Landen,} 737 P.2d at 1331. \textit{See also WHITE & SUMMERS, supra note 69, \S\ 24-6. However, other courts and a number of commentators indicate that a security interest in growing crops may be created and perfected only pursuant to Article 9. \textit{See United States v. Newcomb,} 682 F.2d 758, 761 (8th Cir. 1982); \textit{Hill,} 83 B.R. at 528; 2 GILMORE, supra note 67, \S\ 32.5; Peter F. Coogan & Albert L. Clovis, \textit{The Uniform Commercial Code and Real Estate Law: Problems for Both the Real Estate Lawyer and the Chattel Security Lawyer,} 38 IND. L.J. 535, 551-52 (1963); Peter F. Coogan & C. Parkhill Mays, Jr., \textit{Crop Financing and Article 9: A Dialogue with Particular Emphasis on the Problems of Florida Citrus Crop Financing,} 22 U. MIAMI L. REV. 13, 30-31 (1967); John C. Miller, \textit{Farm Collateral Under the UCC: Those Are Some Mighty Tall Silos, Ain't They Fella?}, 2 AGRIC. L.J. 253, 270 (1980).
\item 248. \textit{See supra} note 39 and accompanying text.
\item 249. \textit{See BARKLEY CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE \S 1.08[10][b] (2d ed. 1988) ("[T]he assignment of rentals under a real estate lease may well involve personal property under state decisional law.");} 1 GILMORE, supra note 67, \S\ 10.6 ("No doubt under pre-Code law in most states a real estate \ldots\ lease could be effectively pledged.").
\item 250. 1 GILMORE, supra note 67, \S\ 10.7. Gilmore provides:
\end{itemize}
B. Details of the Proposal

The author's proposal is that rents from real property should be covered by Article 9 and treated essentially the same as accounts. Rents should be defined as a separate category of intangible property because in a few instances a security interest in rents should be treated differently from a security interest in accounts or general intangibles. Article 9 would pro-

Section 9-104 contains a list of "Transactions Excluded from Article." This curiously compiled list defies rational analysis. In part it merely reiterates, negatively, what has already been said, affirmatively, in § 9-102 on Policy and Scope. In part it seeks to exclude transactions which, although they might fall within the broadly stated coverage of § 9-102, are not the sort of "commercial" transactions which the Article is designed to regulate. In part it reflects what might be described as politically inspired concessions by the Code sponsors to interests which, for good or bad or no reasons, did not want transactions in which they were involved covered by a new-fangled statute.

Id. 251. See infra note 254 and accompanying text.

Unfortunately, the semantics of the words "rent" and "account" are not consistent. While an account is a right to payment, the more common understanding of the term "rent" refers to the payment itself rather than the right to the payment. Tiffany discusses the various meanings of the term "rent" as follows:

The word is used in the law in at least four distinct senses, which it is desirable clearly to distinguish. It is in the first place used in a general sense, to describe any and every tribute which may be payable by one on account of an estate in the land, as when we say that rent is usually payable in money, or rent is collectible by distress, or rent must be certain in amount, and, thus used, it applies either to one payment of tribute to be made, one "installment of rent" or to a succession of such payments. . . . In the second place, the word is used specifically to describe a particular payment of tribute, to be made by a tenant of particular land, or a succession of such payments. For instance, we may say that the rent of a tenant of certain land is overdue, meaning thereby that one installment of the rent is overdue or that a number of installments are overdue. And so we speak of an action having been brought for "the rent," meaning thereby an action for one installment or several installments. . . . In the third place, the word is used specifically to describe the right which a particular person or persons may have to a succession of payments by the tenant or tenants of a partic-
vide the general scheme for creation, perfection, operation, and enforcement of a security interest in rents.

As with security interests in accounts, a security interest in rents would attach when the debtor had signed a security agreement, value had been given, and the debtor had obtained rights in the rents. Upon attachment the security interest would be good as between the debtor and the secured party. Unlike the security interest in accounts, perfection of a security interest in rents would be attained by filing a financing statement in the real property records of the county in which the rent-producing property is located because the rental stream would be severed from the real property upon granting

ular piece of land, as when we refer to a man as having a rent or a ground rent, or say that the rent upon (issuing from) a certain piece of land belongs to a named individual. . . . In the fourth place, the word is used to designate sums paid as rent, the proceeds, that is, of the payment of one or more of the periodic installments, as when one speaks of applying the rent in a certain manner, meaning thereby what is received on account of rent.


An assignment of rents is intended to create a security interest in the right to receive payment, and an Article 9 security interest in rents would be a security interest in the right to receive payment; therefore, the term under Article 9 would be used in the third sense discussed by Tiffany. In addition, the proceeds provisions of Article 9 would extend the security interest to the collected payments which are the proceeds of the right to receive payment. To avoid the semantics problem, a term other than "rent" could be used, but the use of the term "rent" would make it clear that a security interest in the right to receive the payment of rents is within the exception to the general rule that after-acquired property of a bankruptcy estate is not subject to a pre-petition lien. See 11 U.S.C. § 552(b) (1988). See also infra notes 271-72.

252. U.C.C. § 9-203(1) (1990). A security interest could attach only to those rents accruing under existing leases since the debtor would not have rights under a lease to be entered into in the future.

The 1962 version of Article 9 specifically provided that a debtor had no rights "in crops until they [were] planted or otherwise [became] growing crops." U.C.C. § 9-204(2)(a) (1962). This provision was eliminated in the 1972 version of Article 9 because it was "unnecessary and in some cases confusing." U.C.C. § 9-204 Official Reasons for 1972 Change, 3 U.L.A. 447 (1992).

of the security interest. Also unlike the security interest in accounts, perfection and the effect thereof would be governed by the law of the state in which the rent producing property is located. Again, because the granting of the security interest would sever the rental stream from the real property, notice of that severance should be given in the state where the real property is located. Once perfected, the security interest in rents would have priority as against other interests in the rents as provided in Part 3 of Article 9. In some cases the priority issues arising with regard to security interests in rents would be analogous to the priority issues arising with regard to security interests in crops.

In most cases the security interest in rents would be taken by a mortgage lender, but it would be possible for a debtor to grant a security interest in rents independent of any mortgage. The creation of a security interest in rents would

254. See Valley Nat'l Bank v. Avco Dev. Co., 480 P.2d 671 (Ariz. Ct. App. 1971) (holding that a sale of rents which severs them from the real estate must be recorded in the real property records). Two of the alternative provisions regarding place of filing of a financing statement covering crops which are growing or to be grown provide for filing in the county where the land is located. U.C.C. § 9-401.

255. U.C.C. §§ 9-301 to 9-318.

256. One priority issue which arises with crops is between the holder of a duly recorded real estate mortgage purporting to cover crops specifically or as “rents and profits” and a secured party with a security agreement covering crops that was perfected after the recordation of the mortgage. There is a split in authority as to which party prevails. Compare United States v. Newcomb, 682 F.2d 758 (8th Cir. 1982) (secured party prevails) with Anna Nat'l Bank v. Prater, 506 N.E.2d 769 (Ill. App. Ct. 1987) (mortgagee prevails). The problem arises because it is unclear whether it is still possible to create and perfect a lien on crops under real estate law. See supra notes 246-47 and accompanying text. A similar priority contest could arise between the holder of a duly recorded mortgage covering rents and a secured party with a security interest in rents but would not cause a problem because any security interest in rents would be perfected by recordation in the real estate records.

Article 9 provides a special priority for a security interest in crops securing a current crop production loan. U.C.C. § 9-312(2). This type of priority provision would not be necessary with regard to rents because there is no “rents” loan analogous to the crop production loan.

257. The Restatement also contemplates the creation of a security interest in rents independent of any lien on the real estate. See RESTATEMENT
sever the rents from the real property just as the creation of a security interest in crops severs the crops from the real estate. A mortgage lender with a security interest in rents would continue to have all of the rights of a mortgagee in the state where the mortgaged property was located. In those states where a lender now has the right to take possession of the mortgaged property upon default, the lender could still take possession of the mortgaged property in addition to exercising its rights pursuant to its security interest in the rents. The lender would have the right to foreclose on the mortgaged property, and upon foreclosure, the lender would have a right to take possession of the property and collect rents as the owner of the property. Article 9 facilitates this result because it provides that where a security agreement covers both real property and personal property, the secured party need only conduct a foreclosure on the real property in order to foreclose on the personal property.

The effect of the Article 9 security interest in rents would be to give the lender the right to reach the rents upon default independently of the lender's rights to possession of the real estate. The lender would simply notify the tenants that they were to begin making payments to the lender pursuant to the security agreement, and rents collected would be applied against the indebtedness. The lender would be required to account to the borrower for any surplus, and the borrower would remain liable to the lender for any deficiency remaining after application of rental income to the debt. The lender would have a duty to act in a commercially reasonable manner in collecting the rents.


258. See supra note 45.
259. U.C.C. § 9-501(4). Therefore, lenders would probably want to create the security interest in rents in the mortgage instrument.
260. See U.C.C. § 9-502(1). The secured party would also have the right to sell the rental stream in a commercially reasonable manner, id. § 9-504, or could give notice to the debtor that the secured party intended to keep the rental stream in full satisfaction of the indebtedness, id. § 9-505.
261. See id. § 9-502(2).
262. See id. Real estate lenders may have some concern about the
The Article 9 scheme would address the arguments made by courts in support of the requirement that a lender take possession of the mortgaged property or some equivalent action in order to activate a security interest in rents.263 First, the requirement that a lender act in a commercially reasonable manner in collecting rents would solve the objection by some courts that a lender might let rents go uncollected unless the lender was required to take possession prior to collection of rents.264 Second, the Article 9 approach to cash proceeds would circumvent the need for imposition of a constructive trust on rents collected by a borrower after default.265 A lender would have access to proceeds of rents to the extent the lender could meet its burden to trace and identify the funds.266

In bankruptcy, rents covered by a perfected Article 9 security interest would be cash collateral regardless of whether the lender had taken steps to enforce its security interest. Because

imposition of a requirement of commercial reasonableness on the collection of rents from tenants. Neither § 9-502 nor the comments relating thereto discuss commercial reasonableness in the context of the collection of accounts. Id. A few cases have addressed the issue. See Manufacturers & Traders Trust Co. v. Pro-Mation, Inc., 497 N.Y.S.2d 541, 542 (N.Y. App. Div. 1985) (holding that secured party's notification of account debtors to remit payments to bank was commercially reasonable); DeLay First Nat'l Bank & Trust Co. v. Jacobson Appliance Co., 243 N.W.2d 745, 761 (Neb. 1976) (holding that bank did not sustain its burden of proof to show commercial reasonableness where record showed bank took possession of debtor's records on accounts, sent two letters on some of them, and took no further action). A secured party should not be required to pursue a judgment against an account debtor (or tenant) in order to satisfy the requirement of commercial reasonableness. See CLARK, supra note 249, ¶ 4.04 at 4-57; 9 WILLIAM D. HAWKLAND ET AL, UNIFORM COMMERCIAL CODE SERIES § 9-502:03 (1991).

263. See supra notes 64-66 and accompanying text.
264. See supra note 64 and accompanying text.
265. See supra notes 65 and 69 and accompanying text. A security interest in accounts is not invalidated by reason of the right of the debtor to collect accounts or to use, commingle, or dispose of the proceeds thereof. U.C.C. § 9-205. Similarly, a security interest in rents would not be invalidated by these rights in the borrower.
266. See U.C.C. §§ 9-306, 9-502(1); WHITE & SUMMERS, supra note 69, § 23-7. Article 9 provides special rules for perfection of a security interest in proceeds where the debtor is in bankruptcy. See U.C.C. § 9-306(4); WHITE & SUMMERS, supra note 69, § 23-7.
Article 9 makes clear the distinction between perfection and enforcement, rents covered by a perfected security interest would be treated as cash collateral even if the lender had not yet enforced its security interest by notifying tenants to pay rents to the lender. If the lender had notified tenants and had begun collecting rents pre-petition, those rents already collected and applied to the debt would not be property of the bankruptcy estate. Rents not yet collected by the lender at the commencement of bankruptcy would be considered cash collateral, and the trustee in bankruptcy or debtor in possession would be entitled to a turnover order requiring tenants to once again make payments to the trustee or debtor. Since rents covered by an Article 9 security interest would be cash collateral, the debtor would not be entitled to use the rents without the consent of the lender or authorization of the court. The court could authorize the debtor to use rents for operation and maintenance of the property, and in many cases the debtor and lender would reach an agreement as to the use of the rents, with the debtor keeping enough funds to pay expenses of the property and the lender receiving the remainder for application against interest accruing on the indebtedness.

Finally, the author's proposal would address several incidental issues arising with respect to security interest in rents. Article 9 provides a method for the determination of the rights of the account debtor when issues arise with regard to defenses to, modification of, or payment under the contract giving rise to the account. It would similarly address these issues with

268. Id. § 363(c)(2).
269. See U.C.C. § 9-318. In the absence of an agreement to the contrary, the assignee of an account is subject to claims and defenses arising from the terms of the contract and any other claim or defense arising before the account debtor receives notice of the assignment. Id. § 9-318(1). A modification of an assigned contract "made in good faith and in accordance with reasonable commercial standards is effective against an assignee." Id. § 9-318(2). "An account debtor is authorized to pay the assignor until the account debtor receives notification [of the assignment] and that payment is to be made to the assignee." Id. § 9-318(3). If the assignee does not provide reasonable proof of the assignment to the account debtor upon request, the account debtor may continue to pay the assignor. Id.
regard to the rights of a tenant.\textsuperscript{270} In addition, courts are currently split on the issue of whether certain types of income from real property are accounts covered by Article 9 or rents.\textsuperscript{271} Because rents as well as accounts would be defined

\textsuperscript{270} In fact, cases of a mortgagor milking rents from mortgaged property were considered in determining that only those modifications "made in good faith and in accordance with reasonable commercial standards" would be effective against an assignee. See 2 GILMORE, supra note 67, §§ 41.9-41.10.

\textsuperscript{271} The classic example of this type of income is room revenues from a hotel, but the issue arises with regard to any income which results from the use of real property pursuant to a license or some other agreement which is not a lease, such as revenue from a parking lot, a boat marina, or a college dormitory. A number of courts have recently held that hotel room revenues are accounts as defined in Article 9. See, e.g., United States v. PS Hotel Corp., 404 F.Supp. 1188 (E.D. Mo. 1975), aff'd per curiam, 527 F.2d 500 (8th Cir. 1975); Super 8 Motels, Inc. v. M. Vickers, Ltd. (\textit{In re} M. Vickers, Ltd.), 111 B.R. 332, 332 (D. Colo. 1990); \textit{In re} Corpus Christi Hotel Partners, Ltd., 133 B.R. 850, 854 (Bankr. S.D. Tex. 1991); Kearney Hotel Partners v. Richardson (\textit{In re} Kearney Hotel Partners), 92 B.R. 95, 102 (Bankr. S.D.N.Y. 1988). A few courts have held that hotel room revenues are rents. See, e.g., \textit{In re} S.F. Drake Hotel Assocs., 131 B.R. 156, 160 (Bankr. N.D. Cal. 1991), aff'd, 147 B.R. 538 (N.D. Cal. 1992).

The uncertainty over classification of hotel room revenues would not seem to be a problem for lenders since a prudent lender could simply take a security interest in both accounts and rents in connection with a loan secured by a hotel. However, a problem does arise when the borrower is in bankruptcy because property acquired by the bankruptcy estate after the commencement of the bankruptcy proceeding is not subject to a pre-petition lien. 11 U.S.C. § 552(a) (1988). If hotel room revenues are classified as accounts, then revenues generated from guests arriving after the filing of the bankruptcy petition may not be subject to a pre-petition security agreement and therefore may not be cash collateral. See \textit{In re} Corpus Christi Hotel Partners, Ltd., 133 B.R. at 857. "Proceeds, product, offspring, rents, or profits" of property covered by a pre-petition security interest are subject to an exception to the lien avoidance mechanism of § 552(a). 11 U.S.C. § 552(b). Therefore, if hotel room revenues are considered rents, profits, or proceeds of mortgaged property, a security interest in room revenues does extend to room revenues generated from hotel guests arriving after the filing of the bankruptcy petition, and these room revenues are cash collateral. See \textit{In re} S.F. Drake Hotel Assocs., 131 B.R. at 160; Mid-City Hotel Assocs. v. Prudential Ins. Co. (\textit{In re} Mid-City Hotel Assocs.), 114 B.R. 634, 641 (Bankr. D. Minn. 1990). For a full discussion of these issues, see Craig A. Averch, \textit{The Heartbreak Hotel
in Article 9, there would be a means for drawing a line between the two.\textsuperscript{272}

C. Advantages of the Proposal

The best solution to the problems under current law with regard to the treatment of rents as security for the mortgage loan is the amendment of Article 9 to encompass rents. A security interest in rents created under Article 9 could be enforced by notice to tenants rather than by onerous actions on the part of the lender such as taking possession of the property or obtaining the appointment of a receiver. This approach would prevent milking of mortgaged properties by borrowers and would provide the maximum assurance of continued operation and maintenance of mortgaged properties.\textsuperscript{273} In addition, a lender's security interest could extend to proceeds of rents if the parties so intended, which would give the lender the right to rents collected by the borrower after default to the extent they could be traced and identified.\textsuperscript{274}

Amendment of Article 9 to cover rents would promote the negotiation of an arm's length bargain between borrower and lender and would eliminate the disadvantage at which current

\begin{quote}

272. Rent might be defined as "any right to payment for possession, use, or occupancy of real property." This definition borrows from the Restatement provision defining rents as "the proceeds payable by a lessee, licensee, or other person for the right to possess, use, or occupy the real property of another." \textit{RESTATEMENT (THIRD) OF PROPERTY-SECURITY (MORTGAGES)} § 4.2(a) (Tentative Draft No. 2, 1992). Like the Restatement definition, the proposed Article 9 definition of rents would include hotel room charges and fees generated by parking facilities. \textit{Id}. § 4.2 cmt. e. See \textit{supra} note 271. A full discussion of whether these types of income from real property should be classified as rents is beyond the scope of this Article.

273. Because of the lender's interest in seeing that the property is properly operated and maintained, the lender would in many cases turn over some of the rents to the borrower for application to costs of operation and maintenance.

274. \textit{See supra} note 266 and accompanying text.
The parties to a commercial loan transaction should have the right to provide contractually for the grant of a security interest in rents to the lender that can be enforced in a reasonable manner and that extends to identifiable proceeds. If the parties did not intend for the lender to be able to enforce its security interest merely by giving notice to tenants, the parties could simply provide in their agreement for more onerous requirements. Mortgage loans involving rental assignments are almost always commercial loans made to persons in the business of operating income-producing real property who do have negotiating power, and the law does not need to provide protection for sophisticated commercial borrowers.

If rents were covered by Article 9, the absolute assignment of rents would no longer be necessary as a security device, and the confusion caused by this device would be eliminated. Where a borrower and lender intended a true sale of the rents in satisfaction of some portion of the indebtedness, they could accomplish that goal, and the factors discussed by the courts with regard to distinguishing a sale of accounts from a security interest in accounts would prove useful in distinguishing a sale of rents from a security interest in rents. A consideration of these factors would make it clear that an assignment of rents made in connection with a mortgage loan is usually for security rather than constituting a sale of the rents. Article 9 promotes a policy of substance over form by treating any transaction intended to create a security interest as a security inter-


276. If borrowers had no negotiating power, then lenders would collect rents at the inception of most loans and control the release of funds to the borrower for operation and maintenance.

277. The borrower in a commercial real estate loan is “sophisticated, with ample access to professionals.” ABA Report on Rents, supra note 275, at 837.

278. See Major’s Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538 (3d Cir. 1979); In re Evergreen Valley Resort, Inc., 23 B.R. 669 (Bankr. D. Me. 1982).
In bankruptcy, the Article 9 approach to rents would protect the interests of both borrower and lender because rents in which a lender had a security interest would be treated as cash collateral regardless of whether the lender had taken any action to begin collecting rents at the time of the commencement of the bankruptcy and regardless of the form of the instrument creating the security interest. The Bankruptcy Code should promote a policy of permitting a borrower to reorganize where reorganization is possible and a policy of preventing delay solely for the sake of delay where a reorganization is not possible. Treating rents as cash collateral rather than as property of either the lender or the estate alone would promote both of these policies. Because the borrower, as debtor in possession, would be entitled to use rents for operation and maintenance of the property, the borrower could reach his goal of reorganization if feasible, but because the borrower could not use rents for other purposes, the lender’s bargained-for security interest in rents would be protected.

Because of the existing body of case law relating to Article 9, a number of issues that would normally arise after a change in the law would have already been addressed, thus decreasing the amount of litigation that might ordinarily accompany a change in the law. In fact, because of the comprehensiveness of the Article 9 scheme for creating a security interest in accounts, there has been relatively little litigation over the types of issues that have arisen with regard to the current law governing assignments of rents.

If Article 9 were amended to encompass rents, the wide variance among the states in treatment of security interests in rents would likely end. The UCC has been universally accepted

279. See U.C.C. § 9-102(1)-(2).
280. See supra notes 144-46 and accompanying text.
281. Because there seems to have been no confusion over the distinction between perfection and enforcement of an Article 9 security interest in accounts, the author could find very few cases addressing the issues of the treatment of proceeds of accounts as cash collateral. In addition, there are relatively few cases addressing the issue of whether a particular transaction is a sale of accounts or the grant of a security interest in them.
in the various states, and amendments to the UCC have been widely accepted. The uniform treatment of rents in the various states would permit lenders to lend money on a nationwide basis in a more efficient manner. Furthermore, the incorporation of rents into Article 9 would make the treatment of rents as security for the mortgage loan more rational since the UCC is intended to facilitate the modern commercial transaction rather than being based on ancient real property concepts.

Finally, incorporation of rents into Article 9 might promote the use of a new type of financing for owners of income-producing properties. Lenders might be willing to provide financing secured only by rents of real property without requiring a mortgage on the property itself if a rational means for obtaining a security interest in rents were available.

There may be other means of achieving the desired results with respect to the creation of a security interest in rents. Amendment of the Bankruptcy Code coupled with either the enactment by state legislatures of ULSIA or the adoption by state courts of the Restatement view as to assignments of rents would produce a result similar to that which would be attained by amendment of Article 9 to cover rents. Amendments to the Bankruptcy Code are likely; however, state legislatures have not been rushing to pass versions of ULSIA, and state statutory changes in the property area, the more widely-adopted statutes have been those statutes dealing with discrete areas of property law. See, e.g., UNIF. CONDOMINIUM ACT, Table of Jurisdictions Wherein Act Has Been Adopted, 7 U.L.A. 150 (Supp. 1993); UNIF. FRAUDULENT TRANSFER ACT, Table of Jurisdictions Wherein Act Has Been Adopted, 7A U.L.A. 170 (Supp. 1993); UNIF. RESI-

282. U.C.C., Table of Jurisdictions Wherein Code Has Been Adopted, 3 U.L.A. 1 (1992). Every state except Vermont has now adopted the 1972 Revision to Article 9. Id.
283. See supra note 7.
284. Of course, a lender with a security interest in rents but not in the real property to which they relate would not be able to take advantage of Bankruptcy Code § 552(b), which provides an exception to the general rule that property acquired by a bankruptcy estate after the commencement of the bankruptcy proceeding is not subject to a pre-petition lien. 11 U.S.C. § 552 (1988). Therefore, rents to be paid under leases entered into after the borrower's commencement of bankruptcy would not be covered by the lender's security interest. See supra notes 142 and 271.
285. See supra notes 173-78 and accompanying text.
286. Although a number of states have passed uniform statutes in the property area, the more widely-adopted statutes have been those statutes dealing with discrete areas of property law. See, e.g., UNIF. CONDOMINIUM ACT, Table of Jurisdictions Wherein Act Has Been Adopted, 7 U.L.A. 150 (Supp. 1993); UNIF. FRAUDULENT TRANSFER ACT, Table of Jurisdictions Wherein Act Has Been Adopted, 7A U.L.A. 170 (Supp. 1993); UNIF. RESI-
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Courts have not always followed the many provisions of the numerous Restatements. Furthermore, neither ULSIA nor the Restatement deals with rents issues in the detail that Article 9 deals with accounts, and no existing body of case law interprets either ULSIA or the new Restatement. For these reasons, amendment of Article 9 to cover rents is the best solution to the problems under current law governing rents as security for the mortgage loan.

D. Report of the PEB Study Group

The study committee appointed by the Permanent Editorial Board for the UCC to recommend revisions to Article 9 did not ultimately recommend that real property rents be included within the scope of Article 9. A minority of the members of the advisory group on real estate-related collateral felt that Article 9 should be amended to encompass rents for many of the same reasons espoused by the author of this Article. A majority of the members of the advisory group was of the opinion, however, that Article 9 should not be so amended, giving as reasons for the recommendation "that such a change would be politically unwise, that such a change would make impossible many otherwise feasible reorganizations, and that it would be unfair to allow the rents to go to a person who does not have responsibility for the maintenance of the real estate."

The arguments advanced against the amendment of Article 9 to include real property rents do not provide sufficient justification for such a position. The suggestion that the amendment would be politically unwise is based on a concern that it "might meet strong opposition from various interest groups and that such opposition might in many states delay the enactment of the entire package of Article 9 amendments." While this is clearly a concern, it should not be the basis for rejecting this

DENTAL LANDLORD AND TENANT ACT, Table of Jurisdictions Wherein Act Has Been Adopted, 7B U.L.A. 43 (Supp. 1993). Neither of the two comprehensive uniform statutes dealing with real property, the Uniform Land Transactions Act or ULSIA, has yet to be adopted by any state.

287. See PEB STUDY GROUP REPORT, supra note 24, at 60-66.
288. Id. app. at 197-213.
289. Id. app. at 154.
290. Id.
amendment with its many advantages. If there were opposition in a given state to the provision, it could be omitted from that state's statute. If there were opposition in a given state to the provision, it could be omitted from that state's statute. In fact, there might not be as much opposition as anticipated based on the experience of Congress in its hearings on amendments to the Bankruptcy Code with similar effect in the bankruptcy arena.

The concern that the amendment would adversely affect otherwise feasible bankruptcy reorganizations is unfounded. If rents were covered by Article 9, bankruptcy courts would not face confusion over the distinction between perfection and enforcement. Rents covered by a perfected security interest would be treated as cash collateral which is available for use by a debtor in possession for operation and maintenance of the property. Incorporation of rents into Article 9 would also eliminate confusion caused by activated and absolute assignments of rents. Even if a lender had enforced its Article 9 security interest by collecting rents, rents collected after a bankruptcy filing would be cash collateral rather than property of the lender. Therefore, the amendment of Article 9 to include rents could actually promote otherwise feasible reorganizations.

The objection of unfairness in allowing rents to be paid to a lender with no obligation to maintain the property is simply not valid. After a borrower's default, the lender with few exceptions has a greater interest in seeing that the property is properly maintained than does the borrower who is facing foreclosure of the property, and the lender will therefore see that

291. State legislatures have not hesitated in the past to make revisions to the official text of the UCC. Uniform Laws Annotated lists variations between each section of the official text of the UCC and the corresponding section adopted by the various jurisdictions under the heading “Action in Adopting Jurisdictions.” See, e.g., 3 U.L.A. 79, 153, 182 (1992).

292. A number of groups support the proposed amendment of the Bankruptcy Code to treat a duly recorded assignment of rents as perfected, and the amendment has no organized opposition. See supra notes 177-78 and accompanying text.

293. See supra notes 143-46 and accompanying text. The probable amendment of the Bankruptcy Code by Congress will produce this result regardless of whether Article 9 is amended to encompass rents. See supra notes 173-78 and accompanying text.

294. See supra note 267 and accompanying text.
funds are available to the borrower for operation and maintenance.\textsuperscript{295} What is unfair is allowing a borrower in default to divert rents to uses other than operation and maintenance of the property.

The arguments made by the majority of the members of the advisory group on real estate-related collateral do not adequately support the majority position. The drafting committee charged with amending Article 9 should consider this Article and the minority position report of the advisory committee before making a determination about Article 9 applicability to rents.

\textbf{VI. CONCLUSION}

The complexity of current law governing assignments of rents leads to confusion and raises serious issues for borrowers, lenders, tenants of mortgaged property, and citizens in general, all of whom are injured by policies which do not adequately protect mortgaged property against waste. Inordinate costs imposed on real estate lenders may make them reluctant to loan money, and a negative impact on lenders' willingness to loan money has serious implications for borrowers as well as for our national economy. The taxpayers will ultimately have to absorb the losses arising under current law on those loans owned by the FDIC and RTC, and the problems caused in bankruptcy by the confusion in the law governing assignments of rents are so serious that Congress may be forced to preempt state law in order to address one or more of the bankruptcy issues.\textsuperscript{296} The drafting committee charged with making revisions to Article 9 should seriously consider amendment of Arti-

\begin{itemize}
\item \textsuperscript{295} See supra notes 70-72 and accompanying text.
\item \textsuperscript{296} Lenders have mobilized to encourage the passage by Congress of amendments to the Bankruptcy Code that would ensure the treatment of rents covered by a recorded but unactivated collateral assignment of rents as cash collateral, see 1991 Senate Subcomm. Hearing, supra note 12, at 88 (statement of Mary Jane Flaherty on behalf of the American Council of Life Insurance), 213 (statement of William L. Norton III on behalf of the American Bankers Association), and borrowers should be similarly concerned about the treatment of rents covered by an absolute or activated assignment of rents as cash collateral of the bankruptcy estate rather than as property of the lender.
\end{itemize}
cle 9 to encompass rents, as recommended by the author, because treatment of rents under Article 9 would provide a solution to problems arising under current law and would provide a uniform and rational approach to rents as security for the mortgage loan.