PROPOSED DRAFT
July 23, 2003

M E M O R A N D U M

From: Edward F. Lowry, Jr., Chair
Study Committee on Mortgagee Access to Rents from Income-Producing Land

To: Committee on Scope and Program

Date:

Re: Study Committee Proposal

The following memorandum contains a proposed draft report, prepared for Edward F. Lowry, Jr. (Chair of the Study Committee on Mortgagee Access to Rents from Income-Producing Land) by the Reporter to the Study Committee, R. Wilson Freyermuth. After the Study Committee has reviewed this report, the Committee will issue its recommendation regarding whether the Conference should appoint a Drafting Committee to prepare a Uniform Mortgagee Access to Rents Act ("Act"). A final draft of this report (reflecting any modifications necessitated by action of the Study Committee) will accompany the Study Committee's recommendation.

I. Introduction and Background

To make sense of modern law surrounding a mortgagee's access to rents as security, it is useful to appreciate the historical development of mortgage law and the mortgagee's right to rents. The mortgage historically operated as an outright conveyance of title to the mortgagee, typically on a condition subsequent.[1] By virtue of this conveyance, the mortgagee received all incidents of legal title — including the right to possession of the land and the right to collect rents from the land — and could exercise these incidents even prior to the mortgagor's default.[2]

Initially, American states adopted this "title" theory of the mortgage, although mortgagees — consistent

[1]If the mortgagor successfully repaid the loan on a timely basis, this triggered the condition subsequent and permitted the mortgagor to re-enter the premises and terminate the mortgagee's estate. 1 Grant A. Nelson & Dale A. Whitman, Real Estate Finance Law § 1.2, at 6 (3d ed. 1994).

[2]Initially, this structure permitted the mortgagee to collect rents and profits from the land as a substitute for interest, which violated ecclesiastical and legal prohibitions on usury. *Id*. at 7.

with the notion that the mortgage was a security device — commonly permitted mortgagors to remain in occupation of mortgaged land prior to default. Under the "title" theory, there was no specific need for the mortgagee to take a separate assignment of rents and leases as security for the mortgage debt, because the right to collect rents remained an incident of the mortgagee's legal estate. Over time, however, the majority of American states adopted the "lien" theory of mortgages, under which the mortgage grants the mortgagee only a right of security, capable of being enforced via foreclosure in the event of the mortgagor's default. Under this "lien" theory, until such enforcement occurs, the mortgage itself does not convey to the mortgagee the right to collect rents accruing from the land.[3]

As the lien theory of mortgages developed into the dominant theory of mortgage law, it became customary that when a lender made a mortgage loan on an income-producing real estate project, the lender would require the borrower not only to execute a mortgage on the project but also an assignment of leases and rents from the project. An assignment of leases and rents can serve a number of practical purposes, but its most significant utility is to provide the mortgagee with a security interest in rents that accrue prior to the time that the mortgagee can complete a foreclosure proceeding. In many states, the foreclosure process can be quite lengthy. In these states, a mortgage lender faces a heightened risk that while a foreclosure proceeding is pending, the borrower may continue to collect project revenues and expend them other than in reduction of the mortgage debt (a process often referred to as "milking" the rents). By taking an assignment of leases and rents, the lender ostensibly makes clear its intention to have a lien upon all future rents produced by the project, including those that accrue during the period between the mortgagor's default and the mortgagee's completion of a foreclosure proceeding. The assignment of rents and leases typically permits the lender to take steps following the borrower's default to collect project rents and apply them to reduce the mortgage debt. These steps may include, *inter alia*, the lender's taking physical possession of the project (becoming a "mortgagee in possession"), obtaining the appointment of a receiver for the project, or notifying tenants to direct all future rent payment to the lender.

As a starting point, state law generally governs the creation and enforcement of security interests in rents. Most frequently, however, disagreements regarding security interests in rents tend to be resolved in the federal bankruptcy courts. Often, the mortgagor/owner of a distressed real estate project will resort to bankruptcy in order to take advantage of the automatic stay afforded to bankrupt debtors. Generally speaking, the filing of a bankruptcy petition stays any creditor action to enforce a claim that arose prior to the bankruptcy petition — including any attempt by a mortgagee to foreclose its mortgage — and requires the administration of creditor claims in a collective proceeding administered by the bankruptcy court. As a result, when the mortgagor/owner of a project files for bankruptcy, a battle often develops over the revenues that the project expects to generate during the bankruptcy case. The mortgagor/owner (often an entity that owns no significant assets other than the project) wants to use postpetition revenues to fund its effort to restructure the mortgage debt and to pay professional fees and expenses. In contrast, the mortgagee holding an assignment of leases and rents wants to be able to apply postpetition revenues to the mortgage debt.

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[3] A few states (including Maryland, New Jersey, Pennsylvania, and Vermont) adopted an "intermediate" theory, under which the mortgagee's right to possession accrues immediately upon default by the mortgagor, even if the mortgagee has not yet instituted or completed foreclosure proceedings. *Id.* § 4.3, at 158 & n.1.

As a general matter, the Bankruptcy Code preserves any security interest acquired prior to bankruptcy that was both valid and enforceable against third party creditors. Thus, for example, if a mortgage was properly executed and recorded prior to bankruptcy, the mortgage lien continues to remain effective against the mortgaged land despite the bankruptcy petition. The Bankruptcy Code, however, generally operates to cut off the enforceability of a prepetition security agreement to the extent that it would otherwise cover after-acquired property. In § 552(a), the Code provides that property received by a debtor after the bankruptcy petition (or "postpetition") is not subject to any prebankruptcy security agreement.[4] Section 552(a) serves an important economic function, as an after-acquired property clause would (if it remained legally effective) serve to prevent the debtor from obtaining the credit necessary to reorganize its business affairs.

If § 552(a) applied to commercial land developments, a mortgagee with a prepetition lien upon project rents would lose that lien with respect to postpetition rents. Congress considered this result inappropriate, however, because rents — even those collected postpetition — are in the nature of a direct economic return upon the land (which was prepetition collateral). Section 552(b) accordingly allows the mortgagee to mortgagee to maintain its lien against postpetition "rents" or "profits" of the mortgaged premises, to the extent provided by the parties' loan documentation.[5] Thus, as a general matter, if the mortgagee has a valid and properly perfected prepetition lien upon both the premises and its rents, § 552(b) permits the mortgagee to retain a lien against postpetition revenues. These postpetition revenues would constitute the mortgagee's "cash collateral" — a designation which significantly limits the bankrupt debtor's ability to expend those revenues and provides the mortgagee with significant leverage in the bankruptcy proceeding.[6]

II. "Problem Areas" of Litigation Regarding Assignments of Rents

Over the past two decades, the proper characterization and treatment of an assignment of leases and rents has produced a significant volume of litigation. While most of this litigation has occurred in the bankruptcy context, some has also occurred in state courts. Many of the issues presented in this litigation are issues for which an Act could provide useful clarification and desirable consistency. As a result, the following portions of this memorandum will discuss each of these issues in turn.

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[4] *Id*. § 552(a).

[5] *Id*. § 552(b).

[6] Section 363(a) of the Bankruptcy Code defines "cash collateral" to include "cash … or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest." 11 U.S.C. § 363(a). This specifically includes the "rents … or profits of property and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a security interest …." *Id*. The bankrupt debtor may not use a creditor's cash collateral unless that creditor consents or unless the court authorizes that use following notice and a hearing, *id*. § 363(c)(2), and then only after providing the creditor with adequate protection of its security interest.

A. "Perfection" of a Security Interest in Rents

Under Bankruptcy Code § 544(a) and its "strong-arm" clause, a debtor-in-possession can invalidate (or, in bankruptcy parlance, "avoid") any security interest that a judgment lien creditor or bona fide purchaser could have avoided under state law as of the petition date. This provision effectively permits a debtor-in-possession to invalidate an unperfected security interest in the debtor's property. For example, if a creditor had taken a security interest in the debtor's inventory but had failed to file an Article 9 financing statement sufficient to perfect that interest, the creditor's unperfected security interest in inventory would be subordinate (under UCC Article 9) to the lien of a creditor who had obtained a judgment lien against that inventory.[7] Upon the debtor's bankruptcy filing, § 544(a) would thus permit the bankrupt debtor-in-possession to exercise the rights of a lien creditor — enabling the debtor to invalidate the creditor's unperfected security interest in the inventory and use the proceeds of that inventory to fund its reorganization effort.

In the 1980s and early 1990s, bankruptcy courts struggled mightily over the impact of § 544(a) upon a mortgagee's right to postpetition rents under an assignment of leases and rents. This struggle arose, in large part, due to confusion generated by the differing terminologies of mortgage law and UCC Article 9 respectively. Under UCC Article 9, a secured party obtains a security interest in collateral by having the debtor execute a security agreement describing that collateral, and "perfects" that security interest by filing an Article 9 financing statement describing the collateral. By "perfecting" its security interest, the Article 9 secured party makes that interest enforceable against subsequent creditors — such as lien creditors (and thus the trustee in bankruptcy). If the secured party has a properly perfected security interest prior to the petition date, it is irrelevant whether the secured party had taken any steps to enforce that security interest prior to bankruptcy. The perfected security interest continues to remain effective against the collateral and the debtor cannot avoid that security interest using its § 544(a) avoidance power.

By contrast, the term "perfection" is not a term that mortgage law customarily used. Instead, real estate law traditionally talked about the notion that recording of an interest in land served to make that interest valid as against subsequent creditors and bona fide purchasers. Analytically, "recording" in this sense is similar to the Article 9 concept of perfection. Thus, one could argue that if a mortgage lender had taken and properly recorded an assignment of leases and rents prior to bankruptcy, that mortgage lender should have a security interest in rents that was enforceable against third parties. Under this analysis, the debtor could not avoid the mortgage lender's security interest in rents under § 544(a), and thus the mortgage lender would retain its interest in postpetition rents under § 552(b). A number of courts in fact adopted this analytical approach, treating postpetition rents as the lender's cash collateral so long as the mortgagee had properly recorded its assignment of rents prior to bankruptcy.[8]

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[7] U.C.C. § 9-317(a)(2) ("A security interest … is subordinate to the rights of … a person that becomes a lien creditor before … the security interest …is perfected.").

[8] In re Millette, 186 F.3d 638 (5th Cir. 1999); Steinberg v. CrossLand Mortgage Corp. (In re Park at Dash Point L.P.), 985 F.2d 1008, 1011 (9th Cir. 1993); Vienna Park Properties v. United Postal Sav. Ass'n (In re Vienna Park Properties), 976 F.2d 106, 112-15 (2d Cir 1992); J.H. Streiker & Co. v. SeSide Co. (In re SeSide Co.), 152 B.R. 878, 884-85 (E.D. Pa. 1993); In

By contrast, however, numerous bankruptcy courts invalidated security interests in postpetition rents where lenders had taken no "affirmative steps" to enforce those interests prior to a bankruptcy petition. To understand these decisions and how they confused "perfection" or "enforceability" with "enforcement," it is necessary to revisit the distinction between the lien and title theory of mortgages. Under the title theory, the mortgagee held "title" to the land (and unaccrued rents) by virtue of the mortgage, even prior to default. By contrast, under the lien theory, a mortgage by itself gave the mortgagee only a security interest in the land rather than "title" — and thus gave the mortgagee no interest in unaccrued rents until such time as the mortgagee completed a foreclosure, became a mortgagee in possession, or obtained the appointment of a receiver for the land.

Of course, if the mortgage is claiming a security interest in rents by virtue of a separate assignment of leases and rents, then the legal constraints on the mortgagee's right to rents ***by virtue of the mortgage itself*** should be irrelevant. Nevertheless, a number of older state court decisions conflated these two situations, holding that even a separate assignment of rents was not effective until the mortgagee took affirmative steps after default to enforce that assignment. The language of the Texas Supreme Court in *Taylor v. Brennan*[9] is perhaps the best demonstration of this analysis:

> Texas follows the lien theory of mortgages. Under this theory the mortgagee is not the owner of the property and is not entitled to its possession, rentals or profits. Thus, it has become a common practice to include in the deed of trust, or in a separate instrument, terms assigning to the mortgagee the mortgagor's interest in all rents falling due after the date of the mortgage as additional security for payment of the mortgage debt.
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> The Texas cases addressing rentals assigned as security have followed the common law rule that an assignment of rentals does not become operative until the mortgagee obtains possession of the property, or impounds the rents, or secures the appointment of a receiver, or takes some other similar action.[10]

Based upon reasoning such as that reflected in *Taylor* and other state court decisions,[11] numerous bankruptcy courts concluded that an assignment of leases and rents created only an "inchoate" lien upon rents that was ineffective against third parties if the mortgagee had not taken affirmative steps prior to bankruptcy to activate that lien. As a result, these bankruptcy courts concluded that where a mortgagee had not taken action sufficient to divest the mortgagor of control over the property and its rents prior to

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re Northport Marina Assocs., 136 B.R. 911, 917-18 (Bankr. E.D.N.Y. 1992); In re White Plains Dev. Corp., 136 B.R. 93, 95 (Bankr. S.D.N.Y. 1992); In re Rancourt, 123 B.R. 143, 147 (Bankr. D.N.H. 1991); In re Somero, 122 B.R. 634, 638-39 (Bankr. D. Me. 1991); In re Raleigh/Spring Forest Apts. 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).

[9]621 S.W.2d 592 (Tex. 1981).

[10]Taylor, 621 S.W.2d at 593-94.

[11]*See, e.g.*, Bevins v. Peoples Bank & Trust Co., 671 P.2d 875, 879 (Alaska 1983), Martinez v. Continental Enters., 730 P.2d 308, 316 (Colo. 1986); Sullivan v. Rosson, 119 N.E. 405 (N.Y. 1918).

bankruptcy — such as by obtaining the appointment of a receiver, taking possession of the land, or notifying tenants to begin paying rents directly to the mortgagee — the mortgagee's security interest in postpetition rents was "unperfected" and was thus subject to avoidance under § 544(a).[12] Under this view, the debtor was able to use postpetition rents free and clear of any claim by the mortgagee while the debtor remained in bankruptcy.[13]

These diverse interpretations of state mortgage law produced substantial nonuniformity in the treatment of security interests in rents, both from state to state and even from district to district within a particular state. This nonuniformity produced significant criticism among academics, real estate practitioners, and commercial mortgage lenders.[14] In response to this criticism, in 1994 Congress amended Bankruptcy

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[12]*See, e.g.*, In re Century Inv. Fund VIII L.P., 937 F.2d 371, 377 (7th Cir. 1991); In re 1301 Conn. Ave. Assocs., 126 B.R. 1, 3 (D.D.C. 1991); First Federal Sav. & Loan Ass'n v. Hunter (In re Sam A. Tisci, Inc.), 133 B.R. 857, 859 (N.D. Ohio 1991); Condor One, Inc. v. Turtle Creek, Ltd. (In re Turtle Creek, Ltd.), 194 B.R. 267, 278 (Bankr. N.D. Ala. 1996); In re Mews Assocs., L.P., 144 B.R. 867, 868-69 (Bankr. W.D. Mo. 1992); Glessner v. Union Nat'l Bank & Trust Co. (In re Glessner), 140 B.R. 556, 562 (Bankr. D. Kan. 1992); Drummond v. Farm Credit Bank of Spokane (In re Kurth Ranch), 110 B.R. 501, 506 (Bankr. D. Mont. 1990); In re Multi-Group III Ltd. Partnership, 99 B.R. 5 (Bankr. D. Ariz. 1989); Armstrong v. United States (In re Neideffer), 96 B.R. 241, 243 (Bankr. D.N.D. 1988); In re TM Carlton House Partners, Ltd., 91 B.R. 349, 355-56 (Bankr. E.D. Pa. 1988); In re Association Ctr. Ltd. Partnership, 87 B.R. 142, 145 (Bankr. W.D. Wash. 1988); In re Prichard Plaza Assocs. Ltd. Partnership, 84 B.R. 289, 293-94 (Bankr. D. Mass. 1988); In re Hamlin's Landing Joint Venture, 77 B.R. 916, 920 (Bankr. M.D. Fla. 1987); Ziegler v. First Nat'l Bank of Volga (In re Ziegler), 65 B.R. 285, 287 (Bankr. D.S.D. 1986); Exchange Nat'l Bank v. Gotta (In re Gotta), 47 B.R. 198, 204 (Bankr. W.D. Wis. 1985).

[13]A few courts took an intermediate position, relying upon a misapplication of Bankruptcy Code § 546(b). 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 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 as 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 law for such seizure or commencement.

11 U.S.C. § 546(b). Several courts concluded that even if the mortgagee had failed to take sufficient steps prior to bankruptcy to activate its assignment of rents, § 546(b) permitted the mortgagee to give the debtor postpetition notice of its intention to enforce its security interest in rents, thereby perfecting the mortgagee's security interest in postpetition rents. *See, e.g.*, In re Casbeer, 793 F.2d 1436, 1443 (5th Cir. 1986); Wolters Village, Ltd. v. Village Properties, Ltd. (In re Village Properties, Ltd.), 723 F.2d 441, 444 (5th Cir. 1986); In re Mears, 88 B.R. 419, 421 (Bankr. S.D. Fla. 1988); In re McCombs Properties VI, Ltd., 88 B.R. 261, 264 (Bankr. C.D. Cal. 1988); In re Gelwicks, 81 B.R. 445, 447-48 (Bankr. N.D. Ill. 1987); FDIC v. Lancaster (In re Sampson), 57 B.R. 304, 307 (Bankr. E.D. Tenn. 1986).

[14]*See, e.g.*, R. Wilson Freyermuth, *The Circus Continues — Security Interests in Rents, Congress, the Bankruptcy Courts, and the "Rents Are Subsumed in the Land" Hypothesis*, 6 J. Bankr. L. & Prac. 115, 118 (1997); Julia Patterson Forrester, *A Uniform and More Rational Approach to Rents as Security for the Mortgage Loan*, 46 Rutgers L. Rev. 349 (1993); Craig H. Averch, *Revisitation of the Fifth Circuit Opinions of* Village Properties *and* Casbeer*: Is Post-Petition "Perfection" of an Assignment of Rents Necessary to Characterize Rental Income as Cash Collateral?*, 93 Com. L.J. 516 (1988); James McCafferty, *The Assignment of Rents in the Crucible of Bankruptcy*, 94 Com. L.J. 433 (1989); Patrick A. Randolph, Jr., *Recognizing Lenders' Rents Interests in Bankruptcy*, 27 Real Prop., Prob. & Trust J. 281 (1992); Glenn R. Schmitt, *The Continuing Confusion Over Real Property Rents as Cash Collateral in Bankruptcy: The Need*

Code § 552(b) in an apparent attempt to provide more uniform treatment of assignments of rents. Prior to 1994, § 552(b) provided that a prepetition security interest in land and rents from that land extended to postpetition rents "to the extent provided by [the] security agreement and by applicable nonbankruptcy law." By focusing upon the term "applicable nonbankruptcy law," many courts (as noted above) concluded that § 552(b) did not permit the mortgagee to claim a security interest in postpetition rents where the mortgagee had failed to take the necessary steps to obtain actual or constructive possession of the land and its rents prior to bankruptcy. In 1994, however, Congress amended § 552(b) to remove this reference to "applicable nonbankruptcy law":

> Except as provided in sections 363, 506(c), 522, 544, 547, and 548 of this title, an notwithstanding section 546(b) of this title, if the debtor and [the secured party] entered into a security agreement before the commencement of the case and if the security agreement extends to property of the debtor acquired before the commencement of the case and to amounts paid as rents of such property …, then such security interest extends to such rents … acquired by the estate after the commencement of the case to the extent provided in such security agreement, except to any extent that the court, after notice and a hearing and based upon the equities of the case, orders otherwise.[15]

Many commentators concluded that the amended § 552(b) established a federal standard for the enforcement of an assignment of rents, thus rendering state rent assignment law irrelevant.[16] Unfortunately, while there is legislative history suggesting that Congress intended to preempt contrary state laws limiting the postpetition effectiveness of an assignment of rents,[17] the text itself provides no express statement of preemptive intent. Further, § 552(b)'s protection for a security interest in postpetition rents is expressly subject to § 544's strong-arm clause — ***which implicitly incorporates underlying state law regarding the enforceability of a security interest versus third parties***. Under § 544(a), there is no question that the debtor-in-possession may avoid a security interest in rents if a bona fide purchaser of the land could have avoided that interest under state law as of the petition date. Thus, if state law ***actually provides*** that a security interest in rents is ineffective against third parties until the mortgagee has taken affirmative action to enforce that security interest, § 544(a) would appear to permit the debtor to avoid the security interest of such a mortgagee — notwithstanding the amendment to § 552(b) — if the mortgagee failed to take such action prior to bankruptcy.

Roughly one-third of the states have enacted statutes making clear that an assignment of rents is perfected and effective against third persons upon its recordation, without regard to whether the mortgagee

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for a Consistent Interpretation, 5 DePaul Bus. L.J. 1 (1992-93).

[15] 11 U.S.C. § 552(b)(2).

[16] *See, e.g.*, 5 Collier on Bankruptcy ¶ 552.03[1], at 552-17 ("[Section 552(b)(2)] does not refer to applicable nonbankruptcy law and is intended to provide a creditor with a valid postpetition interest in rents notwithstanding the creditor's failure to perfect its security interest in rents under applicable state law ….").

[17] 140 Cong. Rec. H10768 (daily ed. Oct. 4, 1994) (statements of Rep. Brooks).

has taken any steps to "activate" or "enforce" that assignment.[18] Not all states have enacted such provisions, however. By codifying the principle that an assignment of rents is perfected and effective against third persons upon its recordation, an Act could provide desirable uniformity in the bankruptcy context, and effectively moot any remaining question about the proper interpretation of Bankruptcy Code § 552(b).

B. "Absolute" Assignments of Rents

As American states gradually abandoned the title theory of mortgages in favor of lien theory, some mortgage lenders began drafting mortgage documentation by which the mortgagor made an "absolute" assignment of rents. By virtue of an "absolute" assignment of rents, the mortgagor purported to transfer "title" to unaccrued rents to the mortgagee/assignee, as of the execution and delivery of the assignment — thereby ostensibly placing the mortgagee in the same legal position as it would have occupied under the title theory of mortgages. Frequently, such an "absolute" assignment will specify that it is "not merely for purposes of security" and that the borrower has no interest in unaccrued rents other than a revocable license (*i.e.*, not a "property" right) to collect such rents prior to default. By obtaining an "absolute" assignment of rents, the mortgagee could argue that its assignment of rents was already "activated" upon execution and delivery — as opposed to an assignment of rents for security purposes, which (as discussed in Part A above) many states treated as an ineffective until enforced post-default.

The characterization of such assignments as "absolute" was pure form over substance. The typical "absolute" assignment of leases and rents was nothing more than a security device, as evidenced by the fact that such assignments typically permitted mortgagors to collect and dispose of rents prior to default (and, correspondingly, did not permit the mortgagee to collect rents prior to default). Nevertheless, some state courts in lien theory jurisdictions did recognize a distinction between "absolute" and "collateral" assignments.[19]

This distinction, though tenuous, became even more critical in the context of bankruptcy. When a debtor files for bankruptcy, all of the property in which the debtor holds an interest becomes property of the bankruptcy estate under Bankruptcy Code § 541(a). The debtor generally may use property of the

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[18]Cal. Civ. Code §§ 2938, 2938.1; Del. Code tit. 25, § 2121; Fla. Stat. Ann. § 697.07; 765 Ill. St. § 5/31.5; Ind. Code Ann. § 32-21-4-2; Kan. Stat. Ann. § 58-2343; La. Rev. Stat. Ann. § 9:4401; Md. Real Prop. Code Ann. § 3-204; Neb. Rev. Stat. § 52-1704; N.C. Gen. Stat. § 47-20(c); Or. Rev. Stat. § 93.806; S.C. Code § 29-3-100; Tenn. Code Ann. § 66-26-116; Va. Code Ann. § 55-220.1; Wash. Rev. Code Ann. § 7-28-230(3); Wis. Stat. Ann. § 708.11.

Both Michigan and New York have statutes addressing assignments of rents, which on their face do not expressly provide that an assignment of rents is "perfected" upon recording. Nevertheless, court decisions have interpreted these statutes to establish that an assignment of rents is perfected upon recording, even without the mortgagee having taken action to enforce the assignment. Mich. Rev. Stat. §§ 554.231, 554.232, interpreted in In re Mt. Pleasant Ltd. Partnership, 144 B.R. 727 (Bankr. W.D. Mich. 1992); N.Y. Real Prop. L. § 294-a, interpreted in In re Financial Ctr. Assocs. of East Meadow, L.P., 140 B.R. 829 (Bankr. E.D.N.Y. 1992).

[19]*See, e.g.*, Taylor v. Brennan, 621 S.W.2d 592 (Tex. 1981); HomeCorp. v. Secor Bank, 659 So.2d 15 (Ala. 1994).

estate in the course of its bankruptcy proceeding, subject to the obligation to provide adequate protection to a secured creditor holding a lien upon that property (assuming that secured creditor requests adequate protection of its lien).[20] Moreover, a secured party holding a security interest in property of the estate is subject to the automatic stay and cannot seek to enforce its lien or otherwise collect the debt outside the context of the bankruptcy proceeding.[21] Thus, a debtor that owns an income-producing real estate project has a significant incentive to argue that the project's postpetition rents constitute property of the estate. By contrast, the mortgagee/assignee would prefer that the law characterize the rents as property that is ***not*** part of the bankruptcy estate. If the project's postpetition rents are not property of the estate, the automatic stay would place no limitation upon the mortgagee's ability to collect those rents and apply them to the debt.[22] Obviously, if a mortgagee had already completed a foreclosure sale prior to the debtor's bankruptcy filing, then the land and unaccrued rents would belong to the foreclosure purchaser and would no longer constitute property of the bankruptcy estate. But if no foreclosure had yet occurred — and thus equitable ownership of the land remains in the debtor — unaccrued postpetition rents would seem to fit squarely within the broad concept "property of the estate" as articulated in § 541(a).

Nevertheless, in an attempt to boost their leverage in context of bankruptcy, mortgage lenders have often argued that where a borrower executed an "absolute" assignment of rents, unaccrued postpetition rents belong to the lender and therefore do not constitute property of the bankruptcy estate. Most commentators have rejected this view — and properly so, given the context of the typical commercial mortgage loan transaction.[23] In the typical transaction, the mortgagor executes an assignment of rents and leases contemporaneously with its execution of the mortgage. The mortgagee does not immediately begin collecting rents from tenants as soon as it takes the mortgage, and further has no intention to do so at any time prior to the mortgagor's default. These circumstances demonstrate clearly that the parties intend for the assignment of rents to secure the mortgagor's obligation to repay the mortgage debt. In other words, the "absolute" assignment is merely a security device, regardless of its "absolute" characterization.

Mortgage law has long established that instruments purporting absolutely to convey an interest in land nevertheless constitute equitable mortgages when the circumstances demonstrate that the parties are using

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[20]11 U.S.C. § 363(b).

[21]11 U.S.C. § 362(a).

[22]Such a characterization would be particularly important in a case where a mortgage loan is undersecured (*i.e.*, where the unpaid balance of the mortgage debt exceeds the value of the land), because of the *Timbers* case, in which the Supreme Court held that an undersecured creditor is not entitled to collect interest upon the debt during the pendency of the bankruptcy case. United Sav. Ass'n of Texas v. Timbers of Inwood Forest, 484 U.S. 365 (1988). If postpetition rents do not constitute property of the estate, then the undersecured lender could collect net postpetition rentals and apply them to reduce the unsecured portion of its claim on a dollar-for-dollar basis, thereby improving its total recovery vis-a-vis the debtor's other unsecured creditors.

[23]*See, e.g.*, Restatement (Third) of Property — Mortgages § 4.2 Reporters' Note ("The use of 'absolute assignment' terminology … creates needless confusion and is rejected ….").

an interest in land to secure payment of a debt.[24] Under this same principle, a court should recharacterize a typical "absolute" assignment of rents as an assignment for security purposes, and the weight of modern judicial authority so provides.[25] Under this view, where the mortgagee has not taken sufficient steps to enforce its security interest prior to bankruptcy, postpetition rents would constitute property of the bankruptcy estate.

Nevertheless, a significant number of court decisions have elevated form over substance and have given literal effect to an "absolute" assignment of rents. These courts have held that where the bankrupt borrower has executed an absolute assignment of rents prior to bankruptcy, postpetition rents do not constitute property of the estate.[26] These decisions exalt form over substance and encourage lenders to draft rent assignments using language that misrepresents those assignments as something other than security devices, in order to obtain preferred treatment in bankruptcy. An Act could promote valuable uniformity by limiting the concept of an "absolute" assignment of rents to the extremely limited situations in which security is not the purpose of the transaction (*i.e.*, where the parties actually intend to transfer full ownership and control of unaccrued rents immediately upon execution of the assignment).

C. Characterization of Project Revenues

For all commercial real estate mortgage loans, real estate law governs the lender's ability to obtain and enforce a security interest in the land itself. In the typical commercial real estate mortgage loan transaction, however, the lender also secures the borrower's obligation by requiring the borrower to grant a security interest in the revenue stream produced by the development. In many commercial real estate developments

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[24]*See, e.g.*, Restatement of Property (Third) — Mortgages § 3.2 (absolute deed intended to secure an obligation constitutes a mortgage); Smith v. Player, 601 So.2d 946 (Ala. 1992) (same); Steckelberg v. Randolph, 404 N.W.2d 144 (Iowa 1987) (same).

This is likewise consistent with UCC Article 9, under which (generally speaking) any transaction that creates an interest in personal property to secure payment or performance of an obligation constitutes a security transaction (and not an outright transfer), ***regardless of its form***. U.C.C. §§ 1-201(37), 9-109(a)(1).

[25]In re Cavros, 262 B.R. 206 (Bankr. D. Conn. 2001); In re 5877 Poplar, L.P., 268 B.R. 140 (Bankr. W.D. Tenn. 2001); National Operating, L.P. v. Mutual Life Ins. Co. of New York, 630 N.W.2d 116 (Wis. 2001); In re Guardian Realty Group, L.L.C., 205 B.R. 1 (Bankr. D.D.C. 1997); In re RV Centennial Partnership, 202 B.R. 774 (Bankr. D. Colo. 1996); In re Lyons, 193 B.R. 637, 644 (Bankr. D. Mass. 1996).

[26]First Fidelity Bank v. Jason Realty, L.P. (In re Jason Realty, L.P.), 59 F.3d 423 (3d Cir.1995); In re Kingsport Ventures, L.P., 251 B.R. 841 (Bankr. E.D. Tenn. 2000); In re Robin Associates, 275 B.R. 218 (Bankr. W.D. Pa. 2001); In re Carretta, 220 B.R. 203 (D.N.J. 1998); In re Turtle Creek, 194 B.R. 267 (Bankr. N.D. Ala. 1996); First Fidelity Bank v. Eleven Hundred Metroplex Assocs., 190 B.R. 510 (S.D.N.Y. 1995); MacArthur Executive Assocs. v. State Farm Ins. Co., 190 B.R. 189 (D.N.J. 1995); In re Carter, 126 B.R. 811 (Bankr. M.D. Fla. 1991); In re Galvin, 120 B.R. 767 (Bankr. D. Vt. 1990); In re Gould, 78 B.R. 590 (D. Idaho 1987); In re Fry Road Assocs., 64 B.R. 808 (Bankr. W.D. Tex. 1986); In re P.M.G. Properties, 55 B.R. 864 (E.D. Mich. 1985). See also NCNB Texas Nat'l Bank v. Sterling Projects, Inc., 789 S.W.2d 358 (Tex. App. 1990) ("The absolute assignment does not create a security interest but instead passes title to the rents. An absolute assignment of rents is not security but is a pro tanto payment of the obligation."); 801 Nolana, Inc. v. RTC Mortgage Trust 1994-S6, 944 S.W.2d 751 (Tex. App. 1997) (same).

(*e.g.*, office buildings, retail shopping centers, apartment complexes), the owner and occupiers of the development stand in a landlord-tenant relationship, based upon the execution of leases covering portions of the development. Because the common law has treated unaccrued rents as an interest in land (an incorporeal hereditament), there is no question that in these cases, the sums paid by tenant occupiers constitute "rent." Thus, a mortgage lender taking a security interest in those "rents" must comply with the provisions of real estate law in order to obtain and enforce that security interest — *i.e.*, the mortgage lender must have the mortgagor execute and deliver an instrument sufficient to convey an interest in "rents" and must record that instrument on the public land records in the county where the land is situated.

In many other developments, however, the developer and the user/occupier of land do not stand in the relationship of landlord and tenant. In many commercial land developments, the user/occupier might be only a licensee. Examples of this type of project include nursing homes,[27] parking garages,[28] golf courses,[29] landfills,[30] marinas,[31] stadiums/arenas,[32] student dormitories,[33] and hotels. Where the development's occupier is a licensee and not a tenant, a significant classification problem arises. Are the development revenues "rents" governed by real estate law (such that the lender would obtain and record an assignment of rents in the land records) or "accounts" governed by UCC Article 9 (such that the lender would obtain a security interest creating a floating lien on accounts and perfect that interest by filing a financing statement covering accounts in the UCC records)?

In theory, of course, a lender could moot the resolution of this characterization question simply by (a) making sure that its loan documents took a security interest in both "rents" and "accounts," and (b) properly recording/filing evidence of those interests in the respective realty/personalty records.[34] This "belt and

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[27]In re Hillside Assocs. Ltd. Partnership, 121 B.R. 23 (Bankr. 9th Cir. 1990); In re Woodstock Assocs. I, Inc., 120 B.R. 436 (Bankr. N.D. Ill. 1990).

[28]In re Ashford Apartments Ltd. Partnership, 132 B.R. 217 (Bankr. D. Mass. 1991).

[29]In re GGVXX, Ltd., 130 B.R. 322 (Bankr. D. Colo. 1991).

[30]In re West Chestnut Realty of Haverford, Inc., 166 B.R. 53 (Bankr. E.D. Pa. 1993).

[31]In re Northport Marina Assocs., 136 B.R. 911 (Bankr. E.D.N.Y. 1992).

[32]In re Zeeway Corp., 71 B.R. 210 (9th Cir. Bankr. 1987).

[33]Cook v. University Plaza, 427 N.E.2d 405 (Ill. App. 1981).

[34]Initially, some lenders that failed to anticipate the characterization issue made hotel mortgage loans based solely upon a mortgage and an assignment of rents, without taking or perfecting a security interest in accounts. Others had mortgages that contained language broad enough to grant a security interest in hotel room revenues, but (considering those revenues to be "rents") failed to file a financing statement covering accounts so as to perfect that security interest. In bankruptcy, courts held that these lenders either had no security interest in postpetition revenues at all, or that any such security interest was unperfected. *See, e.g.*, In re General Associated Investors Ltd. Partnership, 150 B.R. 756, 759-762 (Bankr. D. Ariz. 1993); United States v. PS Hotel Corp., 404 F. Supp. 1188, 1191-92 (E.D. Mo. 1975); *In re* Northview Corp., 130 Bankr. 543, 546-48 (9th Cir. BAP 1991); *In re* Tri-Growth Centre City, Ltd., 133 Bankr. 524, 526 (Bankr. S.D. Cal. 1991); *In re* Corpus Christi Hotel Partners, Ltd., 133 Bankr. 850, 854 (Bankr. S.D. Tex. 1991); *In re*

suspenders" approach would seem to give the lender a perfected security interest in unaccrued project revenues regardless of how a court resolved the characterization question.

Here, however, one must consider the impact of Bankruptcy Code § 552(a). As explained earlier,[35] § 552(a) generally provides that any prepetition security agreement covering after-acquired property does not affect property that the bankruptcy estate acquires postpetition.[36] By itself, § 552(a) would suggest that a lender's security interest in prepetition revenues would not attach to postpetition revenues (which would, in turn, mean that those revenues would not constitute the lender's cash collateral). Congress drew a careful distinction, however, between ***property received by the debtor postpetition*** and ***postpetition proceeds of prepetition collateral***. This distinction is reflected in § 552(b), which provides that a valid and properly perfected prepetition security interest in collateral will attach to any rents, profits, and proceeds of that collateral that are received by the debtor postpetition.[37] The protection accorded to secured creditors by § 552(b) makes the resolution of this "characterization" question crucial for the commercial real estate mortgage lender. If postpetition project revenues are "rents," "profits," or "proceeds" of the land, the lender's security interest attaches to those revenues. If not, then § 552(a) extinguishes the lender's interest in postpetition project revenues.

Most of the bankruptcy cases addressing this characterization question involved hotels and security interests in hotel room revenues. Prior to 1994, a few decisions sensibly treated hotel room revenues as the functional equivalent of tenant rents and concluded that § 552(b)'s protection for "rents" preserved a lender's properly perfected interest in postpetition hotel room revenues.[38] Most courts, however,

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Nendels-Medford Joint Venture, 127 Bankr. 658, 663-68 (Bankr. D. Or. 1991); *In re* Majestic Motel Associates, 131 Bankr. 523, 526 (Bankr. D. Me. 1991); *In re* Shore Haven Motor Inns, Inc., 124 Bankr. 617, 618 (Bankr. S.D. Fla. 1991); *In re* Airport Inn Associates, Ltd., 132 Bankr. 951, 954 (Bankr. D. Colo. 1990); *In re* Sacramento Mansion, Ltd., 117 Bankr. 592, 606 (Bankr. D. Colo. 1990); *In re* Oceanview/Virginia Beach Real Estate Associates, 116 Bankr. 57, 58-59 (Bankr. E.D. Va. 1990); *In re* M. Vickers, Ltd., 111 Bankr. 332, 335-37 (Bankr. D. Colo. 1990); *In re* Investment Hotel Properties, Ltd., 109 Bankr. 990, 993-94 (Bankr. D. Colo. 1990); *In re* Kearney Hotel Partners, 92 Bankr. 95, 98-102 (Bankr. S.D.N.Y. 1988); *In re* Greater Atlantic & Pacific Investor Group, Inc., 88 Bankr. 356, 359 (Bankr. N.D. Okla. 1988); *In re* Ashkenazy Enterprises, Inc., 94 Bankr. 645, 646-47 (Bankr. C.D. Cal. 1986).

[35] *See* supra note 4 and accompanying text.

[36] Congress felt that § 552(a), while perhaps harsh for secured creditors, was needed to advance the policy of assisting debtors to rehabilitate themselves.

[37] Prior to 1994, § 552(b) read as follows:

> [I]f the debtor and [the secured party] entered into a security agreement before the commencement of the case and if the security agreement extends to property of the debtor acquired before the commencement of the case and to *proceeds, products, offspring, rents, or profits of such property*, then such security interest extends to such proceeds, products, 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 nonbankruptcy law….

[38] *See, e.g.*, In re S.F. Drake Hotel Assocs., 131 B.R. 156, 158-61 (Bankr. N.D. Cal. 1991), aff'd, 147 B.R. 538 (N.D. Cal. 1992); In re Mid-City Hotel Assocs., 114 B.R. 634, 638-642 (Bankr. D. Minn. 1990); Travelers Ins. Co. v. First Nat'l

concluded that postpetition hotel room revenues were accounts (personal property) and were neither "rents," "profits," or "proceeds" of the land.[39] These courts typically applied the formalistic reasoning that room revenues could not be "rent" because hotel guests were not "tenants." As a result, many bankruptcy courts routinely invalidated lenders' claimed interests in postpetition hotel revenues.

The formalistic invalidation of a hotel lender's interest in postpetition room revenues was particularly inappropriate, as hotel room revenues are economically identical to the "rents" paid by tenants under apartment, office, or industrial leases.[40] Recognizing this unfairness, Congress amended § 552(b) in 1994 to preserve the lender's interest in postpetition "fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties."[41] This amendment solved the characterization problem with respect to hotels and other "lodging properties." Unfortunately, because it did not address a wide variety of other income-generating projects — such as

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Bank, 621 N.E.2d 209 (Ill. App. 1993); Great-West Life Assur. Co. v. Raintree Inn, 837 P.2d 267 (Colo. App. 1992); Financial Security Assur., Inc. v. Tollman-Hundley Dalton, L.P., 74 F.3d 1120 (11th Cir. 1996); In re Days California Riverside Ltd. Partnership, 27 F.3d 374 (9th Cir. 1994); Matter of T-H New Orleans Ltd. Partnership, 10 F.3d 1099 (5th Cir. 1993); Great-West Life & Annuity Assur. Co. v. Parke Imperial Canton, Ltd., 177 B.R. 843 (N.D. Ohio 1994); In re Bellevue Place Assocs., 173 B.R. 1009 (Bankr. N.D. Ill. 1994).

[39] *See, e.g., In re* Northview Corp., 130 Bankr. 543, 548 (9th Cir. BAP 1991); In re Green Corp., 154 B.R. 819 (Bankr. D. Me. 1993); In re Shore Haven Motor Inn, Inc., 124 B.R. 617 (Bankr. S.D. Fla. 1991); In re Majestic Motel Assocs., 131 B.R. 523 (Bankr. D. Me. 1991); *In re* Corpus Christi Hotel Partners, Ltd., 133 Bankr. 850, 854-55 (Bankr. S.D. Tex. 1991); *In re* Airport Inn Associates, Ltd., 132 Bankr. 951, 960 (Bankr. D. Colo. 1991); *In re* Sacramento Mansion, Ltd., 117 Bankr. 592, 602-07 (Bankr. D. Colo. 1990); *In re* Investment Hotel Properties, Ltd., 109 Bankr. 990, 994-97 (Bankr. D. Colo. 1990).

[40] *See, e.g.*, R. Wilson Freyermuth, *Of Hotel Revenues, Rents, and Formalism in the Bankruptcy Courts: Implications for Reforming Commercial Real Estate Finance*, 40 UCLA L. Rev. 1461 (1993); R. Wilson Freyermuth, *The Circus Continues — Security Interests in Rents, Congress, the Bankruptcy Courts, and the "Rents Are Subsumed in the Land" Hypothesis*, 6 J. Bankr. L. & Prac. 115 (1997).

[41] 11 U.S.C. § 552(b)(2).

golf courses,[42] parking garages,[43] marinas,[44] landfills,[45] and stadiums or arenas[46] — § 552(b) did not provide a complete solution to the characterization dilemma.

The Restatement (Third) of Property — Mortgages attempted to provide some useful guidance by defining "rents" functionally as "the proceeds payable by a lessee, licensee, or other person for the right to possess, use, or occupy the real property of another."[47] This definition still leaves residual uncertainty, as it implicitly bases the proper characterization of project revenues upon the characteristics of the project itself. For example, the comments to the Restatement suggest that revenues from parking garage would constitute "rents,"[48] but that gate receipts from a racetrack would not constitute "rents."[49] This distinction appears to place the burden on courts to make case-by-case judgments about the extent to which project revenues are traceable to the "land" as opposed to "services" provided by the operator.[50] Furthermore,

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[42]Most courts have concluded that greens fees do not constitute "rents," "profits," or "proceeds" of the land entitled to protection under § 552(b). *See, e.g.*, In re McKim, 217 B.R. 97 (Bankr. D.R.I. 1998); In re Everett Home Town Ltd. Partnership, 146 B.R. 453 (Bankr. D. Ariz. 1992); In re McCann, 140 B.R. 926 (Bankr. D. Mass. 1992); In re GGVXX, Ltd., 130 B.R. 322 (Bankr. D. Colo. 1991)

[43]In re Ashford Apartments Ltd. Partnership, 132 B.R. 217 (Bankr. D. Mass. 1991) (parking fees in nature of "rents").

[44]*Compare* In re Northport Marina Assocs., 136 B.R. 911 (Bankr. E.D.N.Y. 1992) (fees paid by marina users for assigned slip for periods of six months or more were in nature of "rents," while fees paid by transitory users were "accounts") *with* In re Harbour Pointe Ltd. Partnership, 132 B.R. 501 (Bankr. D.D.C. 1991) (fees generated by marina treated as "rents") and Matter of Hamlin's Landing Joint Venture, 77 B.R. 916 (Bankr. M.D. Fla. 1987) (same).

[45]In re West Chestnut Realty of Haverford, Inc., 166 B.R. 53 (Bankr. E.D. Pa. 1993), aff'd, 173 B.R. 322 (E.D. Pa. 1994).

[46]*See, e.g.*, Klingner v. Pocono International Raceway, Inc., 433 A.2d 1357 (Pa. Super. 1981); In re Zeeway Corp., 71 B.R. 210 (9th Cir. Bankr. 1987).

[47]Restatement (Third) of Property — Mortgages § 4.2(a) (1996).

[48]"Because receipts from parking patrons primarily represent fees paid for the right to park motor vehicles on Mortgagor's real estate, they constitute rents and Mortgagee has the right to collect them until the mortgage obligation is satisfied." *Id*. § 4.2 comment f, illustration 10.

[49]"Because the gate receipts are derived primarily from the entertainment provided to race track customers, they do not constitute rents and Mortgagee has no right to collect them." *Id*. § 4.2 comment f, illustration 9.

[50]Courts would face significant practical obstacles in making such allocations. First, "requiring a land/services allocation would require parties to compile and analyze historical information concerning the developer's capital and operational costs in order to allocate revenue into its rent/nonrent components." R. Wilson Freyermuth, Of Hotel Revenues, Rents, and Formalism in the Bankruptcy Courts: Implications for Reforming Commercial Real Estate Finance, 40 UCLA L. Rev. 1461, 1520 (1993). Second, "the extent to which different occupiers are concerned about 'mere occupation of space' as opposed to 'personal services' is a function of each occupier's respective preferences," which may differ from user to user. *Id*. Third, "requiring an allocation would be artificial given the contractual behavior of owners and occupiers of commercial real estate … [who] typically do not separate the occupier's payment obligation into a 'use' component and a 'services' component." *Id*. at 1521.

these judgments have significant implications for the scope of Article 9, as a determination that any particular receivable constitutes "rent" in the nature of realty excludes any security interest in that receivable from the coverage of Article 9.[51] By establishing a clear principle by which parties and courts may correctly characterize project revenues as realty or personalty, an Act could provide valuable certainty to parties involved in the financing of such projects and provide valuable clarity regarding the boundaries between mortgage law and Article 9.

D. Standards for the Appointment of a Receiver

Mortgagees often seek to enforce an assignment of leases and rents by seeking the appointment of a receiver for the land pending foreclosure of the mortgage. There are several reasons why mortgagees often prefer a receivership. First, as discussed in Part IIA above, many courts have concluded that obtaining a receiver is one of the steps by which a mortgagee can unmistakably perfect or activate a collateral assignment of leases and rents.[52] Second, by obtaining a receiver, a mortgagee can enforce its assignment of leases and rents without incurring the potential legal responsibility associated with becoming a "mortgagee in possession."[53] Third, because appointment of a receiver typically requires a court order, any uncertainties over the receiver's authority can be resolved either by reference to the state statute authorizing the appointment of a receiver or to the court order appointing that receiver.

While courts have always exercised equitable authority to appoint receivers of property in appropriate cases, many court decisions have concluded that a mortgagee cannot obtain the appointment of a receiver if the mortgagee's security is adequate (*i.e.*, if the value of the mortgaged land exceeds the debt) and the land is not subject to existing or threatened waste.[54] Other court decisions go even further and require a showing that the mortgagor is insolvent.[55] Many states have enacted statutes that establish both the circumstances under which a court may appoint a receiver of mortgaged property and the scope of the receiver's powers. Not surprisingly, there is significant variation among these statutes. In some states,

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[51]*See* U.C.C. § 9-109(c)(11) ("[Article 9] does not apply to … the creation or transfer of an interest in or lien on real property, including a lease or rents thereunder ….").

[52]*See supra* notes 11-12 and accompanying text.

[53]This responsibility includes potential personal liability in tort for injuries resulting from the mortgagee's operation of the land and by reason of the mortgagee's failure to perform duties imposed by law upon landowners. *See, e.g.*, Grant A. Nelson & Dale A. Whitman, Real Estate Finance Law § 4.26, at 219 (3d ed. 1994). This responsibility also includes a strict duty to account to the mortgagor for rents collected from the land and a duty to use reasonable efforts to preserve and maintain the land so as to avoid injury or diminution of its value. *Id*. § 4.28, at 223; *id*. § 4.29, at 225.

[54]*See, e.g.*, Dart v. Western Sav. & Loan Ass'n, 438 P.2d 407 (Ariz. 1968); Atco Constr. & Dev. Corp. v. Beneficial Sav. Bank, 523 So.2d 747 (Fla. App. 1988); Societe Generale v. Charles & Co. Acquisition, Inc. 597 N.Y.S.2d 1004 (App. Div. 1993).

[55]*See, e.g.*, Mutual Benefit Life Ins. Co. v. Frantz Klodt & Son, Inc., 237 N.W.2d 350 (Minn. 1975); Chase Manhattan Bank v. Turabo Shopping Center, Inc., 683 F.2d 25 (1st Cir. 1982). *But see* Travelers Ins. Co. v. Tritsch, 438 N.W.2d 863 (Iowa App. 1989) (insolvency not required if mortgage specifically assigned rents as security).

statutes require a showing that the land is threatened with waste or comparable injury[56] and/or that the land's value does not provide sufficient security for the debt.[57] Statutes in other states, however, appear to authorize the appointment of a receiver without regard to the adequacy of the mortgagee's security or the mortgagor's solvency.[58] Finally, a significant number of states have no specific statutory provisions governing the appointment of receivers (either generally or for mortgaged land in particular), leaving the development of standards to equitable judicial determination.

Finally, there is significant state-to-state variation regarding whether the parties may circumvent any equitable or statutory limitations upon the appointment of a receiver by contractual stipulation. Assignments of leases and rents commonly contain a clause whereby the mortgagor/assignor consents in advance to the appointment of a receiver (often on an *ex parte* basis) following default. In some states, statutes and/or court decisions have validated receivership clauses as a matter of law.[59] Courts in other states give receivership clauses evidentiary weight but do not make them determinative.[60] In other states, however,

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[56]Ga. Code Ann. § 9-8-3 ("manifest danger of loss, destruction, or material injury" regarding assets charged with payment of debt); Iowa Code § 680.1 (loss or material injury to property or its rents and profits); Kan. Stat. Ann. § 60-1304 (immediate or irreparable injury likely to result absent appointment); Ky. Rev. Stat. Ann. §§ 381.420 (waste or threat of waste), 425.600 (loss or material injury to property); Mich. Rev. Stat. Ann. § 600.2927 (receiver may be appointed to correct/prevent waste in form of nonpayment of taxes/insurance); S.C. Code § 15-65-10 (loss or material injury to property or its rents and profits); Wis. Stat. Ann. § 813.16(1) (loss or material injury to property or its rents and profits)

[57]Ark. Rev. Stat. § 16-117-208 (threat of material injury to land or mortgage default plus probable inadequacy of security); Cal. Code Civ. Proc. § 564 (threat of material injury to land or mortgage default plus probable inadequacy of security); Colo. Rev. Stat. § 38-38-601 (inadequate security or threat of injury that could render security inadequate); Idaho Code §§ 8-601, 8-601(A) (inadequate security or threat of injury/loss to property or its income); Mont. Code § 27-20-102 (threat of material injury to land or mortgage default plus probable inadequacy of security); Neb. Rev. Stat. § 25-1081 (threat of material injury or probable inadequacy of security); Nev. Rev. Stat. § 32.010 (threat of material injury to land or mortgage default plus probable inadequacy of security); N.D. Cent. Code § 32-10-01 (threat of material injury to land or mortgage default plus probable inadequacy of security); Ohio Rev. Code Ann. § 2735.01 (threat of material injury to land or mortgage default plus probable inadequacy of security); Tex. Civ. Prac. & Rem. Code § 64.001 (threat of material injury to land or mortgage default plus probable inadequacy of security); Ut. R. Civ. Proc. 66 (threat of material injury to land or mortgage default plus probable inadequacy of security); Wyo. Stat. § 1-33-101 (threat of material injury to land or mortgage default plus probable inadequacy of security).

[58]*See, e.g.*, Ariz. Rev. Stat. § 33-702 (court may appoint without regard to adequacy of security); Wash. Rev. Stat. Ann. § 7.60.020 (perfected assignment of rents sufficient to justify appointment); Minn. Stat. Ann. § 559.17(2) (court may appoint without regard to adequacy of security where agreement so provides).

[59]Ill. Rev. Stat. ch. 735, § 5/15-1702(a); Ind. Code § 32-30-5-1(4)(C); Minn Stat. Ann. § 559.17(2) (mortgages of $100,000 or more); N.Y. Real Prop. Law § 254(10); Okla. Stat. Ann. tit. 12, § 1551(2)(c); Bank of America Nat'l Trust & Sav. Ass'n v. Denver Hotel Ass'n Ltd. Partnership, 830 P.2d 1138 (Colo. App. 1992); Fleet Bank of Maine v. Zimelman, 575 A.2d 731 (Me. 1990); Metropolitan Life Ins. Co. v. Liberty Center Venture, 650 A.2d 887 (Pa. Super. 1994); Federal Home Loan Mtg. Corp. v. Nazar, 100 B.R. 555 (D. Kan. 1989).

[60]*See, e.g.*, Barclays Bank of California v. Superior Court, 137 Cal. Rptr. 743 (App. 1977); Riverside Properties v. Teachers Ins. & Annuity Ass'n, 590 S.W.2d 736 (Tex. App. 1979); Wellman Sav. Bank v. Roth, 432 N.W.2d 697 (Iowa App. 1988).

courts have refused to enforce such clauses as contrary to public policy.[61]

By clarifying both the circumstances under which the mortgagee can obtain the appointment of a receiver and the impact of a receivership clause, an Act could provide desirable uniformity in the enforcement of security interests in rents.

E. Are Rents "Separate" Collateral or "Subsumed Within the Land"?

If a mortgage lender has a security interest in postpetition rents, then the Bankruptcy Code prevents a bankrupt mortgagor from using those rents over the creditor's objection unless the bankrupt mortgagor can provide the mortgagee with "adequate protection" of its interest in the collateral[62] or the bankruptcy court concludes that the "equities of the case" otherwise justify such use.[63] Thus, when the owner of a commercial land development seeks bankruptcy protection, its mortgagee typically files an immediate motion seeking to prohibit the debtor's use of rents or to require sequestration of the rents in a separate account subject to the court's control. The mortgagee argues that its assignment of leases and rents creates a separate security interest in the rents (*i.e.*, separate from its underlying lien against the land itself). To the extent this is correct, this argument would have significant consequences for the debtor's prospects in reorganization. First, the mortgagee's total secured position (the value of the land plus accrued postpetition rents) could increase over time during the pendency of bankruptcy as postpetition rents accrue. This could benefit an undersecured mortgagee by reducing (and perhaps eventually eliminating) the undersecured portion of the mortgagee's claim over time. Likewise, it would increase the amount that the debtor would have to devote to satisfying the mortgagee's claim in its plan of reorganization. Second, if "rents" constitute a separate source of collateral, the Bankruptcy Code's adequate protection standards may make it extremely difficult for the debtor to use accrued postpetition rents to fund its reorganization efforts and expenses.[64] As a result, characterizing postpetition rents as "separate" collateral provides the mortgagee

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[61]*See, e.g.*, Dart v. Western Sav. & Loan Ass'n, 438 P.2d 407 (Ariz. 1968); Chromy v. Midwest Fed. Sav. & Loan Ass'n, 546 So.2d 1172 (Fla. App. 1989); Barclays Bank, P.L.C. v. Davidson Ave. Assocs., Ltd., 644 A.2d 685 (N.J. Super. 1994).

[62]For noncash collateral, a secured creditor must file a motion with the bankruptcy court seeking adequate protection of its interest in order to condition or prohibit the debtor's use of the collateral. 11 U.S.C. §§ 363(c)(1), 363(e). For cash collateral (including rents), the burden shifts to the debtor to obtain either the secured party's consent or the bankruptcy court's approval for such use in advance. *Id.* § 363(c)(2).

[63]Under Bankruptcy Code § 552(b)(2), the bankruptcy court retains the authority to limit a lender's security interest in postpetition rents, after notice and a hearing, based upon the "equities of the case."

[64]11 U.S.C. §§ 363(c)(2), 363(e) (debtor cannot use cash collateral without consent of secured party or court approval; court must prohibit/condition use of cash collateral as necessary in order to adequately protect secured party's interest). Bankruptcy Code § 361 provides that adequate protection can take the form of cash payments, a replacement lien upon other collateral (to compensate for the depreciation/exhaustion of the collateral being used), or any other form of relief that provides the creditor with the "indubitable equivalent" of its interest in the collateral. If the secured creditor's claim is oversecured (*i.e.*, if the value of the land exceeds the balance of the debt), then this equity cushion may provide adequate protection for the use of postpetition rents. *See* David G. Epstein, Steve H. Nickles & James J.

with significant leverage in the attempted reorganization of distressed real estate projects.

While most court decisions have treated postpetition rents as a separate and distinct source of collateral, some bankruptcy court decisions have instead concluded that postpetition rents do not constitute separate collateral because the postpetition rent stream is in fact subsumed within the valuation of the land itself.[65] These courts have thus concluded that a debtor need not provide adequate protection of a mortgage lender's security interest in postpetition rents as long as the mortgage lender's interest in the project is adequately protected. In other words, these courts have effectively disencumbered postpetition rents so long as it appeared that the value of the mortgaged premises itself was not declining — even if the mortgage itself was undersecured.

Most representative of this position is the decision of the United States Bankruptcy Court for the District of Massachusetts in *In re Mullen*.[66] The debtor in *Mullen* owned several projects (aggregate value = $2.84 million) subject to mortgages and assignments of rents in favor of BayBank securing a total debt of $3.5 million. BayBank sought relief from the automatic stay to foreclose the mortgages, argued that its security interest in the rents was not adequately protected, and moved for an order requiring the debtor to turn over or segregate net rentals. The bankruptcy court denied BayBank's motion, tying together the rents and the projects. The court held that because the value of the projects themselves was not declining, then BayBank's security interest in the rents was by definition adequately protected — even if the debtor consumed a month's worth of net postpetition rents without a corresponding reduction in the mortgage debt. The court explained as follows:

> BayBank says that the value of its interest in the Debtor's property declines each time the Debtor consumes a month's rent in its operations. That is not so. Although BayBank loses its security interest in each month's rents as the rents are consumed, BayBank retains its security interest in all future rents. The value of that stream of future rents is not declining. The lien on each month's rents replaces the lien on the prior month's rents, so there is a replacement lien of equal value, within the meaning of section 361.[67]

To bolster its conclusion, the *Mullen* court drew an analogy between rents and the proceeds of receivables and inventory. The court argued that as contrasted with other cash collateral like a certificate of deposit — which would not be automatically replaced if consumed by the debtor — "[r]ents and receivable

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White, Bankruptcy § 3-27, at 147 (1993). In many cases, however — particularly single-asset real estate cases where the debtor has no source of cash flow other than project rents — the adequate protection standard will be insurmountable where the mortgage is undersecured.

[65] *See, e.g.*, In re Wrecclesham Grange, Inc., 221 B.R. 978 (Bankr. M.D. Fla. 1997); In re Embassy Properties N. Ltd. Partnership, 196 B.R. 172 (Bankr. D. Kan. 1996); In re Citicorp Park Assocs., 180 B.R. 15 (Bankr. D. Me. 1995); In re Barkley 3A Investors, Ltd., 175 B.R. 755 (Bankr. D. Kan. 1994); In re Mullen, 172 B.R. 473 (Bankr. D. Mass. 1994).

[66] 172 B.R. 473 (Bankr. D. Mass. 1994).

[67] *Mullen*, 172 B.R. at 476.

proceeds … constantly renew themselves."[68] *Mullen* thus concluded that "so long as the debtor is not operating at a loss, or rents are not declining, the renewals provide constant value" and that BayBank's security interest was thus adequately protected.[69] To the *Mullen* court, this conclusion — the "rents are subsumed in the land" hypothesis — followed logically from the premises implicit in valuation of commercial real estate:

> The value of the Debtor's properties is … based upon their rental incomes. As a result, so too is the value of BayBank's mortgage interest. It is thus impossible to arrive at a value of BayBank's interest in rents which is independent of the value of its mortgage interest. The value of that mortgage interest is not declining because rents are not declining. Consumption of those rents in the Debtor's real estate operations has no adverse effect upon the mortgage value.[70]

While *Mullen* and other court decisions disencumbering postpetition rentals are correct to suggest that the valuation of a commercial real estate project based upon an income approach implicitly "subsumes" unaccrued rents, this observation does not justify a conclusion that a security interest in rents is effectively "subsumed" within an adequately protected mortgage. Certainly, a foreclosure sale purchaser — who has no claim against rents already accrued — would establish its bid based upon the project's expected stream of unaccrued rents. But as explained in Part I, the very purpose of the assignment of rents is to provide the mortgagee/assignee with a claim against rents that accrue prior to foreclosure (or, in the bankruptcy context, during the pendency of the bankruptcy proceeding while the mortgagee remains subject to the automatic stay). As other courts have correctly recognized, this accumulation of revenues would not be factored into a valuation of the property itself.[71] Second, the *Mullen* court's conclusion fails to take account of the impact of the Supreme Court's *Timbers* decision, which concluded that the debtor's obligation to provide "adequate protection" of a secured creditor's mortgage did not obligate the debtor

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[68] *Id*. at 478.

[69] *Id*. at 478, 481.

[70] *Id*. at 478.

[71] As Judge Leif Clark has observed:

> The way appraisers value real property further supports [the observation that an assignment of rents confers rights that have discrete value apart from the mortgage].… [There are] three general approaches appraisers use to value real property (income, comparable sales, and replacement cost). No one approach by itself yields the true value of the property. Income-producing property is not merely worth the present value of a net income stream. Current real estate market conditions and the cost of construction also must be taken into account.…
>
> What appraisers are valuing (or predicting) is what someone would be willing to pay to own the property and enjoy its fruits. The income approach measures the ability of the property to produce a return on investment (via an income stream) that would justify a buyer's paying the indicated market value to own the property. The right to specific rents prior to ownership of the property, conferred by an assignment of rents, is *a priori* not calculated into this value.

In re Landing Assocs., Ltd., 122 B.R. 288, 296-97 (Bankr. W.D. Tex. 1990).

to pay interest on the debt during the pendency of the bankruptcy case. To the extent that *Timbers* creates a "gap" between the value of the claim evidenced by the mortgage debt and the value of the mortgaged premises,[72] an assignment of rents effectively helps to close that gap by providing the mortgagee with recourse to rents that accrue during the pendency of bankruptcy (while the mortgagee remains subject to the automatic stay). Finally, the *Mullen* court's rationale fails to account for the fact that rents from commercial real estate projects do not "constantly renew themselves" as a matter of nature. A commercial real estate development is a capital asset with a limited economic life. As a project ages, functional and economic obsolescence diminish its revenue-generating capacity, and it will not continue to generate returns consistent with historical expectations (*i.e.*, rents that "constantly renew themselves") absent a new capital investment to infuse the project with a new productive capacity. In this regard, some portion of project rents reflects the proceeds of the exhaustion of the development's productive capacity over time.

By clearly articulating the notion that an assignment of rents creates a security interest that is separate and distinct from the interest created by the mortgage itself, an Act could help to clarify the nature of a mortgage lender's interests as created by state law — and improve the likelihood that these state law interests are respected by federal bankruptcy courts.

III. Other Issues Suitable for Treatment by an Act

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[72]The impact of *Timbers* compromises the *Mullen* court's observation that the value of BayBank's mortgages followed inexorably from the value of the projects' rental streams. Because BayBank's mortgages were undersecured — and because BayBank accordingly could not collect interest on the debt during the pendency of bankruptcy — one would have to discount the value of BayBank's mortgages (*i.e.*, discount it from the fair market value of the mortgaged parcels) in order to account for the expected time period during which the debtor would remain in bankruptcy (and during which the purchaser would not be collecting interest on the debt). In other words, a buyer purchasing BayBank's mortgages would pay less to acquire those mortgages than it would have paid to acquire the mortgaged parcels themselves (and the future rent streams). For an undersecured mortgagee in bankruptcy — thanks to *Timbers* — the economic value of its claim based upon the mortgage debt must of necessity be less than the economic value of the mortgaged parcel.

As a result, an assignment of rents plainly offers a source of collateral that is separate and distinct from that offered by the mortgage itself. The very purpose of the assignment of rents is to provide the mortgagee/assignee with security in rents accruing prior to the mortgagee's foreclosure (and potential acquisition of project ownership). To the extent that *Timbers* creates a "gap" between the value of the claim evidenced by the mortgage debt and the value of the mortgaged premises, an assignment of rents effectively helps to close that gap by providing the mortgagee with recourse to rents that accrue during the pendency of bankruptcy (while the mortgagee remains subject to the automatic stay).

A few courts have wrongly concluded that *Timbers* established a general principle that a secured creditor's secured position could not improve during the pendency of the bankruptcy, and have thus held that a court should exclude postpetition rents from the valuation of the mortgagee's secured claim. *See, e.g.*, In re Embassy Properties N. Ltd. Partnership, 196 B.R. 172 (Bankr. D. Kan. 1996); In re Kalian, 169 B.R. 503 (Bankr. D.R.I. 1994); In re Reddington/Sunarrow Ltd., 119 B.R. 809 (Bankr. D.N.M. 1990). The sounder view is that net postpetition rents properly increase the undersecured mortgagee's overall secured position during the pendency of the bankruptcy case. *See, e.g.*, Beal Bank, S.S.B. v. Waters Edge Ltd. Partnership, 248 B.R. 668 (Bankr. D. Mass. 2000); In re Homestead Partners, Ltd., 200 B.R. 274 (Bankr. N.D. Ga. 1996); In re Union Meeting Partners, 178 B.R. 664 (Bankr. E.D. Pa. 1995); In re Columbia Office Assocs., 175 B.R. 199 (Bankr. D. Md. 1994); In re Landing Assocs., Ltd., 122 B.R. 288, 296-97 (Bankr. W.D. Tex. 1990).

A variety of other issues are relevant to the characterization and enforcement of an assignment of leases and rents. These issues have not produced the same volume of litigation as the issues discussed in Part II; nevertheless, these issues would fall within the potential scope of an Act, and the following portion of the memorandum briefly discusses each issue in turn.

A. Priority of Claims Under Competing Rent Assignments.

In some cases, the owner of a commercial land development subjects the development to two (or more) mortgage loans, each also secured by assignments of leases and rents. In the event of a default, each such mortgagee/assignee may act to enforce its security interest in rents. In such cases, state law must provide a priority rule to resolve the conflicting claims of each mortgagee/assignee. Generally speaking, each state's recording statute provides the default priority rule for conflicting claims to real estate. As a result, an earlier assignment of leases and rents will, if properly recorded, have priority over a subsequent assignment with respect to unaccrued rents as well as accrued but unpaid rents.

One scenario, however, involves a junior mortgagee/assignee that has taken action to enforce its security interest — and has actually collected accrued rents, either directly or through the appointment of a receiver — before the senior mortgagee/assignee has taken steps to enforce its interest in rents. In this circumstance, would the senior mortgagee have priority as to any accrued rents actually collected by the junior mortgagee/assignee (or its receiver)?

The Restatement (Third) of Property — Mortgages addresses this priority question in the context of priorities between competing receivers. Section 4.5(b) provides that a receiver appointed under a junior mortgage has the right to collect rents until a receiver is appointed by the senior mortgagee and to apply those rents to the balance of the junior mortgage obligation (rather than the senior mortgage debt).[73] The Restatement authors took the view that this result "rewards the diligent junior mortgagee" and did not harm the senior mortgagee that had as yet not taken steps to enforce its interest in rents.[74] California has enacted a statute that provides a similar result, even in cases where the junior

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[73] "When a junior mortgagee obtains the appointment of a receiver, that receiver has the right, until a receiver is appointed under a senior mortgage, to collect rents from the mortgaged real estate and, after first using them to pay real estate taxes and other reasonable expenses associated with the maintenance and repair of the real estate, to apply the balance to the junior mortgage obligation." Restatement (Third) of Property — Mortgages § 4.5(b). Section 4.5(b), however, does not address the situation where a senior mortgagee/assignee seeks to enforce its assignment by means other than the appointment of a receiver.

[74] "This preference for the junior mortgagee … rewards the diligent junior mortgagee. Had the latter not sought the appointment of a receiver, the rents that accrued prior to the appointment of the senior mortgage receiver would have gone to the mortgagor and not to the senior lienholder. Thus, allowing the junior mortgagee to reap the benefit of those rents places the senior mortgagee in no worse a position than would have been the case had the junior mortgagee failed to act." *Id.* § 4.5 comment b.

mortgagee has enforced its interest in rents by direct collection rather than receivership.[75] This position reflects the weight of moderate case authority,[76] although there is contrary authority requiring the junior mortgagee to turn over net rents collected upon effective demand by the senior mortgagee.[77] No other states have adopted statutes that address this specific priority dispute.[78]

B. Enforcement by Demand Upon Mortgagor/Assignor

The traditional weight of case authority required that a mortgagee/assignee could enforce its security interest in rents only by taking steps sufficient to divest the mortgagor of control over those rents. As discussed in Part II, this traditionally meant the mortgagee had to become a mortgagee in possession, obtain the appointment of a receiver, obtain a judicial order requiring the sequestration of rents, or (in some cases) by notifying tenants to pay rentals directly to the mortgagee/assignee.[79] Under this approach, it did not suffice for the mortgagee/assignee merely to make a demand upon the mortgagor/assignor to turn over rentals as they were collected. Presumably, this reflected a concern that as long as the mortgagor was collecting and retaining net rentals, third party claimants (such as trade creditors to whom the mortgagor might make payments) could be easily misled by the mortgagor's control over those cash proceeds.

The Restatement (Third) of Property — Mortgages, however, provides that a mortgagee/assignee may

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[75]California's statute provides, in pertinent part:

> [I]f an assignee who has recorded its interest in leases, rents, issues, and profits prior to the recordation of such interest by a subsequent assignee seeks to enforce its interest in those rents, issues, or profits in accordance with this section after any enforcement action has been taken by a subsequent assignee, the prior assignee shall be entitled only to the rents, issues, and profits that are accrued and unpaid as of the date of its enforcement action and unpaid rents, issues, and profits accruing thereafter. The prior assignee shall have no right to rents, issues, or profits paid prior to the date of the enforcement action, whether in the hands of the assignor or any subsequent assignee. …

Cal. Civ. Code § 2938(h).

[76]*See, e.g.*, Stevens v. Blue, 57 N.E.2d 451 (Ill. 1944); Detroit Properties Corp. v. Detroit Hotel Co., 242 N.W. 213 (Mich. 1932); Vecchiarelli v. Garsal Realty, Inc., 443 N.Y.S.2d 622 (Misc. 1980); Goddard v. Clarke, 116 N.W. 41 (Neb. 1908).

[77]*See, e.g.*, Bergin v. Robbins, 146 A. 724 (Conn. 1929); New Jersey Title & Guarantee Co. v. Cone & Co., 53 A. 97 (N.J. 1902).

[78]By analogy, it is useful to consider Article 9's treatment of conflicting security interests in cash proceeds of the same receivables. A party with a junior interest in receivable can collect and retain the cash proceeds of those receivables free of the claim of a senior secured party to those same receivables, if the junior secured party qualifies as a holder in due course of those proceeds. *See* U.C.C. § 9-331, comment 5. Thus, a junior secured party could obtain priority in receivables collections if it acted in good faith (which includes both "honesty in fact" and "observance of reasonable commercial standards of fair dealing," § 9-102(a)(43), which it could do if it did not know that its collection of the receivables would violate the rights of the senior secured party.

[79]*See supra* text accompanying note 12.

enforce its right to rents by "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."[80] Likewise, the California statute provides a comparable result.[81] This result seems perfectly sensible; to the extent that the traditional approach reflected concern over potential harm to third party claimants (such as trade creditors), such creditors would already appear to be sufficiently protected by the common law negotiability of money (at least in those cases where the creditors are acting in good faith and not in collusion with the mortgagor).

C. Enforcement of an Assignment of Rents and Mortgagee-in-Possession Status.

As explained in Part IID above,[82] while a mortgagee can enforce an assignment of rents by taking physical possession of the mortgaged premises and thereby becoming a "mortgagee-in-possession," most mortgagees are reluctant to do so given the legal responsibilities (and the potential financial liabilities) associated with that status. Accordingly, most mortgagee/assignees seek to enforce assignments of leases and rents through mechanisms designed to establish "constructive" possession over the rents without assuming actual physical possession of the land — such as by obtaining a receiver or notifying tenants to make rental payments directly to the mortgagee/assignee.

The weight of common law case authority establishes that these steps (collecting rents by means short of actual physical possession of the land) do not render the mortgagee/assignee as a "mortgagee in possession" with the consequent liabilities/responsibilities of that status.[83] The California statute also makes clear that enforcement via appointment of a receiver, notification of tenants, or direct notification to the mortgagor/assignor does not, by itself, render the mortgagee as a mortgagee-in-possession.[84]

D. "Milking" of Rents and the Mortgagor/Assignor's Liability for Waste

As discussed in Part I, the owner of a distressed real estate project may sometimes engage in "milking" of rents — *i.e.*, collecting rents from the project and using those rents to pay expenses other than the mortgage debt and expenses of preserving or maintaining the mortgaged premises. The milking of rents

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[80]Restatement (Third) of Property — Mortgages § 4.2(c)(2).

[81]"The assignment shall be enforced by one or more of the following: … (4) Delivery to the assignor of a written demand for the rents, issues, or profits, a copy of which shall be mailed to all other assignees of record of the leases, rents, issues, and profits of the real property at the address for notices provided in the assignment or, if none, to the address to which the recorded assignment was to be mailed after recording." Cal. Civ. Code § 2938(c)(4).

[82]*See supra* note 53 and accompanying text.

[83]*See, e.g.*, Restatement (Third) of Property — Mortgages § 4.2 comment c; Prince v. Brown, 856 P.2d 589 (Okla. App. 1993).

[84]*See, e.g.*, Cal. Civ. Code § 2938(e)(1).

that have been assigned as security poses a significant threat to an undersecured mortgagee, who cannot expect to obtain full recovery of the mortgage debt via foreclosure. This threat is even more severe where the mortgagee holds a nonrecourse mortgage debt and the mortgagor thus has no personal liability for a deficiency judgment. Such a threat typically prompts the mortgagee to take prompt action following default to enforce its security interest in rents and thereby divest the mortgagor of control over project rents.

Between the time that the mortgagor goes into default and the time that the mortgagee finally enforces its security interest in rents, the mortgagor has often collected and disposed of rents. In this situation, an undersecured mortgagee may seek to recover, either from the mortgagee or third parties to whom the rents were paid — on account of the mortgagor's collection and disposal of the mortgagee's security.

All authorities agree that the mortgagee has no basis for recovering cash proceeds of rent paid in the ordinary course to third parties acting in good faith; such parties would take those cash proceeds free of the mortgagee's claims by virtue of the common law negotiability of money. The mortgagee might have a damage claim for legal waste against the mortgagor, however, on account of the mortgagor's disposition of the mortgagee's collateral. Traditionally, the common law of mortgages has imposed liability upon a mortgagor who takes action that destroys the mortgaged property, thereby reducing its value.[85] The weight of available authority suggests that the mortgagor's diversion of rents would constitute legal waste, at least where the mortgagee had taken sufficient steps to enforce its security interest in rents,[86] and the Restatement (Third) of Property — Mortgages adopts this view.[87]

In cases involving nonrecourse obligations (either by virtue of specific contractual nonrecourse provisions or the intervention of antideficiency legislation), mortgagors faced with an action for waste of rents often argue that the mortgagee's action is in the nature of a deficiency judgment and should therefore be dismissed. The weight of authority rejects this view and concludes that an action for waste is not in the nature of a deficiency action.[88]

IV. A Framework for an Act

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[85] *See, e.g.*, Restatement (Third) of Property — Mortgages § 4.6.

[86] For example, in Taylor v. Brennan, 621 S.W.2d 592 (Tex. 1981), the court recognized that the mortgagor's collection and disposition of rents could constitute waste, but refused to conclude that waste had occurred in that case because (in the court's judgment) the mortgagee had not taken sufficient steps post-default to enforce its security interest in rents. *See also* Ginsberg v. Lennar Florida Holdings, 645 So.2d 490 (Fla. App. 1994).

[87] Restatement (Third) of Property — Mortgages § 4.6(a)(5) ("Waste occurs when, without the mortgagee's consent, the mortgagor … retains possession of rents to which the mortgagee has the right to possession.…"); § 4.6(b)(3) (mortgagee may recover damages on account of waste, including waste of rents, to the extent that the waste has impaired the mortgagee's security).

[88] *See, e.g.*, Hoelting Enters. v. Nelson, 929 P.2d 183 (Kan. App. 1996); International Business Machines Corp. v. Axinn, 676 A.2d 552 (N.J. Super. 1996). *See also* In re Evergreen Ventures, 147 B.R. 751 (Bankr. D. Ariz. 1992) (distinguishing deficiency action and waste action).

The most comprehensive state statute governing a mortgagee's right to rents is California's statute, adopted in 1996. A copy of this statute is attached as Exhibit A to this report. While an Act would undoubtedly vary from the California statute in some respects, the basic structure of the California statute provides a useful structural framework for a potential Act. As a result, the following paragraphs provide a brief synopsis of the provisions of the California statute.

Paragraph (a) of the statute makes clear that an assignment of rents, whether or not denominated as "absolute," creates a present security interest in the rents, issues and profits of the land as of the moment that assignment is executed and delivered. This provision resolves any uncertainty about whether any interest in rents arises under lien theory prior to the assignor's default and/or the assignee's enforcement. Further, consistent with UCC Article 9, the provision also moots any lingering notion that location of "title" to rents is relevant by making clear that an "absolute" assignment of rents creates only a security interest when executed and delivered in conjunction with a mortgage transaction.

Paragraph (b) makes clear that upon recording in the land records, an assignment of rents is "perfected" and therefore enforceable as against third party creditors and purchasers of the land — effectively preventing a bankruptcy court in the jurisdiction from concluding that a mortgagor/debtor could use its strong-arm power to set aside the mortgagee's interest in postpetition rents.

Paragraph (c) specifies the ways in which the mortgagee could enforce an assignment of rents, including: (1) the appointment of a receiver; (2) obtaining possession of the rents (presumably either by becoming a mortgagee in possession or by obtaining a court order sequestering the rents); (3) delivery of a written demand to tenants directing them to pay rents to the mortgagee; and (4) delivery of a written demand to the mortgagor/assignor for a turnover of rents.

Paragraph (d) provides some protection for tenants of the mortgagor/assignor. Any demand by the mortgagee/assignee for payment of rent is effective only upon receipt by the tenant who receives a demand for payment from the mortgagee/assignee. After such a demand, the tenant must pay the mortgagee/assignee unless the tenant has received a facially valid demand from another rent assignee or unless the tenant pays the assignor within 10 days after receiving the demand.[89]

Paragraph (e) provides that enforcement of the assignment does not by itself render the mortgagee as a mortgagee in possession, does not constitute an "action" within meaning of the "one-action" rule, and

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[89]Presumably, this 10-day period provides some protection for the tenant who receives a demand from the mortgagee, but who has already executed and delivered a rent check to the mortgagor/assignor that has not yet been cashed (and thus "paid"). So long as the check was presented and honored within 10 days following the demand, the payment will have satisfied that month's rental obligation and the tenant would no further liability on account of that month's possession of the premises. This provision may effectively be overbroad, however, to the extent that it also protects tenants who do not actually issue a check for accrued rent until after receiving a demand (so long as the check is paid within the 10-day period following that demand).

does not affect the mortgagee's ability to pursue a deficiency judgment.[90]

Paragraph (f) provides that the mortgagee/assignee shall have a continuously perfected security interest in any cash proceeds (*i.e.*, collected rents) so long as those proceeds are identifiable, incorporating the identifiability standards reflected in UCC Article 9 (*i.e.*, either segregation or traceability under the lowest intermediate balance test). Paragraph (f) also makes clear that a third party who receives ordinary course payments from the assignor in the operation of the assignor's business would be protected against any conversion claim by the mortgagee/assignee based upon the common law negotiability of money.

Paragraph (g) specifies the responsibility of the mortgagee/assignee that enforces its lien upon rents without obtaining the appointment of a receiver. Paragraph (g) permits the mortgagor/assignor to demand that the mortgagee/assignee pay the reasonable expenses of maintaining the premises (including payment of taxes, insurance, and costs of compliance with laws), and obligates the mortgagee/assignee to pay these expenses to the extent of rents actually collected.

Paragraph (h) specifies that priority between conflicting rent assignments will be generally resolved by reference to the state's recording statute. However, it provides that if a prior-in-time assignee enforces its right to rents after a later-in-time assignee has already enforced its rights, then the prior-in-time party will have priority as to (1) unaccrued rents and (2) accrued but unpaid rents, but not as to (3) rents already paid.

Paragraph (j) incorporates existing state common law definitions of real property.[91]

Paragraph (k) provides a safe-harbor form for an assignee's demand to tenants, sufficient to enforce the lender's interest in the rents.

As discussed in Part IID above, the Act would also include provisions governing the appointment of a receiver for mortgaged property, including the standards required for appointment and the effect of a receivership clause.

V. Conference Criteria for Proposed Acts

The preparation of an Act would be consistent with the Conference's Statement of Policy Establishing Criteria and Procedures for Designation and Consideration of Acts:

- As required by Criteria 1(a), the subject matter is particularly appropriate for state legislation. Issues

[90]The latter two provisions would be unnecessary in any jurisdiction without a "one-action" rule or anti-deficiency laws.

[91]This provision will be insufficient, of course, if a drafting committee should conclude that the Act should seek to clarify the classification question discussed in Part IIC above.

relating to mortgage law and the rights of a mortgagee have always fallen within the traditional purview of state law. Nearly 1/3 of the 50 states have statutory provisions relating to the enforceability of an assignment of rents versus third parties, and approximately 1/2 of the states have statutory provisions relating to a mortgagee's ability to obtain a receiver for mortgaged property.

- As required by Criteria 1(b), the subject matter is appropriate for uniform state legislation. As discussed above, issues regarding mortgagee access to rents tend to be resolved in the context of federal bankruptcy courts. As discussed in Part II above, some bankruptcy judges have shown a tendency to the misinterpret state law regarding assignments of rents in order to achieve certain functional results in administering bankruptcy cases. For example, as discussed in Part IIA, some debtor-friendly bankruptcy courts misinterpreted state law in order to characterize assignments of rents as "inchoate" or "unperfected," so as to disencumber postpetition rents and thereby provide debtors with a ready source of cash flow to facilitate their reorganization efforts. By contrast, some creditor-friendly bankruptcy courts misinterpreted state law in order to characterize assignments of leases and rents as "absolute," thereby concluding that the debtor had no interest whatsoever in postpetition rents and that such rents did not constitute property of the bankruptcy estate. As a result, mortgagee access to rents from income-producing land sometimes differs from state to state — not as a function of the states' respective common law of mortgages, but by virtue of federal bankruptcy courts having misinterpreted that common law. Uniform state legislation on the subject of mortgagee access to rents could serve to minimize such misinterpretation and thereby foster more balanced and equitable treatment of the parties to commercial mortgage transactions.

- An Act would conform to Criteria 1(c), because its preparation will be a practical step toward uniformity of state law. There is a reasonable probability that the proposed Act would be adopted by a substantial number of jurisdictions or would promote uniformity indirectly, and this uniformity would produce significant public benefits or avoid significant disadvantages likely to arise from continued diversity of state law. As noted above, nearly 1/3 of the 50 states have statutory provisions relating to the enforceability of an assignment of rents versus third parties, and approximately 1/2 of the states have statutory provisions relating to a mortgagee's ability to obtain a receiver for mortgaged property. Further, the presence of these mortgage-specific provisions indicates that there is a reasonable probability that an Act would meet with approval and have good prospects for adoption.

EXHIBIT A

Cal. Civ. Code § 2938. Assignment of rents; recordation; enforcement; demand; cash proceeds; application of section

(a) A written assignment of an interest in leases, rents, issues, or profits of real property made in connection with an obligation secured by real property, irrespective of whether the assignment is denoted as absolute, absolute conditioned upon default, additional security for an obligation, or otherwise, shall, upon execution and delivery by the assignor, be effective to create a present security interest in existing and future leases, rents, issues, or profits of that real property. As used in this section, "leases, rents, issues, and profits of real property" include the cash proceeds thereof. The term "cash proceeds" means cash, checks, deposit accounts, and the like.

(b) An assignment of an interest in leases, rents, issues, or profits of real property may be recorded in the records of the county recorder in which the underlying real property is located in the same manner as any other conveyance of an interest in real property, whether the assignment is in a separate document or part of a mortgage or deed of trust, and when so duly recorded in accordance with the methods, procedures, and requirements for recordation of conveyances of other interests in real property, (1) the assignment shall be deemed to give constructive notice of the content of the assignment with the same force and effect as any other duly recorded conveyance of an interest in real property and (2) the interest granted by the assignment shall be deemed fully perfected as of the time of recordation with the same force and effect as any other duly recorded conveyance of an interest in real property, notwithstanding any provision of the assignment or any provision of law that would otherwise preclude or defer enforcement of the rights granted the assignee under the assignment until the occurrence of a subsequent event, including, but not limited to, a subsequent default of the assignor, or the assignee's obtaining possession of the real property or the appointment of a receiver.

(c) Upon default of the assignor under the obligation secured by the assignment of leases, rents, issues, and profits, the assignee shall be entitled to enforce the assignment in accordance with this section. On and after the date the assignee takes one or more of the enforcement steps described in this subdivision, the assignee shall be entitled to collect and receive all rents, issues, and profits that have accrued but remain unpaid and uncollected by the assignor or its agent or for the assignor's benefit on that date, and all rents, issues, and profits that accrue on or after the date. The assignment shall be enforced by one or more of the following:

(1) The appointment of a receiver.

(2) Obtaining possession of the rents, issues, or profits.

(3) Delivery to any one or more of the tenants of a written demand for turnover of rents, issues, and profits in the form specified in subdivision (j), a copy of which demand shall also be delivered to the assignor; and a copy of which shall be mailed to all other assignees of record of the leases, rents, issues, and profits of the real property at the address for notices provided in the assignment or, if none, to the address to which the recorded assignment was to be mailed after recording.

(4) Delivery to the assignor of a written demand for the rents, issues, or profits, a copy of which shall be mailed to all other assignees of record of the leases, rents, issues, and profits of the real property at the address for notices provided in the assignment or, if none, to the address to which the recorded assignment was to be mailed after recording. Moneys received by the assignee pursuant to this subdivision, net of amounts paid pursuant to subdivision (g), if any, shall be applied by the assignee to the debt or otherwise in

accordance with the assignment or the promissory note, deed of trust, or other instrument evidencing the obligation; provided, however, that neither the application nor the failure to so apply the rents, issues, or profits shall result in a loss of any lien or security interest which the assignee may have in the underlying real property or any other collateral, render the obligation unenforceable, constitute a violation of Section 726 of the Code of Civil Procedure, or otherwise limit any right available to the assignee with respect to its security.

(d) If an assignee elects to take the action provided for under paragraph (3) of subdivision (c), the demand provided for therein shall be signed under penalty of perjury by the assignee or an authorized agent of the assignee and shall be effective as against the tenant when actually received by the tenant at the address for notices provided under the lease or other contractual agreement under which the tenant occupies the property or, if no address for notices is so provided, at the property. Upon receipt of this demand, the tenant shall be obligated to pay to the assignee all rents, issues, and profits that are past due and payable on the date of receipt of the demand, and all rents, issues, and profits coming due under the lease following the date of receipt of the demand, unless either of the following occurs:

(1) The tenant has previously received a demand which is valid on its face from another assignee of the leases, issues, rents, and profits sent by the other assignee in accordance with this subdivision and subdivision (c).

(2) The tenant, in good faith and in a manner which is not inconsistent with the lease, has previously paid, or within 10 days following receipt of the demand notice pays, the rent to the assignor.

Payment of rent to an assignee following a demand under an assignment of leases, rents, issues, and profits shall satisfy the tenant's obligation to pay the amounts under the lease. If a tenant pays rent to the assignor after receipt of a demand other than under the circumstances described in this subdivision, the tenant shall not be discharged of the obligation to pay rent to the assignee, unless the tenant occupies the property for residential purposes. The obligation of a tenant to pay rent pursuant to this subdivision and subdivision (c) shall continue until receipt by the tenant of a written notice from a court directing the tenant to pay the rent in a different manner or receipt by the tenant of a written notice from the assignee from whom the demand was received canceling the demand, whichever occurs first. Nothing in this subdivision shall affect the entitlement to rents, issues, or profits as between assignees as set forth in subdivision (h).

(e) No enforcement action of the type authorized by subdivision (c), and no collection, distribution, or application of rents, issues, or profits by the assignee following an enforcement action of the type authorized by subdivision (c), shall do any of the following:

(1) Make the assignee a mortgagee in possession of the property, except if the assignee obtains actual possession of the real property, or an agent of the assignor.

(2) Constitute an action, render the obligation unenforceable, violate Section 726 of the Code of Civil Procedure or, other than with respect to marshaling requirements, otherwise limit any rights available to the assignee with respect to its security.

(3) Be deemed to create any bar to a deficiency judgment pursuant to any provision of law governing or relating to deficiency judgments following the enforcement of any encumbrance, lien, or security interest, notwithstanding that the action, collection, distribution, or application may reduce the indebtedness secured by the assignment or by any deed of trust or other security instrument.

The application of rents, issues, or profits to the secured obligation shall satisfy the secured obligation to the extent of those rents, issues, or profits, and, notwithstanding any provisions of the assignment or other loan documents to the contrary, shall be credited against any amounts necessary to cure any monetary default for purposes of reinstatement under Section 2924c.

(f) If cash proceeds of rents, issues or profits to which the assignee is entitled following enforcement as set forth in subdivision (c) are received by the assignor or its agent for collection or by any other person who has collected such rents, issues, or profits for the assignor's benefit, or for the benefit of any subsequent assignee under the circumstances described in subdivision (h), following the taking by the assignee of either of the enforcement actions authorized in paragraph (3) or (4) of subdivision (c), and the assignee has not authorized the assignor's disposition of the cash proceeds in a writing signed by the assignee, the rights to the cash proceeds and to the recovery of the cash proceeds shall be determined by the following:

(1) The assignee shall be entitled to an immediate turnover of the cash proceeds received by the assignor or its agent for collection or any other person who has collected the rents, issues, or profits for the assignor's benefit, or for the benefit of any subsequent assignee under the circumstances described in subdivision (h), and the assignor or other described party in possession of such cash proceeds shall turn over the full amount of cash proceeds to the assignee, less any amount representing payment of expenses authorized by the assignee in writing. The assignee shall have a right to bring an action for recovery of the cash proceeds, and to recover the cash proceeds, without the necessity of bringing an action to foreclose any security interest which it may have in the real property. This action shall not violate Section 726 of the Code of Civil Procedure or otherwise limit any right available to the assignee with respect to its security.

(2) As between an assignee with an interest in cash proceeds perfected in the manner set forth in subdivision (b) and enforced in accordance with paragraph (3) or (4) of subdivision (c) and any other person claiming an interest in the cash proceeds, other than the assignor or its agent for collection or one collecting rents, issues, and profits for the benefit of the assignor, and subject to subdivision (h), the assignee shall have a continuously perfected security interest in the cash proceeds to the extent that the cash proceeds are identifiable.

For purposes hereof, cash proceeds are identifiable if they are either (A) segregated or (B) if commingled with other funds of the assignor or its agent or one acting on its behalf, can be traced using the lowest intermediate balance principle, unless the assignor or other party claiming an interest in proceeds shows that some other method of tracing would better serve the interests of justice and equity under the circumstances of the case. The provisions of this paragraph are subject to any generally applicable law with respect to payments made in the operation of the assignor's business.

(g)(1) If the assignee enforces the assignment under subdivision (c) by any means other than the appointment of a receiver and receives rents, issues, or profits pursuant to this enforcement, the assignor or any other assignee of the affected real property may make written demand upon the assignee to pay the reasonable costs of protecting and preserving the property, including payment of taxes and insurance and compliance with building and housing codes, if any.

(2) On and after the date of receipt of the demand, the assignee shall pay for the reasonable costs of protecting and preserving the real property to the extent of any rents, issues, or profits actually received by the assignee; provided, however, that no such acts by the assignee shall cause the assignee to become a mortgagee in possession and the assignee's duties under this subdivision, upon receipt of a demand from the assignor or any other assignee of the leases, rents, issues, and profits pursuant to paragraph (1), shall not be construed to require the assignee to operate or manage the property, which obligation shall remain that of the assignor.

(3) The obligation of the assignee hereunder shall continue until the earlier of (A) the date on which the assignee obtains the appointment of a receiver for the real property pursuant to application to a court of competent jurisdiction, or (B) the date on which the assignee ceases to enforce the assignment.

(4) Nothing in this subdivision shall be construed to supersede or diminish the right of the assignee to the

appointment of a receiver.

(h) The lien priorities, rights, and interests among creditors concerning rents, issues, or profits collected before the enforcement by the assignee shall be governed by subdivisions (a) and (b). Without limiting the generality of the foregoing, if an assignee who has recorded its interest in leases, rents, issues, and profits prior to the recordation of such interest by a subsequent assignee seeks to enforce its interest in those rents, issues, or profits in accordance with this section after any enforcement action has been taken by a subsequent assignee, the prior assignee shall be entitled only to the rents, issues, and profits that are accrued and unpaid as of the date of its enforcement action and unpaid rents, issues, and profits accruing thereafter. The prior assignee shall have no right to rents, issues, or profits paid prior to the date of the enforcement action, whether in the hands of the assignor or any subsequent assignee. Upon receipt of notice that the prior assignee has enforced its interest in the rents, issues, and profits, the subsequent assignee shall immediately send a notice to any tenant to whom it has given notice under subdivision (c). The notice shall inform the tenant that the subsequent assignee cancels its demand that the tenant pay rent to the subsequent assignee.

(i) This section shall apply to contracts entered into on or after January 1, 1997.Sections 2938 and 2938.1, as these sections were in effect prior to January 1, 1997, shall govern contracts entered into prior to January 1, 1997, and shall govern actions and proceedings initiated on the basis of these contracts.

(j) “Real property,” as used in this section, shall mean real property or any estate or interest therein.

(k) The demand required by paragraph (3) of subdivision (c) shall be in the following form:

DEMAND TO PAY RENT TO
PARTY OTHER THAN LANDLORD
(SECTION 2938 OF THE CIVIL CODE)

Tenant: [Name of Tenant]Property Occupied by Tenant: [Address]Landlord: [Name of Landlord]Secured Party: [Name of Secured Party]Address: [Address for Payment of Rent to Secured Party and for Further Information]:The secured party named above is the assignee of leases, rents, issues, and profits under [name of document] dated _____, and recorded at [recording information] in the official records of _____ County, California. You may request a copy of such assignment from the secured party at _____ (address).THIS NOTICE AFFECTS YOUR LEASE OR RENTAL AGREEMENT RIGHTS AND OBLIGATIONS. YOU ARE THEREFORE ADVISED TO CONSULT AN ATTORNEY CONCERNING THOSE RIGHTS AND OBLIGATIONS IF YOU HAVE ANY QUESTIONS REGARDING YOUR RIGHTS AND OBLIGATIONS UNDER THIS NOTICE.IN ACCORDANCE WITH SUBDIVISION (C) OF SECTION 2938 OF THE CIVIL CODE, YOU ARE HEREBY DIRECTED TO PAY TO THE SECURED PARTY, _____ (NAME OF SECURED PARTY) AT _____ (ADDRESS), ALL RENTS UNDER YOUR LEASE OR OTHER RENTAL AGREEMENT WITH THE LANDLORD OR PREDECESSOR IN INTEREST OF LANDLORD, FOR THE OCCUPANCY OF THE PROPERTY AT _____ (ADDRESS OF RENTAL PREMISES) WHICH ARE PAST DUE AND PAYABLE ON THE DATE YOU RECEIVE THIS DEMAND, AND ALL RENTS COMING DUE UNDER THE LEASE OR OTHER RENTAL AGREEMENT FOLLOWING THE DATE YOU RECEIVE THIS DEMAND UNLESS YOU HAVE ALREADY PAID THIS RENT TO THE LANDLORD IN GOOD FAITH AND IN A MANNER NOT INCONSISTENT WITH THE AGREEMENT BETWEEN YOU AND THE LANDLORD. IN THIS CASE, THIS DEMAND NOTICE SHALL REQUIRE YOU TO PAY TO THE SECURED PARTY _____, (NAME OF THE SECURED PARTY), ALL RENTS THAT COME DUE FOLLOWING THE DATE OF THE PAYMENT TO THE LANDLORD.IF YOU PAY THE RENT TO THE UNDERSIGNED SECURED PARTY, _____ (NAME OF

SECURED PARTY), IN ACCORDANCE WITH THIS NOTICE, YOU DO NOT HAVE TO PAY THE RENT TO THE LANDLORD. YOU WILL NOT BE SUBJECT TO DAMAGES OR OBLIGATED TO PAY RENT TO THE SECURED PARTY IF YOU HAVE PREVIOUSLY RECEIVED A DEMAND OF THIS TYPE FROM A DIFFERENT SECURED PARTY.[For other than residential tenants]. IF YOU PAY ANY RENT TO THE LANDLORD THAT BY THE TERMS OF THIS DEMAND YOU ARE REQUIRED TO PAY TO THE SECURED PARTY, YOU MAY BE SUBJECT TO DAMAGES INCURRED BY THE SECURED PARTY BY REASON OF YOUR FAILURE TO COMPLY WITH THIS DEMAND, AND YOU MAY NOT BE DISCHARGED FROM YOUR OBLIGATION TO PAY SUCH RENT TO THE SECURED PARTY. YOU WILL NOT BE SUBJECT TO SUCH DAMAGES OR OBLIGATED TO PAY SUCH RENT TO THE SECURED PARTY IF YOU HAVE PREVIOUSLY RECEIVED A DEMAND OF THIS TYPE FROM A DIFFERENT ASSIGNEE.Your obligation to pay rent under this demand shall continue until you receive either (1) a written notice from a court directing you to pay the rent in a manner provided therein, or (2) a written notice from the secured party named above canceling this demand.The undersigned hereby certifies, under penalty of perjury, that the undersigned is an authorized officer or agent of the secured party and that the secured party is the assignee, or the current successor to the assignee, under an assignment of leases, rents, issues, or profits executed by the landlord, or a predecessor in interest, that is being enforced pursuant to and in accordance with Section 2938 of the Civil Code.Executed at _____, California, this _____ day of _____, _____.[Secured Party] Name: _____ Title: _____