

# UNIFORM ASSIGNMENT OF RENTS ACT

drafted by the

NATIONAL CONFERENCE OF COMMISSIONERS  
ON UNIFORM STATE LAWS

and by it

APPROVED AND RECOMMENDED FOR ENACTMENT  
IN ALL THE STATES

at its

ANNUAL CONFERENCE  
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By

NATIONAL CONFERENCE OF COMMISSIONERS  
ON UNIFORM STATE LAWS

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## **UNIFORM ASSIGNMENT OF RENTS ACT**

### **Prefatory Note**

Traditionally, under the title theory of mortgages, a mortgage effected a transfer of legal title to real property as security for the mortgage debt. As an incident of this legal title, the mortgagee obtained the right to collect rents arising from the real property and apply them to the mortgage debt unless the mortgage stated otherwise. By contrast, in the majority of American states that follow the lien theory of mortgages, a mortgage grants the mortgagee only a right of security, capable of being enforced via foreclosure in the event of the mortgagor's default. Under the lien theory, until such enforcement occurs, a mortgage does not by itself convey to the mortgagee the right to collect rents accruing from the mortgaged real property.

As a result, it has become customary that when a lender makes a mortgage loan on income-producing real property, the lender requires the borrower to execute a document typically entitled an "Assignment of Leases and Rents." This assignment can serve a number of practical purposes, but its most significant purpose is to provide the mortgagee with a security interest in rents that accrue before the mortgagee can complete a foreclosure proceeding. In many states, the foreclosure process can be quite lengthy, and the mortgage lender faces a heightened risk that while a foreclosure proceeding is pending, the borrower may continue to collect rents and spend them other than to reduce the mortgage debt or paying operating expenses of the real property (a process often referred to as "milking" the rents). By taking the assignment, the lender makes clear its intent to hold a lien upon all future rents produced by the real property, including those that accrue during the period between the mortgagor's default and the mortgagee's completion of a foreclosure proceeding. The assignment typically permits the lender to take steps following the borrower's default to collect rents and apply them to reduce the mortgage debt. These steps may include, among others, 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 payments to the lender.

State law generally governs the creation and enforcement of security interests in rents. Unfortunately, most states do not have detailed statutory provisions dealing with the creation, perfection, and enforcement of security interests in rents (by contrast to the comprehensive provisions in Uniform Commercial Code Article 9 governing the creation, perfection, and enforcement of security interests in accounts and other personal property payment rights). Thus, the creation and enforcement of security interests in rents tends to be governed by the common law of real property. Not surprisingly, this has produced undesirable variation in the rules governing the creation and enforcement of security interests in rents. Perhaps more significantly, disagreements regarding security interests in rents tend to be resolved in the federal bankruptcy courts, after the owner of mortgaged real property has resorted to bankruptcy to obtain a stay from creditor collection efforts. Bankruptcy courts have proven exceptionally adept at creatively interpreting (or misinterpreting) state law principles — in some cases to disencumber a lender's security interest in rents altogether, or in other cases to exclude post-bankruptcy rents from the bankruptcy estate.

To address some of these concerns, the Act seeks to bring consistency to commercial real property transactions by establishing a comprehensive statutory model for the creation, perfection, priority, and enforcement of a security interest in rents. The Act addresses (among others) the following issues:

*A security interest in rents is a distinct form of collateral.* As stated above, the most significant purpose of an assignment of leases and rents is to provide the mortgagee with a security interest in rents that accrue before the mortgagee can complete a foreclosure proceeding. Most courts have held that while rents arise from and are thus related to the mortgaged real property, an assignment of rents creates an additional source of collateral, distinct from the mortgagee's lien on the real property itself. In other words, the assignee of rents obtains a lien on the rents that accrue prior to foreclosure, as well as a security interest in the mortgaged real property (which inherently covers those rents that would accrue after a completed foreclosure). Unfortunately, some bankruptcy court decisions have wrongly concluded that rents do not constitute separate collateral, but are "subsumed within the land." In reaching this conclusion, these courts have held that a bankrupt mortgagor/owner may use rents during the pendency of its bankruptcy, without regard to the lender's security interest in rents, so long as the mortgaged real property itself is not decreasing in value. To the extent that these decisions purport to be based upon state law, the Act rejects these decisions and confirms the prevailing view that a security interest in rents that accrue prior to foreclosure is an interest that is distinct from the lien on the real property from which the rents arise. For further background, *see* Act § 4(b), Comment 2.

*"Perfection" of a security interest in rents.* The Act codifies the principle that an assignment of rents is perfected and effective against third persons upon its proper recordation. The Act thus establishes, as a matter of state law, that once a lender has recorded an assignment of rents, no further action is generally necessary to protect the enforceability and priority of the lender's security interest in rents against subsequent purchasers or creditors. The Act should thus resolve any remaining ambiguity regarding the enforceability of a lender's security interest in rents accruing during the pendency of a mortgagor/owner's bankruptcy case — as the Bankruptcy Code makes clear that the bankruptcy trustee/debtor-in-possession cannot use its "strong-arm" avoiding power, 11 U.S.C. § 544(a), to avoid a security interest that was properly perfected prior to bankruptcy. The Act would thus reject existing case law that suggests that a security interest in rents is "inchoate" or ineffective until the lender takes affirmative action after default to obtain possession of the real property, impound the rents, secure the appointment of a receiver, or some other similar action. For further background, *see* Act § 5, Comment 2.

*"Absolute" assignments of rents.* Often, an assignment of leases and rents will state that the assignor is making an "absolute" transfer of rents, even though the context of the transaction (and often the terms of the assignment itself) indicate that the assignor is making the assignment only as security for repayment of the mortgage obligation. Mortgage law has long established that instruments purporting to make an absolute conveyance of title nevertheless constitute equitable mortgages if the surrounding circumstances demonstrate that the parties are using title to secure payment of a debt. Consistent with this long-established principle, the Act establishes that an assignment of rents executed in conjunction with and to secure payment of a mortgage

debt creates only a security interest in rents, even if the assignment purports to constitute an absolute transfer of the rents. For further background, *see* Act § 4(b), Comment 3.

*Appointment of a receiver.* In some states, comprehensive statutory provisions address the circumstances in which a court should appoint a receiver for mortgaged real property. In many states, however, there is little statutory guidance. As a result, standards governing the appointment of receivers in most states are defined judicially, and tend to vary somewhat from jurisdiction to jurisdiction — and, within many jurisdictions, from judge to judge. Some decisions require that the mortgagee’s security be inadequate or that the real property be subject to existing or threatened waste; others require a showing of mortgagor insolvency. By contrast, many courts will appoint a receiver in any circumstance in which the mortgage contains a receivership clause authorizing such an appointment after default. The Act establishes consistent standards to govern the appointment of a receiver for mortgaged real property, including the effectiveness of a receivership clause. For further background, *see* Act § 7, Comments 1-8.

*Characterization of real property revenues.* In many commercial real property developments (*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 real property (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 property 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 in the public real property records. In many other developments, however, the occupiers are not “tenants,” but merely licensees (*e.g.*, nursing home residents, persons occupying garage spaces or marina slips, hotel guests, and the like). Court decisions involving security interests in the revenues paid by such occupiers have disagreed over the proper characterization of these revenues — with some treating them as “rents” in the nature of real property, and others treating them as “accounts” subject to the provisions of Uniform Commercial Code Article 9. These decisions have created uncertainty regarding both the proper way to create and perfect a security interest in these occupancy revenues, as well as the appropriate treatment of a security interest in those revenues generated during the pendency of a bankruptcy case. The Act establishes that rents include any sum paid by a tenant, licensee, or other person for the right to possess or occupy the real property of another. For further background, *see* Act § 2, Comment 12.

*Enforcement by notification to assignor/owner.* The traditional weight of case authority required that an assignee of rents could enforce its security interest in rents only by taking steps sufficient to divest the assignor of control over those rents. Under this approach, it did not suffice for the assignee to make a demand upon the mortgagor/assignor to turn over rentals as they were collected. These decisions 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 Act rejects this approach and permits an assignee to enforce its security

interest in rents by giving a notification demanding that the assignor turn over any rents that it may collect following the notification — and thus an assignor who fails to turn over any such rents to the assignee is liable for conversion of those rents. For further background, *see* Act § 8, Comment 1.

*Enforcement by notification to tenants.* The Act seeks to facilitate the enforcement of a security interest in rents by allowing the assignee to give a notification to tenants demanding that the tenants make future rent payments directly to the assignee. The Act addresses the liability of the tenant for making payments to the assignor following receipt of such a notification, the need for a tenant to have adequate opportunity to seek counsel regarding the legal effect of the notification, and the possibility of a tenant receiving a notification from multiple rents assignees. The Act also provides a standard form notification suitable for use by assignees. For further background, *see* Act § 9, Comments 1-7.

*Mortgage creates a security interest in rents by default.* Under Uniform Commercial Code Article 9, a security interest in personal property automatically extends to proceeds of that property unless the security agreement provides otherwise. Because Article 9 defines “proceeds” to include whatever is received upon disposition (including a lease) of the collateral, a security interest in personal property collateral automatically extends to rentals arising from that collateral. Article 9’s treatment of personal property rents as “proceeds” reflects the presumed intention of lender and borrower that the lender’s security interest should extend to sums (e.g., rents) that reflect a return upon the economic value of the collateral.

By contrast to Article 9’s clear and straightforward coverage of “proceeds,” real property law has been less clear regarding the mortgagee’s interest in rents. Under the title theory of mortgages, the mortgagee’s title to the real property automatically included the right to collect and apply rents arising from the real property to the mortgage debt (unless the mortgage itself provided otherwise). Thus, the mortgagee in a title theory state implicitly acquired an interest in the rents arising from the real property, regardless of whether the mortgagee received an explicit assignment of rents. By contrast, under the lien theory of mortgages, the mortgagee did not automatically acquire the right to collect and apply rents as an incident of the mortgage. For this reason, most commercial real property mortgage lenders require the mortgagor to make an assignment of rents in order to give the mortgagee an unquestioned interest in rents that accrue prior to the completion of a foreclosure.

Particularly with respect to commercial real property, rents reflect the economic return received by the owner in exchange for a temporal disposition of the right to possess and occupy the real property. This explains why a mortgagee on income-producing real property almost inevitably require the mortgagor to execute and deliver an assignment of rents (either as part of, or in addition to, the mortgage). In this regard, commercial practice demonstrates that rents from real property are and should be viewed as a form of proceeds of the real property — and should receive treatment comparable to the treatment Article 9 accords to proceeds of personal property collateral. In order to promote desirable consistency between Article 9 and real property law, the Act establishes that a mortgage creates a security interest in rents by default (*e.g.*, unless the



mortgage provides otherwise), even if the mortgage does not by its express terms create an assignment of rents. For further background, *see* Act § 4(a), Comment 1.

*Expenses of operating and preserving the real property.* Often, commercial leases obligate the tenant to pay a sum characterized as “additional rent.” This sum is typically determined by the tenant’s pro rata share of the cost of real property taxes, insurance, and maintenance expenses (or the increase in such costs or expenses beyond an established baseline amount), and serves to reimburse the landlord for the payment of these expenses. Leases customarily characterize the tenant’s obligation to pay these sums as “rent,” and assignments of leases and rents typically require the landlord/assignor to grant a security interest in these sums. Based upon these customary practices, the Act treats such sums as “rents.”

California’s comprehensive assignment of rents statute places an affirmative obligation on the assignee to use whatever rents it collects to pay the reasonable expenses of operating and maintaining the real property. By contrast, under the traditional rule prevailing in most states, the landlord’s obligation to pay these expenses — even if the obligation is expressed or implied into its tenant leases — does not bind the lender as a successor until the lender acquires possession or ownership of the real property (by becoming a mortgagee in possession or purchasing the premises at foreclosure). A prudent lender may choose to apply collected rents to the payment of real property taxes, insurance, and project maintenance in order to protect its own security. Nevertheless, under the traditional view, a lender that collect rents without taking actual or constructive possession of the real property may apply those rents to the mortgage debt without any obligation to apply such sums to the payment of taxes, insurance, or property maintenance.

If the assignor/landlord fails to pay real property taxes or insurance or fails to perform its obligations with respect to project maintenance, a tenant injured by such failure may have a claim or defense with respect to its continuing liability for rents. Although the assignee has no affirmative obligation to pay these real property-related expenses prior to obtaining possession or ownership of the real property, the Act does make clear that the assignee’s ability to collect rents from tenants is subject to any such claim or defense that the tenant may have based upon the assignor’s nonperformance (absent an enforceable agreement not to assert such a claim or defense). For further background, *see* Act § 13, Comments 1-2.

*Coordination with Uniform Commercial Code Article 9.* The Act provides that a perfected security interest in rents extends automatically into the identifiable proceeds received upon collection of rent. In the typical case, however, “proceeds” of rents will constitute personal property. This means that conflicting interests may arise in the same proceeds — the assignee’s interest by virtue of this Act, and another person’s by virtue of other law such as Article 9 of the Uniform Commercial Code. The Act provides a set of rules to establish priority between such conflicting interests. To ensure the coordination of this Act with Article 9, this Act generally treats the assignee’s “proceeds” interest as if it had arisen under Article 9 and applies Article 9’s priority rules. For example, the Act protects a third person to whom an assignor transfers money that constitute proceeds of rents, so long as the transferee is not acting in collusion with the

assignor to violate the rights of the assignee. *Cf.* U.C.C. § 9-332(a). For further background, *see* Act § 15, Comments 1-4.

## **UNIFORM ASSIGNMENT OF RENTS ACT**

**SECTION 1. SHORT TITLE.** This [act] may be cited as the Uniform Assignment of Rents Act.

**SECTION 2. DEFINITIONS.** In this [act]:

- (1) “Assignee” means a person entitled to enforce an assignment of rents.
- (2) “Assignment of rents” means a transfer of an interest in rents in connection with an obligation secured by real property located in this state and from which the rents arise.
- (3) “Assignor” means a person that makes an assignment of rents or the successor owner of the real property from which the rents arise.
- (4) “Cash proceeds” means proceeds that are money, checks, deposit accounts, or the like.
- (5) “Day” means calendar day.
- (6) “Deposit account” means a demand, time, savings, passbook, or similar account maintained with a bank, savings bank, savings and loan association, credit union, or trust company.
- (7) “Document” means information that is inscribed on a tangible medium or that is stored on an electronic or other medium and is retrievable in perceivable form.
- (8) “Notification” means a document containing information that this [act] requires a person to provide to another, signed by the person required to provide the information.
- (9) “Person” means an individual, corporation, business trust, estate, trust, partnership, limited liability company, association, joint venture, public corporation, government, or governmental subdivision, agency, or instrumentality, or any other legal or commercial entity.
- (10) “Proceeds” means personal property that is received or collected on account of a tenant’s obligation to pay rents.
- (11) “Purchase” means to take by sale, lease, discount, negotiation, mortgage, pledge, lien, security interest, issue or reissue, gift, or any other voluntary transaction creating an interest in property.
- (12) “Rents” means:

(A) sums payable for the right to possess or occupy, or for the actual possession or occupation of, real property of another person;

(B) sums payable to an assignor under a policy of rental interruption insurance covering real property;

(C) claims arising out of a default in the payment of sums payable for the right to possess or occupy real property of another person;

(D) sums payable to terminate an agreement to possess or occupy real property of another person;

(E) sums payable to an assignor for payment or reimbursement of expenses incurred in owning, operating and maintaining, or constructing or installing improvements on, real property; or

(F) any other sums payable under an agreement relating to the real property of another person that constitute rents under law of this state other than this [act].

(13) “Secured obligation” means an obligation the performance of which is secured by an assignment of rents.

(14) “Security instrument” means a document, however denominated, that creates or provides for a security interest in real property, whether or not it also creates or provides for a security interest in personal property.

(15) “Security interest” means an interest in property that arises by agreement and secures performance of an obligation.

(16) “Sign” means, with present intent to authenticate or adopt a document:

(A) to execute or adopt a tangible symbol; or

(B) to attach to or logically associate with the document an electronic sound, symbol, or process.

(17) “State” means a state of the United States, the District of Columbia, Puerto Rico, the United States Virgin Islands, or any territory or insular possession subject to the jurisdiction of the United States.

(18) “Submit for recording” means to submit a document complying with applicable legal standards, with required fees and taxes, to the appropriate governmental office under [insert reference to the recording act of this state].

(19) “Tenant” means a person that has an obligation to pay sums for the right to possess or occupy, or for possessing or occupying, the real property of another person.

### **Comment**

1. “Assignee.” The term “assignee” means the person entitled to enforce an assignment of rents. Consistent with standard agency principles, the term “assignee” would include an authorized agent of the assignee.

2. “Assignment of rents.” The Act uses the term “assignment of rents” to mean the transfer of an interest in rents, rather than the document by which the transfer is made. Any document sufficient to effect a transfer of a security interest in rents constitutes an assignment of rents under the Act. As a result, a mortgagee need not use a separate document to create an assignment of rents, but can merely incorporate into the mortgage document language that creates an assignment of rents. *See* Act § 4, Comment 4.

For sake of simplicity, the Act uses the term “assignment of rents” even though the document creating such an assignment is usually termed “Assignment of Leases and Rents” and effectively transfers to the assignee an interest in the leases covering the real property (as well as an interest in the rents payable under those leases). The focus of the Act is to govern the creation, perfection, and enforcement of security interests in rents. By using the term “assignment of rents,” the Act is not intended to bifurcate a tenant’s obligation to pay rents from the lease under which the tenant’s obligation to pay rents arises.

3. “Assignor.” The term “assignor” means a person that makes an assignment of rents or the successor owner of the real property subject to the assignment. Consistent with standard agency principles, the term “assignor” would include an authorized agent of the assignor. Thus, for example, if the document creating an assignment of rents provided that a notification given pursuant to that assignment was to be given to the assignor’s lawyer, notification to the lawyer would suffice to constitute notification to the assignor.

4. “Cash proceeds.” The term “proceeds” means personal property that is collected on account of a tenant’s obligation to pay rents covered by this Act. *See* Comment 10. The term “cash proceeds” means proceeds that are in the form of cash, checks, funds in a deposit account, and the like.

5. “Day.” The Act defines “day” as a calendar day.

6. “Deposit account.” This definition is similar to that contained in U.C.C. Section 9-102(a)(29). The term uses the term “bank” in a fashion comparable to the definition contained in U.C.C. Section 1-201(b)(4).

7. “Document.” The definition of “document” is media-neutral and comparable to the definition used in Section 102(3) of the Uniform Residential Mortgage Satisfaction Act. Because this Act uses the term “record” in its customary fashion under real property law — *i.e.*,

as a verb to describe the act of filing an instrument of conveyance with the recorder's office — the Act does not use the term "record" as a noun, and instead uses the term "document."

8. "Notification." The Act permits an assignee to enforce an assignment of rents by giving a notification to the assignor (Section 8) or by giving a notification to tenants of the assignor (Section 9). In any circumstance in which the Act requires notification to be given to a person, any such notification shall be in the form of a document, as defined in Section 2(7), and shall contain the information required by the specific section authorizing that notification.

9. "Person" includes both natural persons (individuals) and all forms of legally recognized public and private organizations.

10. "Proceeds." In this Act, the term "proceeds" means whatever is collected from a tenant on account of the tenant's obligation to pay rent. In most instances, these proceeds will be in the form of cash or checks. The Act provides that a security interest in rents extends automatically to any proceeds of those rents so long as those proceeds are identifiable. Section 14(b), (c).

It is possible that an assignee may claim a security interest in proceeds of rents and that another creditor or person may also claim a conflicting interest in those proceeds by virtue of other law, particularly Article 9 of the Uniform Commercial Code. The Act provides priority rules in Section 15 to address such potential priority conflicts.

11. "Purchase" is defined in the same manner as in Uniform Commercial Code Section 1-201(b)(29), and includes any voluntary transaction creating an interest in property.

12. "Rents." In many commercial real property developments (*e.g.*, office buildings, industrial parks, retail shopping centers, and apartment complexes), the owner stands in a landlord-tenant relationship with the occupiers of the development, based upon the execution of leases covering portions of the development. Because the common law has treated unaccrued rents as an interest in real property (an incorporeal hereditament), the right to collect sums paid by tenant occupiers undoubtedly constitutes "rent" in the nature of real property. Thus, a mortgage lender taking a security interest in "rents" must comply with the provisions of real property law in order to obtain and enforce that security interest. In other words, the mortgage lender must have the mortgagor execute and deliver an instrument sufficient to convey an interest in "rents" and must record that instrument in the appropriate real property records.

In many other developments, however, the owner does not stand in a landlord-tenant relationship with the user/occupier of real property because that user/occupier is only a licensee. Examples of this type of project include nursing homes, parking garages, golf courses, landfills, marinas, stadiums/arenas, student dormitories, and hotels/motels. If the development's occupier is a licensee and not a tenant, a significant classification problem arises — whether the right to collect sums from project occupiers is "rent" governed by real property law (such that the lender would obtain and record an assignment of rents in the real property records), or is instead an "account" governed by Article 9 of the Uniform Commercial Code (such that the lender would

create a security interest in present and after-acquired accounts and perfect that interest by filing a financing statement covering accounts in the Article 9 filing system).

In theory, a lender could moot the resolution of this characterization question simply by (a) making sure that its loan documents create a security interest in both “rents” and “accounts,” and (b) recording/filing evidence of those interests in the respective filing systems. This “belt and suspenders” approach would appear to give the lender a perfected security interest in the right to collect unaccrued occupancy charges, regardless of how a court resolved the characterization question.

Unfortunately, Bankruptcy Code § 552(a) complicates this analysis. Section 552(a) generally provides that any pre-petition security agreement covering after-acquired property does not affect property that the bankruptcy estate acquires post-petition. By itself, section 552(a) would suggest that a lender’s security interest in pre-petition revenues would not attach to post-petition 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 post-petition* and *post-petition proceeds of pre-petition collateral*. This distinction is reflected in section 552(b), which provides that a valid and properly perfected pre-petition security interest in collateral will attach to any rents, profits, and proceeds of that collateral that are received by the debtor post-petition. The protection accorded to secured creditors by section 552(b) makes the resolution of the “what revenues are ‘rents’?” question critical for the commercial real property mortgage lender. If post-petition project revenues are “rents,” “profits,” or “proceeds” of the real property, the lender’s security interest attaches to those revenues. If not, then section 552(a) extinguishes the lender’s interest in post-petition project revenues.

Most of the bankruptcy cases addressing this characterization question involved hotels and security interests in hotel room revenues. Before 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 post-petition hotel room revenues. *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). Most courts, however, concluded that post-petition hotel room revenues were accounts (personal property) and were neither “rents,” “profits,” nor “proceeds” of the real property. *See, e.g., In re Northview Corp.*, 130 Bankr. 543, 548 (9th Cir. BAP 1991); *In re Investment Hotel Properties, Ltd.*, 109 Bankr. 990, 994-97 (Bankr. D. Colo. 1990). These courts typically applied the formalistic reasoning that room revenues could not be “rents” because hotel guests were not “tenants.” As a result, many bankruptcy courts routinely invalidated lenders’ claimed interests in post-petition hotel revenues. The formalistic invalidation of a hotel lender’s interest in post-petition room revenues was particularly inappropriate, as hotel room revenues are economically identical to the “rents” paid by tenants under apartment, office, or industrial leases. *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). Recognizing the absurdity of these decisions, Congress amended section 552(b) in 1994 to preserve the lender’s interest in

post-petition “fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties.”

This amendment provided a practical solution to the classification problem with respect to hotels and other “lodging properties,” but it did not address a wide variety of other income-generating developments. Courts have generally concluded that golf course greens fees do not constitute “rents,” “profits,” or “proceeds” of the real property. *See, e.g., In re McKim*, 217 B.R. 97 (Bankr. D.R.I. 1998); *In re GGVXX, Ltd.*, 130 B.R. 322 (Bankr. D. Colo. 1991). Likewise, courts have refused to characterize stadium/arena revenues as rents. *See, e.g., Klingner v. Pocono International Raceway, Inc.*, 433 A.2d 1357 (Pa. Super. 1981); *In re Zeeway Corp.*, 71 B.R. 210 (9<sup>th</sup> Cir. Bankr. 1987). By contrast, courts have treated revenues from parking garages as rents, *see, e.g., In re Ashford Apartments Ltd. Partnership*, 132 B.R. 217 (Bankr. D. Mass. 1991), and have treated landfill dumping fees as rents. *See, e.g., 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). Courts have split on the characterization of marina slip fees, with some characterizing these as “rents” depending upon the duration of use and others characterizing such fees as accounts subject to Article 9. *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 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 *In re Hamlin’s Landing Joint Venture*, 77 B.R. 916 (Bankr. M.D. Fla. 1987) (same).

In Section 2(12)(A), the Act takes the view that “rents” should include all sums payable for the right to possess or occupy the real property of another. A person “possesses” the real property of another if that person has a possessory interest in that real property (*e.g.*, the interest of a tenant under a lease). A person “occupies” the real property of another if that person has a contractual right that permits them to occupy the real property of another to the exclusion of persons other than the owner. Thus, the Act defines the term “rents” to include all sums paid by a person in order to acquire the right to possess or occupy the real property of another.

The Act also provides that the term “rents” includes any right to payment on account of the actual possession or occupation of the real property of another. Thus, the right to collect from a tenant at sufferance for the period in which that tenant holds over following the termination of its lease constitutes “rents,” even if the landlord chooses to treat the holdover tenant as a trespasser and institute eviction proceedings.

The application of subsection (12)(A) is demonstrated by the following illustrations:

*Illustration 1.* ABC Life Insurance Company holds an assignment of rents on the Friendly Shopping Center. Grocer signs a 20-year lease for an anchor tenancy within the Friendly Shopping Center. The lease provides that Grocer will pay base rent and (depending upon sales) percentage rent. Sums payable from Grocer under the terms of the lease (whether for base rent or percentage rent) constitute “rents” within the meaning of the Act.



*Illustration 2.* ABC Life Insurance Company holds an assignment of rents on the Friendly Hotel. Heinsz is a guest of Friendly Hotel for three nights. Although Heinsz has no possessory interest in a particular hotel room vis-a-vis the owner of Friendly Hotel, Heinsz does “occupy” the room in a fashion that essentially excludes third persons. Sums payable for the room occupancy charges that Heinsz incurs for his stay are “rents.” Sums payable for charges that Heinsz incurs for additional hotel-related services (such as room service meals, dry cleaning or laundry services, or the like) would not constitute “rents,” as they are not incurred in exchange for the right to occupy the room.

*Illustration 3.* ABC Life Insurance Company holds an assignment of rents on the Friendly Nursing Home, where Davis is a resident. Although Davis may not have a possessory interest in the room vis-a-vis the owner of Friendly Nursing Home, Davis does “occupy” the room in a fashion that essentially excludes third persons. Sums payable for the room occupancy charges that Davis incurs for his stay are “rents.” Sums payable for medical treatment, medication, physical therapy, or the like would not constitute “rents,” as they are not incurred in exchange for the right to occupy the room.

*Illustration 4.* First Bank holds an assignment of rents on the Friendly Marina. Smith has a contract with Friendly Marina pursuant to which he pays a monthly fee for a slip at which he may dock his yacht. The monthly fees payable by Smith under this agreement are “rents.”

*Illustration 5.* First Bank holds an assignment of rents on Friendly Parking Garage. Smith has a contract with Friendly Parking Garage pursuant to which he pays \$150 per month for a reserved parking space. Sums payable by Smith for this parking space constitute “rents.”

*Illustration 6.* First Bank holds an assignment of rents on Friendly Golf Course. Smith pays greens fees to play at Friendly Golf Course. Sums payable on account of Smith’s greens fees are not right “rents,” as Smith does not “occupy” the real property but is merely using it in a temporary and essentially nonexclusive fashion.

In jurisdictions adopting this Act, there will remain certain developments for which the definition of “rents” does not unambiguously resolve the classification dilemma. For example, consider a stadium that stages athletic or entertainment events. On the one hand, one might characterize as “rents” the right to collect admission fees from patrons, on the ground that while patrons do not have a possessory interest, they may “occupy” a stadium seat in a more or less exclusive fashion (as two persons cannot literally occupy the same seat simultaneously). On the other hand, one might characterize the right to collect admission fees as “accounts” governed by Uniform Commercial Code Article 9, on the ground that patrons have merely a temporary interest that is more appropriately characterized as “use” rather than “occupancy.” In such cases, a prudent lender may choose to follow the “belt and suspenders” approach — taking both an assignment of rents (and recording it in the real property records) and an Article 9 security interest in present and after-acquired accounts (and perfecting it by filing an Article 9 financing

statement) — in order to assure that it has a perfected security interest in the revenues generated by the project.

Subsections (12)(B) through (E) define rents to include sums payable that leases or occupancy agreements often characterize as “rents,” as well as the right to collect sums that constitute an economic substitute for rents that might otherwise have accrued or been collected. These include the sums payable under a policy of rental interruption insurance; claims arising out of a default in the payment of rents (*e.g.*, liquidated damages); sums payable in order to terminate a lease or occupancy agreement; and sums payable for the purpose of paying or reimbursing the assignor’s payment of expenses incurred in owning, operating and maintaining the real property (such as taxes or insurance) or in constructing or installing improvements.

In any particular state, a court or legislature might choose to define particular sums payable as “rents” even though such sums would not be covered by subsection (12)(A) through (E). Under subsection 12(F), such sums would constitute “rents” under this Act.

13. “Secured obligation.” The term “secured obligation” covers any obligation the performance of which is secured by an assignment of rents.

14. “Security instrument.” This definition is similar to that used in Section 102(19) of the Uniform Nonjudicial Foreclosure Act, and recognizes that the title given to a document by its parties is not dispositive of whether the document is a security instrument. Instead, the key issue is whether the document creates a security interest in real property. The definition thus covers a mortgage, deed of trust, deed to secure debt, or any other document used by the parties to create a security interest in real property.

15. “Security interest.” Under the Act, a security interest arises in any transaction, regardless of its form, in which a person receives or retains an interest in property for the purpose of securing an obligation owed to that person. Thus, the term “security interest” as used in this Act would cover both a security interest in “rents” taken by an assignee as well as a security interest in the proceeds of rents taken by a secured party under Article 9 of the Uniform Commercial Code.

16. “Sign.” This definition is media-neutral and comparable to that contained in Uniform Commercial Code § 2-103(1)(p).

17. “Submit for recording.” This definition is comparable to that contained in Section 102(21) of the Uniform Residential Mortgage Satisfaction Act. To “submit for recording” means that the person has submitted a document that has complied with the appropriate legal requirements for the document submitted, along with required fees and taxes, to the appropriate recording official. Whether an assignment of rents that is submitted for recording is actually recorded or otherwise binds third parties is determined by the state’s recording act.

18. “State.” This definition is the standard definition of the term as used in uniform acts.

19. “Tenant.” For purposes of this Act, a “tenant” is any person that holds a right to possess or occupy the real property of another, or who actually possesses or occupies that real property, and is thereby obligated to pay rents. The Act defines “rents” to include sums payable by certain occupants of real property that do not have a possessory interest in the real property and thus do not stand in a landlord-tenant relationship with the assignor. Although the Act treats such a licensee as a “tenant” for the purposes of this Act, it does not render such a licensee a tenant within the meaning of the state’s landlord-tenant law. Thus, for example, nothing in this Act would grant a licensee the benefit of the state’s forcible entry and detainer statutes, the benefit of an implied warranty of habitability, or any other right recognized under the state’s general law of landlord and tenant.

### **SECTION 3. MANNER OF GIVING NOTIFICATION.**

(a) Except as otherwise provided in subsections (c) and (d), a person gives a notification or a copy of a notification under this [act]:

(1) by depositing it with the United States Postal Service or with a commercially reasonable delivery service, properly addressed to the intended recipient’s address as specified in subsection (b), with first-class postage or cost of delivery provided for; or

(2) if the recipient agreed to receive notification by facsimile transmission, electronic mail, or other electronic transmission, by sending it to the recipient in the agreed manner at the address specified in the agreement.

(b) The following rules determine the proper address for giving a notification under subsection (a):

(1) A person giving a notification to an assignee shall use the address for notices to the assignee provided in the document creating the assignment of rents, but, if the assignee has provided the person giving the notification with a more recent address for notices, the person giving the notification shall use that address.

(2) A person giving a notification to an assignor shall use the address for notices to the assignor provided in the document creating the assignment of rents, but, if the assignor has provided the person giving the notification with a more recent address for notices, the person giving the notification shall use that address.

(3) If a tenant’s agreement with an assignor provides an address for notices to the tenant and the person giving notification has received a copy of the agreement or knows the address for notices specified in the agreement, the person giving the notification shall

use that address in giving a notification to the tenant. Otherwise, the person shall use the address of the premises covered by the agreement.

(c) If a person giving a notification pursuant to this [act] and the recipient have agreed to the method for giving a notification, any notification must be given by that method.

(d) If a notification is received by the recipient, it is effective even if it was not given in accordance with subsection (a) or (c).

### **Comment**

1. *Methods of giving notification.* This section specifies the methods for giving any notification required by this Act. Under subsection (a), notices required by the Act may be transmitted by first-class United States mail or via a commercial reasonable delivery service. Subsection (a) also permits notices to be given by electronic mail, facsimile, or other form of electronic transmission, but only if the recipient agreed to receive notification in that manner and only at the address specified in that agreement. Such an agreement may arise either by express written provisions or by virtue of an established course of conduct between the giver and recipient of the notification (such as the consistent delivery and receipt of previous formal notices).

Proper dispatch, not receipt, satisfies the obligation to give notification. The person asserting that notification was given has the burden of proof that notification was given in accordance with the provisions of this section.

Typically, the document evidencing an assignment of rents contains provisions regarding the manner by which notification shall be sent and the appropriate addresses for notification. Subsection (c) provides that if an agreement between the person giving a notification and the recipient dictates a method of notification other than the methods permitted under subsection (a), any notification must be given by the agreed-upon method.

Under subsection (d), a notification actually given in a manner not authorized by subsection (a) or (c), but received by the recipient, is nevertheless effective under this Act. Thus, for example, personal (by hand) delivery would be effective notification when received by the recipient.

2. *Identifying the address for notification.* Typically, an assignment of rents contains a provision specifying addresses for notices to the assignor and the assignee. Subsection (b) provides that the respective addresses for notice contained in an assignment of rents will be the default addresses for any notification to the assignor or assignee under this Act. If the intended recipient has provided the person giving a notification with a more recent address, then the Act requires the person giving the notification to use that address. For example, if an assignee gives a notification to the assignor enforcing its interest in rents under Section 8 (which governs enforcement by notification to the assignor), and that notification specifies a new address for future notices to the assignee, the assignor would thereafter be obligated to use that new address in giving any notification required by the Act.

Subsection (b)(3) provides that a tenant's address for notification will be the address of the leased premises, unless the lease provides an alternative address for notification to the tenant and the notifier either has a copy of the lease or knows of the alternative address.

3. *Obligations under the Act triggered by receipt.* While a person obligated to give a notification under the Act satisfies the obligation to give that notification by dispatch in accordance with subsection (a), several substantive provisions of the Act effectively require that the intended recipient actually receive notification. For example, although an assignee may give notification to a tenant by mail directing that tenant to pay rents to the assignee, the Act does not legally obligate the tenant to pay rents to the assignee until the tenant receives the notification. *See* Section 9(b).

#### **SECTION 4. SECURITY INSTRUMENT CREATES ASSIGNMENT OF RENTS; ASSIGNMENT OF RENTS CREATES SECURITY INTEREST.**

(a) An enforceable security instrument creates an assignment of rents arising from the real property described in the security instrument, unless the security instrument provides otherwise.

(b) An assignment of rents creates a presently effective security interest in all accrued and unaccrued rents arising from the real property described in the document creating the assignment, regardless of whether the document is in the form of an absolute assignment, an absolute assignment conditioned upon default, an assignment as additional security, or any other form. The security interest in rents is separate and distinct from any security interest held by the assignee in the real property.

#### **Comment**

1. *Security instrument creates an assignment of rents.* Under subsection (a), a security instrument that creates a security interest in real property automatically creates a security interest in the rents arising from that real property, unless the security instrument expressly provides otherwise. In this regard, the Act adopts a default rule comparable to the "proceeds" rules of Uniform Commercial Code Article 9, under which a security agreement covering collateral automatically covers the proceeds of that collateral (including rents from the collateral) unless the agreement provides otherwise. U.C.C. §§ 9-203(f), 9-315(a)(2).

Subsection (a) applies only to a mortgage that is signed and delivered after this Act takes effect. Existing mortgages that do not contain an express assignment of rents will not be covered by subsection (a). *See* Section 20(c). Thus, a mortgage that was signed and delivered before this Act takes effect would not effect an assignment of rents unless it did so by its express terms.

The operation of subsection (a) should not significantly affect the negotiation and documentation of mortgage transactions. In nearly all commercial mortgage transactions, the applicable loan documentation creates an express assignment of rents.

In residential mortgage transactions, most current mortgage documents in “lien theory” states do not contain an express assignment of rents. Nevertheless, the operation of subsection (a) should have no systematic negative effects on residential mortgagors for two reasons. First, because rents typically will not arise if the borrower occupies the mortgaged real property as its primary residence, in most cases the implicit assignment of rents created by Section 4(a) will be of no practical relevance. Second, in the rare case where rents would arise from such property — *e.g.*, where a mortgagor occupies the mortgaged premises as a residence but “rents out” the basement or the attic to a tenant or boarder — the Act’s remedial mechanisms for enforcing the assignee’s interest in rents by notification (either to the assignor or to tenants) would not be available if the assignee holds a security interest in rents solely by virtue of subsection (a). *See* Sections 8(d) and 9(g). Thus, without obtaining an express assignment of rents, a mortgagee could not obtain control over any rents accruing from a mortgagor-occupied residence unless the mortgagee could demonstrate equitable circumstances justifying the appointment of a receiver for the property. Courts have rarely granted receiverships where the mortgaged real property is mortgagor-occupied residential real property.

In a narrow set of cases, Section 4(a) should operate to the direct benefit of unsophisticated sellers of real property. On occasion, a seller of real property will take back a purchase money mortgage but will not obtain an express assignment of rents — often because the seller may have completed the transaction without benefit of legal counsel and thus did not appreciate the need for a separate assignment of rents. Under Section 4(a), such a seller would obtain a security interest in rents automatically (unless the mortgage disclaimed such an interest), and this would provide the seller with a security interest in any rents collected by the buyer in the event that the buyer leased the property and later defaulted or declared bankruptcy.

Subsection (a) would also have relevance if the United States were to adopt the United Nations Convention on the Assignment of Receivables in International Trade. Under article 4.5(a) of that Convention, the priority choice of law rules for assignments of receivables do not affect the priority of an interest in rents under the law of the state in which the related real property is located if under that law an interest in the real property conveys an interest in the rents. A state which enacts this Act would have the benefit of article 4.5(a), as the security instrument creating a security interest in the real property would automatically create an assignment of the rents, unless the security instrument expressly provides otherwise.

In a Chapter 13 bankruptcy case, Bankruptcy Code § 1322(b)(2) permits a debtor to modify the rights of a mortgagee (called a “cram-down”), but not if the mortgagee’s claim is “secured *only* by a security interest in real property that is the debtor’s principal residence” (emphasis added). Prevailing case law suggests that the debtor cannot modify a residential mortgage under Chapter 13 solely because the mortgage also contained an assignment of rents, and that modification of a residential mortgage can occur only if the transaction covered collateral not implicitly related to the mortgage loan. *See In re Fernandos*, 402 F.3d 147 (3d Cir.

2005) (“[T]he grant of an interest in rents does not render the claim secured by anything other than the real property. Therefore, the protections of § 1322(b)(2) still apply to a mortgage in New Jersey where the debt is also secured by rents.”). Consistent with this view, Section 4(a) should not deprive the residential mortgagee of its protection from cram-down under § 1322(b).

*2. Rents as a distinct source of collateral.* An assignment of rents permits the assignee to collect rents that accrue between the date of the assignor’s default and the date that the assignee can complete a mortgage foreclosure on the underlying real property. In many states, this foreclosure process can be quite lengthy. In these states, a mortgagee faces a heightened risk that the mortgagor may collect rents and expend the proceeds other than to reduce the mortgage debt or to pay the expenses of operating and maintaining the real property (a process often referred to as “milking” the rents) while a foreclosure proceeding is pending. By taking an assignment of rents, the assignee demonstrates its intention to have a lien upon all future rents arising from the real property, including those accruing prior to the completion of a foreclosure sale — a period that may be extended if the assignor files a bankruptcy petition that stays the foreclosure.

Traditionally, state law has governed the creation and enforcement of security interests in rents. Most frequently, however, disagreements regarding security interests in rents arise in the federal bankruptcy courts. On its face, the Bankruptcy Code appears to recognize that state law has traditionally treated “rents” that accrue between default and foreclosure as a source of collateral that is separate and distinct from the real property that generated those rents. The Bankruptcy Code characterizes rents from mortgaged real property as “cash collateral,” 11 U.S.C. § 363(a), and preserves a secured creditor’s pre-bankruptcy lien on rents that the debtor receives after it files a bankruptcy petition, *id.* § 552(b). These provisions appear to acknowledge that a pre-bankruptcy assignment of rents creates a distinct security interest in the rents (*i.e.*, distinct from the underlying mortgage lien against the real property itself, at least with respect to rents that accrue prior to completion of a foreclosure).

Most bankruptcy court decisions have treated post-petition rents as a distinct source of collateral, but a few bankruptcy court decisions have instead concluded that post-petition rents do not constitute distinct collateral because the post-petition rent stream is in fact “subsumed” within the valuation of the real property itself. *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). These courts have wrongly concluded that a debtor can use post-petition rents without regard to a pre-bankruptcy assignment of rents as long as the mortgage lender’s interest in the mortgaged real property is adequately protected (*i.e.*, as long as the real property itself is not declining in value), even if the real property was worth less than the mortgage debt. To the extent that these decisions rest upon state law, the Act rejects the position that rents accruing prior to foreclosure are “subsumed within the land.” The Act instead confirms that all rents accruing prior to the completion of a foreclosure constitute a source of collateral that is distinct from the real property from which those rents accrued.

3. *The “Absolute Assignment of Rents.”* As many American states adopted the lien theory of mortgages, some mortgagees began requiring the mortgagor to make an “absolute” assignment of rents. Under a so-called “absolute” assignment of rents, the assignor purported to transfer “title” to unaccrued rents to the assignee, ostensibly placing the assignee in the same legal position as it would have occupied under the title theory of mortgages. Frequently, a so-called “absolute” assignment will specify that it is “not merely for purposes of security” and that the assignor has no title to or interest in unaccrued rents, other than a revocable license (*i.e.*, not a “property” right) to collect such rents prior to default.

Mortgagees have argued that the so-called “absolute” assignment of rents strengthens their position regarding rents in the bankruptcy context. When a debtor files for bankruptcy, all of the debtor’s property becomes property of the bankruptcy estate. 11 U.S.C. § 541(a). The debtor generally may use property of the 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. 11 U.S.C. § 363(b). Moreover, a secured party holding a security interest in property of the estate is subject to the automatic stay and cannot enforce its lien or otherwise collect the debt outside of the bankruptcy proceeding. *Id.* § 362(a). As a result, a debtor that owns income-producing real property gains significant leverage if the post-petition rents constitute property of the estate. By contrast, the mortgagee/assignee would prefer that the law characterize the post-petition rents as property that is **not** part of the estate, as then the automatic stay would place no limit upon the mortgagee’s ability to collect those rents and apply them to the debt.

If a mortgagee had already completed a foreclosure sale before bankruptcy, the real property belongs to the foreclosure purchaser and thus unaccrued rents would not constitute property of the bankruptcy estate. But if no foreclosure has yet occurred — and thus equitable ownership of the real property remains in the debtor — unaccrued post-petition rents would seem to fit squarely within the broad concept “property of the estate” defined in § 541(a). Nevertheless, in an attempt to boost their leverage in bankruptcy, mortgage lenders have argued that under a so-called “absolute” assignment of rents, “title” to the post-petition rents is in the lender and such rents therefore do not constitute property of the estate. A number of courts have accepted this argument. *See, e.g.*, *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); *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.”).

The Restatement (Third) of Property — Mortgages and most commentators have rejected this view. In the typical transaction, the assignor executes an assignment of rents and leases contemporaneously with its execution of the mortgage. The assignee does not immediately begin collecting rents from tenants as soon as it takes the assignment, and typically has no intention to do so at any time before the assignor’s default — indeed, the typical assignment expressly acknowledges the assignor’s right to collect and expend the rents before default.



Under such an “assignment,” the circumstances demonstrate that the parties intend the rents to secure the repayment of 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 real property nevertheless constitute equitable mortgages when the circumstances demonstrate that the parties are using title to real property to secure a debt. *See, e.g.*, Restatement of Property (Third) — Mortgages § 3.2 (absolute deed intended to secure an obligation constitutes a mortgage); *accord* Smith v. Player, 601 So.2d 946 (Ala. 1992); Steckelberg v. Randolph, 404 N.W.2d 144 (Iowa 1987). Under this same principle, courts should treat a typical “absolute” assignment of rents as an assignment for security purposes, and the weight of modern judicial authority so provides. *See, e.g.*, *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). Under this view, where the underlying real property is property of the estate, post-petition rents would likewise constitute property of the estate. The assignee of those rents, however, would continue to have a security interest in those rents by virtue of Bankruptcy Code § 552(b), and the debtor/assignor would be obligated to provide adequate protection of the assignee’s interest in those rents under Bankruptcy Code § 363.

The Act adopts the view that any assignment of rents creates a security interest in rents, regardless of whether the document creating that assignment is in form denominated an “absolute” assignment. The term “assignment of rents” includes only an assignment of rents made in conjunction with a secured loan, and any such assignment creates a security interest governed by the Act. By contrast, nothing in the Act precludes an owner of real property from making a truly absolute transfer of rents in a transaction that is not a security transaction, such as a “true sale” of rents (in which the owner of the real property transfers full legal, equitable ownership and control of unaccrued rents immediately upon execution and delivery). Such a transfer, however, is not an “assignment of rents” as defined in the Act (unless applicable state law dictates otherwise), and thus the provisions of the Act governing the enforcement of an assignment of rents would not apply to such a transfer.

4. *Conveyancing formalities.* The Act is not intended to effect any change in the underlying law of states adopting the Act with respect to the formalities necessary to effect a conveyance of an interest in real property. If a document entitled “Assignment of Rents” is not executed in accordance with the formal requirements for an effective conveyance of an interest in real property, it does not effect a “transfer” of an interest in rents and thus the document would not constitute an “assignment of rents” as defined in Section 2(2). The Act does not specify precisely what formalities are necessary for a document to constitute an effective assignment of rents, but leaves this question to other state law. For example, if an assignor has signed and delivered a document entitled “Assignment of Rents,” but the assignee has not yet extended credit to the assignor and state law provides that no transfer of rents occurs until such credit is actually extended, the document would not effect an “assignment of rents” until the credit is actually extended.

The Act uses the term “assignment of rents” to mean the transfer of an interest in rents, rather than the document by which the transfer is made. This definition serves an important purpose in promoting document simplification and transactional efficiency. In many commercial transactions, it has become customary for the lender to require the borrower to execute multiple documents, including both a “mortgage” or “deed of trust” covering the real property and an “assignment of rents and leases” which assigns to the lender all leases covering the mortgaged real property and all rents accruing under those leases. By contrast, in some transactions, lenders have simply incorporated into the mortgage language sufficient to assign to the lender all leases covering the mortgaged real property and rents accruing under such leases, without a separate assignment document. Under this Act, either approach is sufficient to create an assignment of rents. As a result, there is no need to use a separate document to create an assignment of rents. Mortgage lenders may achieve efficiencies in transactional drafting and negotiation merely by incorporating into the mortgage document language that creates an assignment of rents.

## **SECTION 5. RECORDATION; PERFECTION OF SECURITY INTEREST IN RENTS; PRIORITY OF CONFLICTING INTERESTS IN RENTS.**

(a) A document creating an assignment of rents may be submitted for recording in the [insert reference to appropriate governmental office under the recording act of this state] in the same manner as any other document evidencing a conveyance of an interest in real property.

(b) Upon recording, the security interest in rents created by an assignment of rents is fully perfected, even if a provision of the document creating the assignment or law of this state other than this [act] would preclude or defer enforcement of the security interest until the occurrence of a subsequent event, including a subsequent default of the assignor, the assignee’s obtaining possession of the real property, or the appointment of a receiver.

(c) Except as otherwise provided in subsection (d), a perfected security interest in rents takes priority over the rights of a person that, after the security interest is perfected:

(1) acquires a judicial lien against the rents or the real property from which the rents arise; or

(2) purchases an interest in the rents or the real property from which the rents arise.

(d) A perfected security interest in rents has priority over the rights of a person described in subsection (c) with respect to future advances to the same extent as the assignee’s security interest in the real property has priority over the rights of that person with respect to future advances.

## Comment

1. *Recording.* An assignee may submit a document creating an assignment of rents for recording in accordance with the requirements of the state's recording act. The document is "submitted for recording" when it is presented to the appropriate recording official. Whether the recording official must actually record the document depends upon the assignee's compliance with the substantive and procedural requirements of the recording act. Likewise, the state's recording act governs whether the document is actually "recorded" or binds third parties under state law. For example, in some states a misindexed instrument is considered to be unrecorded, while in other states a misindexed instrument is considered to be properly recorded. *Compare* First Citizen's Nat'l Bank v. Sherwood, 879 A.2d 178 (Pa. 2005) (misindexed mortgage nevertheless gave constructive notice to subsequent purchasers) *with* Howard Savings Bank v. Brunson, 582 A.2d 1305 (N.J. Super. 1990) (misindexed mortgage did not give constructive notice).

2. *Perfection.* 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, in the case of a security interest in non-fixture real property, a bona fide purchaser could have avoided under state law as of the petition date. In the 1980s and early 1990s, bankruptcy courts struggled with the proper impact of § 544(a) upon a mortgagee's security interest in post-petition rents under an assignment of rents. This struggle derives in part from the confusion generated by the differing terminologies of mortgage law and Article 9 of the Uniform Commercial Code. Under 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, including judicial lien creditors. U.C.C. § 9-317(a). Because Bankruptcy Code § 544(a) gives the bankruptcy trustee/debtor-in-possession the status of a hypothetical judicial lien creditor under state law, the trustee/debtor-in-possession takes property of the estate subject to any security interest that was properly perfected under Article 9 before the filing of the bankruptcy petition. If the secured party has a properly perfected security interest before 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 trustee/debtor-in-possession cannot avoid that security interest using its § 544(a) avoidance power.

By contrast, mortgage law did not customarily use the term "perfection." Under mortgage law, recording of a mortgage interest served to make that interest valid as against subsequent creditors and bona fide purchasers of the real property. Analytically, of course, "recording" in this sense is similar to the Article 9 concept of perfection. By analogy, one could argue that if a mortgage lender had taken and properly recorded an assignment of rents before bankruptcy, that mortgage lender should have a security interest in rents that was "perfected" and thus enforceable against third parties. Under this analysis, the trustee/debtor-in-possession could not avoid the mortgage lender's security interest in rents under § 544(a), and thus the mortgage lender would retain its security interest in post-petition rents under § 552(b). A number of courts in fact adopted this analytical approach, treating post-petition rents as the lender's cash collateral

so long as the mortgagee had properly recorded its assignment of rents before bankruptcy. *See, e.g., In re Millette*, 186 F.3d 638 (5<sup>th</sup> Cir. 1999); *Steinberg v. CrossLand Mortgage Corp. (In re Park at Dash Point L.P.)*, 985 F.2d 1008, 1011 (9<sup>th</sup> 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).

Unfortunately for lenders, some bankruptcy courts held that § 544(a) permitted the trustee/debtor-in-possession to invalidate a security interest in post-petition rents if the lender had not taken sufficient steps to *enforce* that interest (*e.g.*, actually collect the rents) prior to bankruptcy. To understand how these decisions confused “perfection” or “enforceability” with “enforcement,” it is helpful to review the distinction between the lien and title theories of mortgage law. Under the title theory, the mortgagee holds “title” to the real property (and thus title to unaccrued rents) by virtue of the mortgage, even before default. By contrast, under the lien theory, a mortgagee holds only a security interest in the real property rather than “title” — and thus a mortgage by itself traditionally gives the mortgagee no interest in unaccrued rents until such time as the mortgagee completes a foreclosure, becomes a mortgagee in possession, or obtains the appointment of a receiver for the real property.

If a mortgagee claims a security interest in rents by virtue of a separate assignment of rents, however, any legal constraints on the mortgagee’s right to collect 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, such as by obtaining the appointment of a receiver, becoming a mortgagee in possession, or impounding the rents. *See, e.g., Taylor v. Brennan*, 621 S.W.2d 592, 593-94 (Tex. 1981); *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). Based upon these decisions, 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 before bankruptcy to activate that lien. These courts concluded that if a mortgagee had not taken action to divest the mortgagor of control over the property and its rents before bankruptcy — such as by obtaining the appointment of a receiver, taking possession of the real property, or notifying tenants to pay rents directly to the mortgagee — the mortgagee’s security interest in post-petition rents was “unperfected” and subject to avoidance under § 544(a). *See, e.g., In re Century Inv. Fund VIII L.P.*, 937 F.2d 371, 377 (7<sup>th</sup> 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). Under this view, the debtor-in-possession could use post-petition rents free and clear of any claim by the mortgagee while the debtor remained in bankruptcy.

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 property practitioners, and commercial mortgage lenders. *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); Patrick A. Randolph, Jr., *Recognizing Lenders’ Rents Interests in Bankruptcy*, 27 Real Prop., Prob. & Trust J. 281 (1992).

In response to this criticism, Congress amended Bankruptcy Code § 552(b) in 1994 in an apparent attempt to provide more uniform treatment of assignments of rents. Before 1994, § 552(b) provided that a pre-petition security interest in real property and rents from that real property extended to post-petition 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 post-petition rents where the mortgagee had failed to take the necessary steps to obtain actual or constructive possession of the real property and its rents before bankruptcy. In 1994, however, Congress amended § 552(b) to remove this reference to “applicable nonbankruptcy law.” Some 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. *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 post-petition interest in rents notwithstanding the creditor’s failure to perfect its security interest in rents under applicable state law ...”). But while legislative history suggests that Congress intended to preempt contrary state laws limiting the post-petition effectiveness of an assignment of rents, the text itself provides no express statement of pre-emptive intent. Further, § 552(b)’s protection for a security interest in post-petition 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 real property 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 in rents — notwithstanding the amendment to § 552(b) — if the mortgagee failed to take such action before bankruptcy.

Roughly one-third of the states have enacted statutes making clear that an assignment of rents is “perfected,” without regard to whether the mortgagee has taken any steps to “activate” or “enforce” that assignment. Cal. Civ. Code §§ 2938; 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. The Act adopts this approach, and provides that a perfected security interest in rents cannot be avoided by a person that thereafter becomes a judgment lien creditor or a purchaser of the rents or the real property from which they arise.

3. *Priority versus purchasers and lien creditors.* Under subsection (c), a perfected security interest in rents takes priority over the rights of a creditor that thereafter acquires a judicial lien against the rents or the real property from which they arise. Likewise, a perfected security interest in rents takes priority over the rights of a person that thereafter purchases an interest in the rents or the real property from which they arise. “Purchaser” includes both buyers and other secured creditors (such as a subsequent assignee of rents).

Subsection (c) is not intended to displace the general priority rules that arise by application of a state’s recording act, but to supplement them. For example, in many states, the recording act does not operate to benefit lien creditors, donees, or other non-reliance creditors. In those states, even an unrecorded mortgage would remain effective against a lien creditor (at least outside of the bankruptcy context). Subsection (c) is not intended to alter this result, but only to make clear that an assignee holding a recorded assignment of rents holds a security interest in rents that cannot be avoided by the bankruptcy trustee under Bankruptcy Code section 544(a) in the event of the assignor’s bankruptcy.

Under subsection (d), a perfected security interest in rents has priority over a purchaser or lien creditor with respect to future advances to the same extent as the assignee’s security interest in the real property has priority over the rights of that purchaser or lien creditor with respect to future advances. In this regard, the Act is neutral with regard to existing state law regarding priority with respect to future advances.

## **SECTION 6. ENFORCEMENT OF SECURITY INTEREST IN RENTS.**

(a) An assignee may enforce an assignment of rents using one or more of the methods specified in Sections 7, 8, and 9 or any other method sufficient to enforce the assignment under law of this state other than this [act].

(b) From the date of enforcement, the assignee or, in the case of enforcement by appointment of a receiver under Section 7, the receiver, is entitled to collect all rents that:

- (1) have accrued but remain unpaid on that date; and
- (2) accrue on or after that date, as those rents accrue.

### **Comment**

1. *Nonexclusive method of enforcement.* Section 6 provides that the assignee may enforce an assignment of rents in accordance with its terms. The Act specifies several methods of enforcement of an assignment of rents in Sections 7 (appointment of a receiver), 8 (notification to the assignor), and 9 (notification to tenants). If the assignee enforces an assignment of rents under Section 7 or 8, the enforcement is effective with respect to all accrued but unpaid rents and all rents accruing thereafter. By contrast, if the assignee enforces an assignment of rents by notifying tenants under Section 9, that enforcement is effective only with respect to tenants actually notified.

The Act also permits enforcement of an assignment of rents by any other method recognized under other law of this state. Thus, for example, this Act would not prevent an assignee holding a mortgage on the real property from taking possession of the real property and thus becoming a “mortgagee in possession.” Generally speaking, mortgage lenders are loathe to assume the status of a mortgagee in possession for a variety of reasons, including potential tort liability to third parties, the obligation to account for rentals collected, and the assumption of a duty to maintain the physical condition of the premises. *See, e.g.*, 1 GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW §§ 4.24 - 4.29, at 213-230 (3d ed. 1993). Still, in rare cases a mortgagee may voluntarily choose to become a mortgagee in possession, and the Act is not intended (either explicitly or implicitly) to eliminate the mortgagee-in-possession doctrine. Thus, to the extent that becoming a mortgagee in possession under the law of this state would be sufficient to enforce a security interest in rents, this Act would permit an assignee to enforce its interest in this manner.

Moreover, the various methods that the Act provides for enforcement of an assignment of rents are not mutually exclusive. An assignee may in appropriate circumstances enforce an assignment of rents by multiple methods. For example, the assignee may choose to enforce its security interest by providing simultaneous notification to the assignor (under Section 8) and to tenants (under Section 9). Likewise, the assignee’s decision to do so would not limit the assignee’s right to later obtain the appointment of a receiver under Section 7.

*2. Rents collectable under this Act.* Upon enforcement, an assignee may collect (1) accrued but unpaid rents, and (2) unaccrued rents as they accrue in the future.

Section 6 does not authorize the assignee to collect the proceeds of rents that the assignor had already collected before enforcement. However, this Act does not prevent the assignee from using another legal mechanism to obtain and enforce a security interest in the proceeds of rents that the assignor has already collected before enforcement. For example, the express terms of an assignment of rents could (1) require the assignor to deposit the cash proceeds of rents into a particular deposit account, and (2) grant the assignee a security interest in that deposit account under Article 9 of the Uniform Commercial Code. If the assignment of rents so provided, the assignee could exercise its available remedies under Article 9 to collect any sums within that deposit account, including the proceeds of rents collected by the assignor before the assignee’s enforcement of its assignment of rents.

*3. Date of enforcement.* The Act specifies a “date of enforcement” of a security interest in rents. This date is important for two reasons. First, under Section 6, the assignee may collect rents beginning on the date of enforcement. Second, under Section 14, an assignor that collects rents after the date of enforcement is obligated to turn those rents over to the assignee and faces liability if it fails to do so.

The date of enforcement will depend upon the method of enforcement used by the assignee. If the assignee enforces the assignment by appointment of a receiver, the date of enforcement will be the date that the court appoints the receiver. Section 7(c). If the assignee enforces the assignment by notification to the assignor, the date of enforcement will be the date

that the assignor receives the notification. Section 8(b). If the assignee enforces the assignment by notification to a tenant, the date of enforcement with respect to rents payable by that tenant is the date that the tenant receives the notification. Section 9(b).

## **SECTION 7. ENFORCEMENT BY APPOINTMENT OF RECEIVER.**

(a) An assignee is entitled to the appointment of a receiver for the real property subject to the assignment of rents if:

(1) the assignor is in default and:

(A) the assignor has agreed in a signed document to the appointment of a receiver in the event of the assignor's default;

(B) it appears likely that the real property may not be sufficient to satisfy the secured obligation;

(C) the assignor has failed to turn over to the assignee proceeds that the assignee was entitled to collect; or

(D) a subordinate assignee of rents obtains the appointment of a receiver for the real property; or

(2) other circumstances exist that would justify the appointment of a receiver under law of this state other than this [act].

(b) An assignee may file a petition for the appointment of a receiver in connection with an action:

(1) to foreclose the security instrument;

(2) for specific performance of the assignment;

(3) seeking a remedy on account of waste or threatened waste of the real property subject to the assignment; or

(4) otherwise to enforce the secured obligation or the assignee's remedies arising from the assignment.

(c) An assignee that files a petition under subsection (b) shall also give a copy of the petition in the manner specified in Section 3 to any other person that, 10 days before the date the petition is filed, held a recorded assignment of rents arising from the real property.



(d) If an assignee enforces an assignment of rents under this section, the date of enforcement is the date on which the court enters an order appointing a receiver for the real property subject to the assignment.

(e) From the date of its appointment, a receiver is entitled to collect rents as provided in Section 6(b). The receiver also has the authority provided in the order of appointment and law of this state other than this [act].

(f) The following rules govern priority among receivers:

(1) If more than one assignee qualifies under this section for the appointment of a receiver, a receivership requested by an assignee entitled to priority in rents under this [act] has priority over a receivership requested by a subordinate assignee, even if a court has previously appointed a receiver for the subordinate assignee.

(2) If a subordinate assignee obtains the appointment of a receiver, the receiver may collect the rents and apply the proceeds in the manner specified in the order appointing the receiver until a receiver is appointed under a senior assignment of rents.

### **Comment**

1. *Actions to which receivership is ancillary.* Traditionally, a receivership of mortgaged property is a remedy that is ancillary to some action to enforce either the mortgage debt or the mortgage lien. In states that recognize only judicial foreclosure, the existence of a judicial foreclosure proceeding provides the action to which a receivership may be ancillary. In states that authorize power of sale foreclosure, however, a mortgagee may choose to foreclose privately without any judicial proceeding. In these states, the lack of any pending action raises a concern about whether the mortgagee can obtain the “ancillary” remedy of a receivership.

The Act addresses this concern by authorizing the assignee to file an action for specific performance of the assignment of rents. The filing/pendency of this action would provide a sufficient jurisdictional predicate for the appointment of a receiver, even if the assignee chose to proceed with its foreclosure by power of sale.

Most frequently, a receiver will be appointed in conjunction with a foreclosure proceeding or an action for specific performance of an assignment of rents. However, an action against the assignor for waste would also serve as a sufficient jurisdictional predicate for the appointment of a receiver under subsection. Furthermore, any other action to enforce the secured obligation or the assignee’s remedies, including an action to recover damages from the assignor under Section 14(d) of the Act, may also serve as a sufficient jurisdictional predicate for the appointment of a receiver.

2. *Default.* Generally speaking, a receivership is appropriate only in the event that the assignor is in default on the secured obligation. Consistent with the approach of Uniform

Commercial Code Article 9, the Act does not define the term “default,” but leaves to the agreement of the parties the circumstances giving rise to a default. *Cf.* U.C.C. § 9-601 cmt. 3.

3. *Traditional standards for appointment of a receiver.* Traditionally, courts have appointed a receiver for mortgaged real property if the value of the real property was insufficient to satisfy the mortgage debt (*i.e.*, where the mortgagee’s security was inadequate) or the owner of the mortgaged real property was committing waste (thereby threatening the value of the mortgagee’s security). *See, e.g.*, Restatement (Third) of Property — Mortgages §§ 4.3(a)(2), 4.3(a)(3); 1 G. Nelson & D. Whitman, Real Estate Finance Law § 4.34 (3d ed. 1993). Consistent with this traditional approach, Section 7(a)(1)(B) authorizes the appointment of a receiver if the real property appears insufficient to satisfy the secured obligation. Likewise, Section 7(a)(2) authorizes the appointment of a receiver where “other circumstances” justify the appointment of a receiver under the law of this state other than this Act. Such “other circumstances” could include waste as defined under state law other than this Act. Thus, for example, if the law of this state other than this Act treats nonpayment of real property taxes as actionable waste and allows appointment of a receiver in the event of waste, the assignor’s nonpayment of taxes would provide a justification for the appointment of a receiver.

A few court decisions have required a mortgagee seeking appointment of a receiver to show that the mortgagor was insolvent. *See, e.g.*, Mutual Benefit Life Ins. Co. v. Frantz Klodt & Son, Inc., 237 N.W.2d 350 (Minn. 1975). The Restatement (Third) of Property — Mortgages and most commentators have rejected this view. The Act does not require the assignee to demonstrate the assignor’s insolvency as a predicate to obtaining the appointment of a receiver, but Section 7(a)(2) would permit an assignee to use the assignor’s insolvency as grounds for appointment of a receiver where other state law has recognized the assignor’s insolvency as sufficient grounds for a receivership.

4. *Receivership clauses.* The modern commercial mortgage typically contains a provision in which the mortgagor consents to the appointment of a receiver for the real property following default. Often, receivership clauses provide that the mortgagor consents to the appointment of a receiver following default as a matter of contract, without regard to whether the mortgagor is insolvent or whether the physical condition of the real property would otherwise justify the appointment of a receiver.

Because the appointment of a receiver has traditionally originated from within the court’s equitable discretion, some courts have refused to appoint a receiver — despite the presence of a receivership clause — in cases where they would have denied appointment of a receiver otherwise. *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); Sazant v. Foremost Investments, N.V., 507 So.2d 653 (Fla. App. 1987) (receivership clause not binding on court where mortgagor had not committed waste and default did not place mortgagee at serious risk of noncollection); Gage v. First Federal Sav. & Loan Ass’n, 717 F. Supp. 745 (D. Kan. 1989); Barclays Bank, P.L.C. v. Davidson Ave. Assocs., Ltd., 644 A.2d 685 (N.J. Super. 1994) (receivership clause “usurps the judicial function” and thus violates public policy). In other states, courts have treated receivership clauses as presumptively but not conclusively

enforceable. For example, in *Barclays Bank v. Superior Court*, 137 Cal. Rptr. 743 (Cal. App. 1977), the court held that a receivership clause presented a prima facie (but rebuttable) evidentiary showing of the mortgagee's entitlement to the appointment of a receiver. *See also, e.g., Riverside Properties v. Teachers Ins. & Annuity Ass'n*, 590 S.W.2d 736 (Tex. App. 1979); *Okura & Co. v. Careau Group*, 783 F. Supp. 482 (C.D. Cal. 1991); *Wellman Sav. Bank v. Roth*, 432 N.W.2d 697 (Iowa App. 1988).

By contrast, significant recent judicial authority supports the view that a receivership clause provides a sufficient basis to appoint a receiver after the mortgagor's default. *See, e.g., Bank of America Nat'l Trust & Sav. Ass'n v. Denver Hotel Ass'n Ltd. Partnership*, 830 P.2d 1138 (Colo. App. 1992) (upholding appointment of receiver under receivership clause, without regard to adequacy of security or solvency of mortgagor, under abuse of discretion standard); *Fleet Bank v. Zimelman*, 575 A.2d 731 (Me. 1990) (freely bargained-for receivership clause should be enforced); *Metropolitan Life Ins. Co. v. Liberty Center Venture*, 650 A.2d 887 (Pa. Super. 1994); *Federal Home Loan Mortgage Corp. v. Nazar*, 100 B.R. 555 (D. Kan. 1989). These cases are consistent with the position adopted by Restatement (Third) of Property — Mortgages § 4.3(b). Further, statutes in several states provide that a receivership clause is enforceable as a matter of right. *See, e.g., Ind. Code* § 32-30-5-1; *Minn. Stat. Ann.* § 559.17(2) (mortgages of \$100,000 or more); *N.Y. Real Prop. Law* § 254(10) (receivership clause enforceable "without notice and without regard to adequacy of any security of the debt"); *Okla. Stat. Ann. tit. 12, § 1551(2)(c)* (court shall appoint receiver when "a condition of the mortgage has not been performed and the mortgage instrument provides for the appointment of a receiver"). Finally, federal courts have routinely held receivership clauses in federally insured mortgages sufficient to justify the appointment of a receiver. *See, e.g., United States v. Berk & Berk*, 767 F. Supp. 593 (D.N.J. 1991); *United States v. Drexel View II, Ltd.*, 661 F. Supp. 1120 (N.D. Ill. 1987).

Consistent with this view, Section 7(a)(1)(A) takes the position that a receivership clause is enforceable following the assignor's default, whether that clause is contained in the document creating the assignment of rents or elsewhere. No post-default agreement or consent by the assignor is necessary. Further, by expressing the circumstances justifying the appointment of a receiver in the disjunctive, Section 7(a)(1) adopts the view that a receivership clause is enforceable by the assignee without regard to the condition of the real property, the solvency of the assignor, or the adequacy of the security for the secured obligations.

5. *Notification to other record rents assignees.* Subsection (c) provides that an assignee that petitions for the appointment of a receiver must give a copy of the petition to any other person that, 10 days before the petition is filed, held a recorded assignment of rents covering the real property. Notification will alert another person holding a recorded assignment of rents as to the receivership petition, and permit that person to take whatever steps it considers justified to protect its interest in the rents. For example, if the enforcing rents assignee holds a junior assignment of rents, notification to the senior could lead the senior to immediately file its own petition for the appointment of a receiver — thereby enabling the senior to avoid the risk that the junior might by collection acquire effective priority as to the following period's rents. By

contrast, if the enforcing rents assignee holds a senior assignment of rents, notification to the junior would alert the junior of the need to investigate the status of the senior obligations.

The Act only requires that the petitioner give a copy of the petition to other recorded rents assignees in the manner specified in Section 3 of the Act; it does not require that the petitioner actually join the other recorded rents assignees as a party to the primary action and serve the petition upon them. Whether the petitioner is required to join the other recorded rents assignees as a party to the primary action is governed by law of the state other than this Act.

6. *Priority between conflicting receivers.* Subsection (f), which is modeled upon § 4.5 of the Restatement (Third) of Property — Mortgages, provides a priority rule in the event where multiple rents assignees obtain the appointment of a receiver. As a threshold matter, conflicting security interests in rents are resolved based upon the priorities established by the state's recording act, and thus an assignee holding a recorded assignment of rents would be entitled to priority over the interest of a later assignee of the same rents. Act § 5(c). Consistent with this approach, if the senior assignee is entitled to the appointment of a receiver under Section 7, the court's appointment of that receiver will take priority over and displace a prior receivership obtained by a subordinate assignee. Any proceeds actually collected by the receiver for the subordinate assignee, however, need not be turned over to the receiver for the senior assignee; instead, the receiver for the subordinate assignee must apply those sums in the manner specified in its order of appointment.

7. *Ex parte appointment of a receiver.* Many assignments of rents contain a clause entitling the assignee to the appointment of a receiver on an *ex parte* basis, without notice to the assignor. The Act does not establish that the assignee is entitled to a receivership on an *ex parte* basis, and instead leaves to other state law the question of whether (and in what circumstances) prior notice to the assignor is excused.

8. *Receiver's power to terminate or disaffirm existing leases.* In many states, statutory or case law regarding receiverships has generally established (or limited) the receiver's power to terminate leases in default or to disaffirm leases not in default. Likewise, the court order appointing a receiver will often specify the extent to which a receiver can take these steps with or without the approval of the court and/or the assignee. As a result, subsection (e) addresses the receiver's power to terminate and/or disaffirm leases by leaving this question to the terms of the court order appointing the receiver and other state law.

## **SECTION 8. ENFORCEMENT BY NOTIFICATION TO ASSIGNOR.**

(a) Upon the assignor's default, or as otherwise agreed by the assignor, the assignee may give the assignor a notification demanding that the assignor pay over the proceeds of any rents that the assignee is entitled to collect under Section 6. The assignee shall also give a copy of the notification to any other person that, 10 days before the notification date, held a recorded assignment of rents arising from the real property.

(b) If an assignee enforces an assignment of rents under this section, the date of enforcement is the date on which the assignor receives a notification under subsection (a).

(c) An assignee's failure to give a notification under subsection (a) to any person holding a recorded assignment of rents does not affect the effectiveness of the notification as to the assignor, but the other person is entitled to any relief permitted under law of this state other than this [act].

(d) An assignee that holds a security interest in rents solely by virtue of Section 4(a) may not enforce the security interest under this section while the assignor occupies the real property as the assignor's primary residence.

### Comment

1. *Enforcement by notification to assignor.* An assignment of rents typically requires the assignor to pay rents to the assignee following default, either immediately or upon demand by the assignee. The Restatement (Third) of Property — Mortgages adopted the view that notification to the assignor following default is sufficient to enforce a perfected security interest in rents and to give the assignee the legal right to possession of the rents. *See* Restatement (Third) of Property — Mortgages § 4.2(c). This position effectively places an obligation on the assignor to pay over to the assignee any rents thereafter collected by the assignor; the assignor's collection and retention of rents following such notification would constitute waste that would potentially subject the assignor to liability for damages. *Id.* §§ 4.6(a)(5), 4.6(b)(3).

The Act likewise adopts this approach, authorizing the assignee to enforce an assignment of rents by means of a notification to the assignor following default under the assignment. As provided in Section 14(d), the assignor's failure to pay over to the assignee any rents it collects following receipt of such notification would subject to the assignor to liability to the assignee for the amount of the rents not turned over.

Consistent with the approach of Uniform Commercial Code Article 9, the Act does not define the term "default," but leaves to the agreement of the parties the circumstances giving rise to a default. *Cf.* U.C.C. § 9-601 cmt. 3.

2. *Notification to other record rents assignees.* Subsection (a) provides that an assignee enforcing an assignment of rents must give notification not only to the assignor, but also to any other person that, 10 days before the notification date, held a recorded assignment of rents covering the real property. Notification will alert another person holding a recorded assignment of rents as to the pending enforcement effort, and permit that person to take whatever steps it considers justified to protecting its interest in the rents. For example, if the enforcing rents assignee holds a junior assignment of rents, notification to the senior could lead the senior to enforce its interest in rents immediately (assuming its assignment permitted immediate action under the circumstances) — thereby avoiding the risk that the junior might by collection acquire effective priority as to the following period's rents. By contrast, if the enforcing rents assignee

holds a senior assignment of rents, notification to the junior would alert the junior of the need to investigate the status of the senior obligations.

Subsection (c) provides that the failure of the enforcing assignee to give notification to other rents assignees does not negate the effectiveness of the notification as to the assignor. If the assignor received the notification and subsequently collected rents but failed to turn those over to the assignee, the assignor would face liability under Section 14(d) regardless of whether the enforcing assignee had given notification to other rents assignees. If a rents assignee fails to give a required notification to another creditor entitled to notification, subsection (c) entitles the other creditor to any relief provided by law other than this Act. This would permit the other creditor to plead and prove any damages proximately caused by the failure to give notification.

3. *Nonexclusivity of means of enforcement.* The Act's various methods of enforcement of an assignment of rents are not exclusive in nature. The primary benefit of enforcement by notification to the assignor under Section 8 may be that such enforcement triggers the assignor's liability under Section 14(d) for failure to turn over any rents thereafter collected. By contrast, an assignee that wants more immediate control over actual collection of rents as they accrue may simultaneously choose to enforce its assignment of rents by means of appointment of a receiver (Section 7) or notification to tenants (Section 9). The Act does not limit the ability of an assignee to enforce its interest in rents by multiple methods.

4. *Limitation on notification remedy where mortgage does not contain express assignment of rents.* Under Section 4(a) of the Act, the signing and delivery of a mortgage creates an assignment of rents automatically, even without express language creating an assignment of rents, unless the mortgage provides otherwise. However, an assignee that claims a security interest in rents solely by virtue of Section 4(a) — *i.e.*, by virtue of a mortgage that does not expressly create an assignment of rents and without any other document that grants the assignee a security interest in rents — cannot enforce its security interest by notification under subsection (a), as long as the assignor occupies the real property as its primary residence.

## **SECTION 9. ENFORCEMENT BY NOTIFICATION TO TENANT.**

(a) Upon the assignor's default, or as otherwise agreed by the assignor, the assignee may give to a tenant of the real property a notification demanding that the tenant pay to the assignee all unpaid accrued rents and all unaccrued rents as they accrue. The assignee shall give a copy of the notification to the assignor and to any other person that, 10 days before the notification date, held a recorded assignment of rents arising from the real property. The notification must be signed by assignee and:

(1) identify the tenant, assignor, assignee, premises covered by the agreement between the tenant and the assignor, and assignment of rents being enforced;

(2) provide the recording data for the document creating the assignment or other reasonable proof that the assignment was made;

(3) state that the assignee has the right to collect rents in accordance with the assignment;

(4) direct the tenant to pay to the assignee all unpaid accrued rents and all unaccrued rents as they accrue;

(5) describe the manner in which subsections (c) and (d) affect the tenant's payment obligations;

(6) provide the name and telephone number of a contact person and an address to which the tenant can direct payment of rents and any inquiry for additional information about the assignment or the assignee's right to enforce the assignment; and

(7) contain a statement that the tenant may consult a lawyer if the tenant has questions about its rights and obligations.

(b) If an assignee enforces an assignment of rents under this section, the date of enforcement is the date on which the tenant receives a notification substantially complying with subsection (a).

(c) Subject to subsection (d) and any other claim or defense that a tenant has under law of this state other than this [act], following receipt of a notification substantially complying with subsection (a):

(1) a tenant is obligated to pay to the assignee all unpaid accrued rents and all unaccrued rents as they accrue, unless the tenant has previously received a notification from another assignee of rents given by that assignee in accordance with this section and the other assignee has not canceled that notification;

(2) unless the tenant occupies the premises as the tenant's primary residence, a tenant that pays rents to the assignor is not discharged from the obligation to pay rents to the assignee;

(3) a tenant's payment to the assignee of rents then due satisfies the tenant's obligation under the tenant's agreement with the assignor to the extent of the payment made; and

(4) a tenant's obligation to pay rents to the assignee continues until the tenant receives a court order directing the tenant to pay the rent in a different manner or a signed document from the assignee canceling its notification, whichever occurs first.

(d) A tenant that has received a notification under subsection (a) is not in default for nonpayment of rents accruing within 30 days after the date the notification is received before the earlier of:

(1) 10 days after the date the next regularly scheduled rental payment would be due; or

(2) 30 days after the date the tenant receives the notification.

(e) Upon receiving a notification from another creditor that is entitled to priority under Section 5(c) that the other creditor has enforced and is continuing to enforce its interest in rents, an assignee that has given a notification to a tenant under subsection (a) shall immediately give another notification to the tenant canceling the earlier notification.

(f) An assignee's failure to give a notification under subsection (a) to any person holding a recorded assignment of rents does not affect the effectiveness of the notification as to the assignor and those tenants receiving the notification. However, the person entitled to the notification is entitled to any relief permitted by law of this state other than this [act].

(g) An assignee that holds a security interest in rents solely by virtue of Section 4(a) may not enforce the security interest under this section while the assignor occupies the real property as the assignor's primary residence.

### **Comment**

1. *Enforcement by notification to tenants.* Section 9 provides that an assignee may enforce its security interest in rents by notification to tenants either following default or otherwise in accordance with the assignment. Because many assignments of rents do not authorize the assignee to collect rents before the assignor's default, enforcement by Section 9 will usually arise only after the assignor's default. Nevertheless, this Act would permit the assignee to collect rents directly from the tenants even before default if the assignor so agrees.

Subsection (a) specifies the required contents of the notification. Although the Act does not require that the notification be in any particular form, Section 10 provides a form notification sufficient to satisfy subsection (a) if properly completed. Consistent with standard agency principles, the term "assignee" would include an authorized agent of the assignee. Thus, for example, if the assignee had authorized its mortgage servicer to enforce the secured obligation and the assignment of rents, the mortgage servicer's signature on the notification would be sufficient to satisfy subsection (a)(8).



Consistent with the approach of Uniform Commercial Code Article 9, the Act does not define the term “default,” but leaves to the agreement of the parties the circumstances giving rise to a default. *Cf.* U.C.C. § 9-601 cmt. 3.

2. *Effect of notification.* Once the tenant receives notification from the assignee demanding payment of rents pursuant to the assignment, the tenant must pay accrued but unpaid rents and rents accruing in the future to the assignee in order to satisfy its rental obligation. In this respect, the Act’s provisions generally operate comparably to Uniform Commercial Code Section 9-406(a), which governs the circumstances under which an account debtor can discharge its obligation following notification and demand by an assignee of that account. Following receipt of a notification, a tenant cannot discharge its rental obligations by payment to the assignor. Thus, a tenant that pays its landlord following receipt of a notification under this section faces the risk of having to make double payment of the sums necessary to discharge its rental obligation.

The Act provides an exception to this rule in the case of a tenant that occupies the premises as its primary residence. The Act allows an assignee to notify residential tenants to pay rents to the assignee, and also provides that any such tenant that pays the assignee following receipt of such a notification is discharged to the extent of the payment. Under subsection (c)(2), however, a tenant that occupies the premises as its primary residence is discharged by payment to the assignor, even if the tenant has received a notification directing it to pay rents to the assignee. This exception prevents a residential tenant that has paid the assignor from being evicted from its primary residence. The exception is viewed as a justifiable protection for residential tenants in light of the fact that the assignee of rents arising from residential property can more effectively enforce its security interest in rents through alternative means (such as by obtaining the appointment of a receiver).

The tenant’s obligation to direct payment of rents to the assignee following receipt of a notification under subsection (a) is subject to two caveats. First, the tenant’s obligation to pay rents is subject to any claim or defense available to the tenant under law other than the Act. See Act §§ 9(c), 13(b). Second, the tenant need not comply if it has previously received a notification from another assignee of rents given by that assignee in accordance with this section, and the other assignee has not cancelled that notification. Until such a tenant receives instructions canceling that prior notification, the tenant may continue to pay the other assignee in accordance with the prior notification.

3. *Notification to other rents assignees.* Subsection (a) requires that the enforcing assignee give notification to the assignor and to any person that, 10 days prior to the notification date, held a recorded assignment of rents on the real property. Under this provision, an enforcing assignee must search the public records to identify any other creditors holding a recorded assignment of rents (whether junior or senior to the assignee’s interest) and provide notification of enforcement to such creditors. Notification will alert another person holding a recorded assignment of rents as to the pending enforcement effort and permit that person to protect its secured position with respect to the rents. *See* Act § 8, Comment 2.

Failure to give notification to another rents assignee under this section does not defeat the effectiveness of the notification as to the assignor and tenants receiving the notification. If a rents assignee fails to give a required notification to another creditor entitled to notification, subsection (f) entitles the other creditor to any relief provided by law other than this Act. This would permit the other creditor to plead and prove any damages proximately caused by the failure to give notification.

4. *Tenant protected for payment to assignee.* Subsection (c)(3) provides that a tenant that pays rents to the assignee following receipt of a notification under this section discharges its rental obligation to the extent of such payment. Even if the assignor subsequently established that the assignee's notification was wrongful, the assignor would not be able to declare a tenant in breach for nonpayment of rent if that tenant paid the assignee pursuant to the notification.

5. *Extension of time for payment of next rental payment following notification.* If a tenant receives a notification directing payment of rents to an assignee, the tenant reasonably may wish to obtain counsel regarding the effect of the notification. If the notification arrives shortly before the tenant's rental due date, however, the tenant may find it difficult to obtain that advice before its rental obligation would become past due.

To give the tenant a reasonable opportunity to obtain counsel, subsection (d) provides that neither the assignor nor the assignee may hold a tenant in default solely for nonpayment of rents that accrue after the notification is given until the earlier of 10 days after the next regularly scheduled rental payment would be due under the lease or 30 days after the date the tenant receives the notification. Subsection (d) would not in any way protect a tenant from the consequences of a breach of the lease on grounds other than nonpayment of rent, or for nonpayment of rents that accrued before the giving of the notification.

The application of subsection (d) is demonstrated by the following illustrations:

*Illustration 1.* Tenant's rent is due and payable to Assignor monthly, on the first of each month. On March 28, Tenant receives a notification from Assignee demanding that Tenant pay future rents to Assignee. Neither Assignor nor Assignee may declare Tenant in default of the April 1 rent payment until after April 11.

*Illustration 2.* Tenant's rent is due and payable to Assignor monthly, on the first of each month. On April 3, Tenant receives a notification from Assignee demanding that Tenant pay future rents to Assignee. Neither Assignor nor Assignee may declare Tenant in default of the May 1 rent payment until after May 3.

*Illustration 3.* Tenant's rent is due and payable to Assignor quarterly, on the first of January, April, July, and October. On February 28, Tenant receives a notification from Assignee demanding that Tenant pay future rents to Assignee.

Under subsection (c), Tenant receives no extension of the time for its April 1 quarterly rent payment.

*Illustration 4.* Tenant's lease provides that base rental is due and payable to Assignor monthly, on the first of each month. Tenant's lease also provides a percentage rental clause by which percentage rental is payable on an annual basis on September 25. On September 15, Tenant receives a notification from Assignee demanding that Tenant pay future rents to Assignee. Neither Assignor nor Assignee may declare Tenant in default for failure to pay the October 1 base rent payment until after October 11. Neither Assignor nor Assignee may declare Tenant in default for failure to pay the September 25 percentage rental payment until after October 5.

6. *Enforcement by multiple rent assignees.* In some circumstances, multiple creditors may seek to collect rents directly from tenants pursuant to this Act. If a subordinate rents assignee collect rents under this section, the subordinate rents assignee may keep the rents collected in good faith and apply those rents to its secured obligations notwithstanding its subordinate position, until such time as the senior rents assignee enforces its superior collection rights. Once a subordinate rents assignee that has enforced its security interest in rents under this section receives a notification that a senior assignee has enforced its interest in rents, subsection (e) obligates the subordinate rents assignee to give an immediate notification to tenants canceling its previous payment instructions. A subordinate rents assignee that fails to cancel its prior notification may not thereafter collect rents in good faith within the meaning of Section 14(f).

7. *Limitation on notification remedy where mortgage does not contain express assignment of rents.* Under Section 4(a) of the Act, the signing and delivery of a mortgage creates an assignment of rents automatically, even without express language creating an assignment of rents, unless the mortgage provides otherwise. However, an assignee that claims a security interest in rents solely by virtue of Section 4(a) — *i.e.*, by virtue of a mortgage that does not expressly create an assignment of rents and without any other document that grants the assignee a security interest in rents — cannot enforce its security interest by notification under subsection (a), as long as the assignor occupies the real property as its primary residence.

**SECTION 10. NOTIFICATION TO TENANT: FORM.** No particular phrasing is required for the notification specified in Section 9. However, the following form of notification, when properly completed, is sufficient to satisfy the requirements of Section 9:

**NOTIFICATION TO PAY RENTS TO PERSON OTHER THAN LANDLORD**

Tenant: \_\_\_\_\_  
Name of Tenant

Property Occupied by Tenant (the "Premises"): \_\_\_\_\_  
Address

Landlord: \_\_\_\_\_  
Name of landlord

Assignee: \_\_\_\_\_  
Name of assignee

Address of Assignee and Telephone Number of Contact Person:

\_\_\_\_\_  
Address of assignee

\_\_\_\_\_  
Telephone number of person to contact

1. The Assignee named above has become the person entitled to collect your rents on the Premises listed above under \_\_\_\_\_  
Name of document  
(the "Assignment of Rents") dated \_\_\_\_\_, and recorded at \_\_\_\_\_  
Date Recording data  
in the \_\_\_\_\_.  
Appropriate governmental office under the recording act of this state

You may obtain additional information about the Assignment of Rents and the Assignee's right to enforce it at the address listed above.

2. The Landlord is in default under the Assignment of Rents. Under the Assignment of Rents, the Assignee is entitled to collect rents from the Premises.

3. This notification affects your rights and obligations under the agreement under which you occupy the Premises (your "Agreement"). In order to provide you with an opportunity to consult with a lawyer, if your next scheduled rental payment is due within 30 days after you receive this notification, neither the Assignee nor the Landlord can hold you in default under your Agreement for nonpayment of that rental payment until 10 days after the due date of that payment

or 30 days following the date you receive this notification, whichever occurs first. You may consult a lawyer at your expense concerning your rights and obligations under your Agreement and the effect of this notification.

4. You must pay to the Assignee at the address listed above all rents under your Agreement which are due and payable on the date you receive this notification and all rents accruing under your Agreement after you receive this notification. If you pay rents to the Assignee after receiving this notification, the payment will satisfy your rental obligation to the extent of that payment.

5. Unless you occupy the Premises as your primary residence, if you pay any rents to the Landlord after receiving this notification, your payment to the Landlord will not discharge your rental obligation, and the Assignee may hold you liable for that rental obligation notwithstanding your payment to the Landlord.

6. If you have previously received a notification from another person that also holds an assignment of the rents due under your Agreement, you should continue paying your rents to the person that sent that notification until that person cancels that notification. Once that notification is canceled, you must begin paying rents to the Assignee in accordance with this notification.

7. Your obligation to pay rents to the Assignee will continue until you receive either:

(a) a written order from a court directing you to pay the rent in a manner specified in that order; or

(b) written instructions from the Assignee canceling this notification.

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Name of assignee

By: Officer/authorized agent of assignee

**SECTION 11. EFFECT OF ENFORCEMENT.** The enforcement of an assignment of rents by one or more of the methods identified in Sections 7, 8, and 9, the application of proceeds by the assignee under Section 12 after enforcement, the payment of expenses under Section 13, or an action under Section 14(d) does not:

- (1) make the assignee a mortgagee in possession of the real property;
- (2) make the assignee an agent of the assignor;
- (3) constitute an election of remedies that precludes a later action to enforce the secured obligation;
- (4) make the secured obligation unenforceable[; or][;]
- (5) limit any right available to the assignee with respect to the secured obligation[.][;]
- [(6) violate [cite the “one-action” statute of this state][.][; or]]
- [(7) bar a deficiency judgment pursuant to any law of this state governing or relating to deficiency judgments following the enforcement of any encumbrance, lien, or security interest.]

**Legislative Note:** *A state that does not have a “one action” statute or anti-deficiency legislation should omit subsections (6) and (7), as appropriate.*

### Comment

1. *Mere enforcement of security interest in rents does not trigger mortgagee-in-possession status.* A number of common law decisions suggest that a mortgagee can become a “mortgagee in possession” — with the legal responsibilities attendant to that status — without physical occupation of the mortgaged premises. *See, e.g.,* 1 GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW §§ 4.25, at 218 & nn. 1-9 (3d ed. 1993) (collecting cases). This result is not surprising, given the factual and legal uncertainty attendant to the term “possession.” This ambiguity can produce concern for the assignee that wishes to protect its security interest in rents without assuming the duties and liabilities attendant to mortgagee-in-possession status. Consistent with commentary to the Restatement (Third) of Property — Mortgages, the Act provides that the mere collection of rents does not render the mortgagee a “mortgagee in possession” with the duties and liabilities attendant to that status. *Cf.* Restatement (Third) of Property — Mortgages § 4.2 cmt. c.

2. *Cumulative nature of mortgagee’s remedies.* Under the traditional rule, the mortgagee holding an assignment of rents could proceed after default to enforce its right to collect rents without concern about the impact that action might have on the mortgagee’s other remedies. The traditional approach treated the mortgagee’s remedies as cumulative; the mortgagee’s selection of one remedy did not preclude the mortgagee from subsequently seeking another remedy (*e.g.,*

initially suing on the mortgage note, and later foreclosing on the mortgage). *See, e.g.*, Restatement (Third) of Property — Mortgages § 8.2 Reporters’ Note (collecting cases).

The Act adopts this view, and makes clear that the assignee’s enforcement of its assignment of rents does not constitute an election of remedies that precludes a later action to enforce the secured obligation, render the secured obligation unenforceable, or otherwise limit any rights available to the assignee with respect to the secured obligation. Thus, for example, if an assignee enforces its security interest by obtaining the appointment of a receiver under Section 7, and the appointment is ancillary to an action by the assignee for specific performance of the assignment of rents, the assignee’s enforcement action does not preclude the assignee from subsequently asserting any other remedies it may have to enforce the secured obligation or against any other collateral it may hold securing that obligation.

3. *“One action” rules and anti-deficiency provisions.* In some states, “one action” rules provide that there can be only one form of action for the recovery of any debt secured by real property. *See, e.g.*, Cal. Code Civ. Pro. § 726(a); Idaho Code § 6-101(1); Mont. Code Ann. § 71-1-222(1); Nev. Rev. Stat. § 40.430(1); Utah Code § 78-37-1; *see also* First State Bank of Cooperstown v. Ihringer, 217 N.W.2d 857 (N.D. 1974). Under this approach, for example, a mortgagee’s decision to sue on the mortgage note would constitute an “action” that subsequently bars the mortgagee from foreclosing the mortgage.

Ambiguity over the scope of a “one action” rule — and whether it would treat an attempt to enforce an assignment of rents as an “action” that would prevent other collection efforts — could create significant confusion over the enforcement of an assignment of rents. For this reason, the Restatement (Third) of Property — Mortgages, while generally rejecting the one-action approach, further argued that any limitation on the mortgagee’s remedies with respect to foreclosure of the mortgage should not limit the mortgagee’s enforcement of its interest in rents:

[Section 8.2] does not affect the mortgagee’s right to enforce a mortgage on rents under § 4.2 or to the appointment of a receiver under § 4.3. This is because, under § 4.2, the mortgagee is proceeding against separate security and, under § 4.3, a receivership is an interim remedy ancillary to the remedies delineated in [Sections 8.2(a) and (b)]. Nor does this section limit the mortgagee’s remedies for waste under § 4.6 or the recovery of sums expended by the mortgagee for the protection of the security under § 2.2. [Restatement (Third) of Property — Mortgages § 8.2, cmt. b]

Consistent with this approach, the rent-collection statute in California (a one-action rule state) provides that enforcement of a security interest in rents and collection of rents does not constitute an “action” for purposes of the one-action rule or a “deficiency” action under the state’s anti-deficiency statutes. To make the Act workable in states with one-action rules and deficiency legislation, the Act follows the California approach.

4. *Marshaling requirements.* Nothing in this section limits a court’s equitable discretion to order lien marshaling in appropriate cases. For example, assume Debtor owes Bank \$2 million, secured by a mortgage and an assignment of rents on Blackacre and a separate mortgage



on Whiteacre. Debtor also owes Henning \$1 million secured only by a mortgage on Whiteacre. Nothing in Section 10 is intended to constrain a court's equitable discretion to order Bank to proceed against Blackacre and its rents first before foreclosing against Whiteacre or its rents.

**SECTION 12. APPLICATION OF PROCEEDS.** Unless otherwise agreed, an assignee that collects rents under this [act] or collects upon a judgment in an action under Section 14(d) shall apply the sums collected in the following order to:

- (1) the assignee's reasonable expenses of enforcing its assignment of rents, including, to the extent provided for by agreement and not prohibited by law of this state other than this [act], reasonable attorney's fees and costs incurred by the assignee;
- (2) reimbursement of any expenses incurred by the assignee to protect or maintain the real property subject to the assignment;
- (3) payment of the secured obligation;
- (4) payment of any obligation secured by a subordinate security interest or other lien on the rents if, before distribution of the proceeds, the assignor and assignee receive a notification from the holder of the interest or lien demanding payment of the proceeds; and
- (5) the assignor.

#### **Comment**

1. *Recovery of attorneys' fees.* The term "reasonable attorneys' fees and costs" in Section 12(1) includes those fees and costs the assignee incurs in enforcing its assignment of rents. This would include, for example, the fees and costs incurred in obtaining the appointment of a receiver, providing a notification under Section 8, or collecting rents from tenants following notification to tenants under Section 9. Unlike U.C.C. § 9-607(d) — under which an assignee's right to recover these expenses from collected receivables arises automatically — the assignee may recover reasonable attorneys' fees under this Act only to the extent such fees are provided for in the assignment of rents and are not prohibited by applicable law other than this Act. This limitation is consistent with the expectations of mortgagors and mortgagees.

The assignee may also incur other attorneys' fees and legal expenses in proceeding against the assignor, such as expenses incurred in foreclosing the mortgage or seeking a deficiency judgment. Whether the assignee has a right to collect those fees and expenses depends on the parties' agreement and the provisions of law other than this Act.

2. *Expenses incurred by the assignee to protect or maintain the real property.* Under Section 13(a), an assignee that collects rents under Section 8 or 9 is not obligated to apply those rents to the payment of expenses of protecting or maintaining the real property. Nevertheless, if the assignee does in fact incur expenses of protecting or maintaining the real property (such as real property taxes or casualty insurance), the assignee can apply any collected rents toward the reimbursement of those expenses before applying the balance to the secured obligation. \_\_

**SECTION 13. APPLICATION OF PROCEEDS TO EXPENSES OF PROTECTING REAL PROPERTY; CLAIMS AND DEFENSES OF TENANT.**

(a) Unless otherwise agreed by the assignee, and subject to subsection (c), an assignee that collects rents following enforcement under Section 8 or 9 need not apply them to the payment of expenses of protecting or maintaining the real property subject to the assignment.

(b) Unless a tenant has made an enforceable agreement not to assert claims or defenses, the right of the assignee to collect rents from the tenant is subject to the terms of the agreement between the assignor and tenant and any claim or defense arising from the assignor's nonperformance of that agreement.

(c) This [act] does not limit the standing or right of a tenant to request a court to appoint a receiver for the real property subject to the assignment or to seek other relief on the ground that the assignee's nonpayment of expenses of protecting or maintaining the real property has caused or threatened harm to the tenant's interest in the property. Whether the tenant is entitled to the appointment of a receiver or other relief is governed by law of this state other than this [act].

**Comment**

1. *Expenses of operation and preservation of the real property.* Typically, a tenant's payment of rents enables the assignor to pay the expenses of operating and preserving the real property (such as real property taxes, insurance, and maintenance). In many commercial leases, the tenant pays a sum designated as "additional rent," specifically to reimburse the assignor for the tenant's pro rata share of real property taxes, insurance, and maintenance expenses, or for any increases in these items above a defined baseline.

If an assignor defaults and an assignee enforces its assignment of rents, the assignor may be unable to collect rents that it needs to pay the expenses of operating and preserving the real property. Potentially, the assignor's nonpayment of these expenses or the nonperformance of its obligation to maintain the real property threatens the interests of the tenants.

In some circumstances, an assignee's enforcement of an assignment of rents will result in little or no disruption of the operation and preservation of the real property. For example, if an assignee enforces an assignment of rents by obtaining the appointment of a receiver under Section 7, the receivership order will authorize the receiver to apply collected rents to the costs of operating and preserving the real property. Likewise, if an assignee becomes a mortgagee in possession, the assignee has a duty to apply collected rents to the operation and preservation of the real property.

The assignor's obligation to pay taxes, insurance, or maintenance expenses (whether expressed or implied in tenant leases), however, does not generally bind the assignee as a successor if the lender has not yet acquired possession or ownership of the real property. If a lender purchases mortgaged real property at foreclosure, the lender becomes obligated to fulfill the assignor's responsibilities under the tenant leases, as the landlord's covenants in those leases then run with the real property to bind the lender. By contrast, if the lender collects rents prior to completing foreclosure, but without taking either actual or constructive possession of the real property, the lender may collect those sums and apply them to the mortgage debt with no legal obligation to pay taxes, insurance, or maintenance expenses. Such a lender is not a successor that is bound to perform the landlord's covenants under tenant leases; further, courts have not generally treated such sums as being impressed with a "trust" that obligates the lender to apply such sums to the payment of taxes, insurance, or maintenance.

As a result, if the assignee enforces its assignment of rents by means of Section 8 (notification to the assignor) or Section 9 (notification to tenants), the assignor effectively remains in day-to-day possession and control of the real property. In such a case, the assignee's collection of rents and payment of property-related expenses does not place day-to-day operational and management responsibility upon the assignee. Instead, that responsibility remains upon the assignor. Such an assignee may apply the collected rents to the mortgage debt in accordance with Section 12, and need not apply such rents to property-related expenses (such as taxes, insurance, and/or maintenance), absent a contrary agreement by the assignee. A prudent assignee may choose, however, to apply collected rents to the payment of such expenses, both to protect its own interest in (and the value of) the real property and to avoid any possible claim or defense that a tenant might have to payment of rent based upon the assignor's nonperformance of the lease agreement.

*2. Tenant's defenses or claims.* Subsection (b) provides that the assignee's ability to collect rents is subject to the agreement between the assignor and the tenant and any defense or claim that the tenant may have arising from the nonperformance of that agreement, unless the tenant has made an enforceable agreement not to assert such defenses or claims. *Cf.* U.C.C. Section 9-404(a)(1).

In some cases, an assignor's failure to make full performance its lease covenants (such as a covenant to maintain the premises or common areas) will permit the tenant to raise a defense to subsequent payment of rent or to assert a right of recoupment or set-off against its subsequent rental obligation. This Act recognizes that unless the tenant has made an enforceable agreement not to assert such a claim or defense, the tenant may, to the extent permitted under law other than the Act, raise such a claim or defense in the event that the assignee attempts to collect rents from the tenant under this Act.

In many transactions, mortgage lenders may require tenants to execute a subordination, nondisturbance and attornment agreement (SNDA) agreement in which the tenant agrees not to assert against the lender any claims or defenses arising out of the landlord's performance or nonperformance of its obligations. Subsection (b) recognizes the enforceability of such waiver agreements.\_\_\_\_

3. *Receivership or other relief.* A tenant that pays rents expects that the assignor/landlord will apply some portion of those rents to pay real property taxes, insurance, and maintenance expenses. In many cases, some portion of the rents may be attributable specifically to the cost of paying or reimbursing the payment of these expenses.

If the assignee begins collecting rents from tenants after the assignor's default (without obtaining the appointment of a receiver or becoming a mortgagee in possession), subsection (a) does not impose a general obligation on the assignee to apply such rents to the costs of operating and preserving the real property. Nevertheless, the assignor may fail to pay such costs, especially if enforcement of the assignment of rents has divested the assignor of control over the rents. In this circumstance, the expectations of a tenant can be significantly frustrated, particularly if the nonperformance of the assignor's maintenance significantly compromises the tenant's operations.

Subsection (c) recognizes that Section 13 does not preclude such a tenant from seeking the appointment of a receiver or other relief, if the tenant can demonstrate that the nonpayment of expenses of operating and preserving the real property threatens the tenant's interest in the real property. The Act does not establish that the nonpayment of such expenses itself creates an affirmative right to the appointment of a receiver or other relief. Instead, the Act leaves to other state law whether the particular circumstances justify the appointment of a receiver or other relief for the tenant. Because the particular circumstances may vary widely across different cases, the Act leaves this issue to judicial resolution on a case-by-case basis.

#### **SECTION 14. TURNOVER OF RENTS; COMMINGLING AND IDENTIFIABILITY OF RENTS; LIABILITY OF ASSIGNOR.**

(a) In this section, "good faith" means honesty in fact and the observance of reasonable commercial standards of fair dealing.

(b) If an assignor collects rents that the assignee is entitled to collect under this [act]:

(1) the assignor shall turn over the proceeds to the assignee, less any amount representing payment of expenses authorized by the assignee; and

(2) the assignee continues to have a security interest in the proceeds so long as they are identifiable.

(c) For purposes of this [act], cash proceeds are identifiable if they are maintained in a segregated account or, if commingled with other funds, to the extent the assignee can identify them by a method of tracing, including application of equitable principles, that is permitted under law of this state other than this [act] with respect to commingled funds.

(d) In addition to any other remedy available to the assignee under law of this state other than this [act], if an assignor fails to turn over proceeds to the assignee as required by subsection (b), the assignee may recover from the assignor in a civil action:

(1) the proceeds, or an amount equal to the proceeds, that the assignor was obligated to turn over under subsection (b); and

(2) reasonable attorney's fees and costs incurred by the assignee to the extent provided for by agreement and not prohibited by law of this state other than this [act].

(e) The assignee may maintain an action under subsection (d) without bringing an action to foreclose any security interest that it may have in the real property. Any sums recovered in the action must be applied in the manner specified in Section 12.

(f) Unless otherwise agreed, if an assignee entitled to priority under Section 5(c) enforces its interest in rents after another creditor holding a subordinate security interest in rents has enforced its interest under Section 8 or 9, the creditor holding the subordinate security interest in rents is not obligated to turn over any proceeds that it collects in good faith before the creditor receives notification that the senior assignee has enforced its interest in rents. The creditor shall turn over to the senior assignee any proceeds that it collects after it receives the notification.

### **Comment**

1. *"Milking" of rents and existing law.* The owner of distressed income-producing real property may sometimes engage in "milking" of rents — *i.e.*, collecting rents and using the proceeds for purposes unrelated to the mortgage debt. Milking of rents 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 often causes the mortgagee to take prompt action following default to divest the mortgagor of control over 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 desire to recover damages that it suffered because the mortgagor collected and disposed of rents that might otherwise have reduced the mortgage obligations.

All authorities agree that the mortgagee has no basis for recovering cash proceeds of rents 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. See Act § 15, Comment 4, Illustrations 6 and 7. The mortgagee might have a damage

claim against the mortgagor, however, on account of the mortgagor's disposition of rents. The common law of mortgages treated this conduct as a species of legal waste — consistent with its treatment of “rents” as an incorporeal hereditament in the nature of real property. The common law generally imposed liability upon a mortgagor who took any action that damaged or destroyed the mortgaged real property, thereby reducing its value. [In title theory jurisdictions, this liability extended to the full reduction in the collateral's value; under the lien theory, this liability existed only to the extent that the waste actually impaired the mortgagee's security.]

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. *See, e.g.*, *Taylor v. Brennan*, 621 S.W.2d 592 (Tex. 1981) (mortgagor's collection and disposition of rents following mortgagee's enforcement of security interest in rents would constitute waste, but holding that no waste occurred because mortgagee had not taken sufficient steps post-default to enforce its security interest in rents); *Ginsberg v. Lennar Florida Holdings*, 645 So.2d 490 (Fla. App. 1994). The Restatement (Third) of Property — Mortgages adopts this view in § 4.6(a)(5), which provides that “[w]aste occurs when, without the mortgagee's consent, the mortgagor ... retains possession of rents to which the mortgagee has the right to possession....”

The Act does not precisely duplicate the Restatement approach, as it does not specifically use the term “waste” to identify the basis of the assignor's liability for milking rents. In lien theory states, courts traditionally held that the mortgagor was liable for waste only to the extent that its conduct impaired the mortgagee's security. Rather than focusing upon impairment of security — which would require proof of the value of the mortgaged real property — the Act instead takes a more straightforward approach. If the assignor is obligated to turn over rents to the assignee under Section 14(b), but fails to do so, the assignee may enforce its security interest in the rents under Section 14(b)(2) and, in any event, the assignor is liable for damages equal to the full amount of the rents not turned over. Any such recovery must be applied by the assignee in the manner specified by Section 12, so the assignee's total recovery could not exceed the loss that the assignee actually suffered. Any surplus proceeds remaining after full satisfaction of the secured obligation would go to the assignor or to subordinate lienholders in accordance with Section 12.

*2. Assignor's liability to turn over rents.* The Act provides that upon default as defined in the document creating an assignment of rents or as otherwise agreed, an assignee may collect (1) accrued but unpaid rents and (2) unaccrued rents as they accrue in the future. If the assignor collects any such sums following enforcement by the assignee, the assignee may enforce its security interest in the rents under Section 14(b)(2) and, in any event, if the assignor fails to turn over such sums to the assignee under subsection (b), the assignor faces personal liability for failure to do so by virtue of subsection (d).

In cases involving nonrecourse obligations (either by virtue of specific contractual nonrecourse provisions or the intervention of anti-deficiency legislation), mortgagors that have milked 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 damages for waste of rents or conversion of the proceeds of rents is not in the nature of

a deficiency action. *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 Act follows this approach.

Subsection (e) makes clear that an assignee may bring an action to recover damages on account of the assignor's failure to turn over rents, without first having to foreclose on the underlying real property or pursue other legal remedies. Requiring the assignee to pursue foreclosure first "would probably result in more foreclosures." Restatement (Third) of Property — Mortgages § 4.6 cmt. f. Moreover, as provided in Section 11 of the Act, the assignee's action under Section 14(d) would not constitute an election of remedies that precludes later action to enforce the secured obligation, or an action to enforce the debt within the meaning of a state's one-action law.

Once the assignor receives a turnover demand from the assignee, the assignor must turn over to the assignee rents that it thereafter collects. The assignor may not escape liability under subsection (d) merely by arguing that the assignor applied such rents to the expenses of operating and maintaining the real property. The assignor and assignee may, of course, reach an agreement that permits the assignor to apply such rents to the expenses of operating and maintaining the real property. In that event, subsection (b) recognizes that the assignor would not have to turn over the agreed-upon amounts. In the absence of such an agreement, the assignor is liable to the assignee under subsection (d) for any rents that it collects but fails to turn over. Any amounts recovered by the assignee under subsection (d) must be applied in accordance with Section 12.

3. *Commingling.* An assignor that collects rents following enforcement of an assignment of rents may commingle those funds with other funds that are not rents or the proceeds of rents. For example, an assignor hotel operator might receive a notification of enforcement from the assignee under Section 8, and thereafter might generate a day's worth of revenues consisting in part of rents (room revenues) and in part of nonrents (food and beverage revenues). Subsections (b) and (c) make clear that the assignor's commingling of these funds does not automatically deprive the assignee of its security interest in the rents. As long as the proceeds of the rents are "identifiable," the assignee's interest remains enforceable against those proceeds. In this context, "identifiable" has the same meaning as it does in U.C.C. § 9-315(a). As a result, if the assignor has commingled the proceeds of collected rents with other operating funds of the assignor, those proceeds will remain identifiable only if the assignee can identify them by a method of tracing (such as the lowest intermediate balance rule) that is recognized by law other than this Act with respect to commingled property.

4. *Collection of rents by subordinate assignee.* Subsection (f) provides that a person holding a subordinate assignment of rents generally may enforce that assignment, collect rents, and apply any proceeds collected in good faith to its debt without having any obligation to turn over those proceeds to a senior assignee. This protection is subject to two limitations, however. First, once the junior assignee that has enforced its interest in rents under Section 8 (by notification to the assignor) or Section 9 (by notification to tenants) receives a notification from the senior assignee that the senior assignee has enforced its assignment of rents, the junior assignee must turn over any proceeds that it collects after receiving that notification. Second, if

the junior assignee has entered into an intercreditor agreement that obligates it to turn over any collected proceeds to the senior assignee, the senior assignee may enforce that agreement. Furthermore, the protection of subsection (f) extends only to rents collected by the subordinate assignee in good faith. If the subordinate assignee collects rents under Sections 8 or 9 of this Act without having given notification of its enforcement to the senior assignee as required by the Act, the subordinate assignee would not be collecting rents in good faith and would not be protected by subsection (f).

Subsection (f) applies only where a subordinate assignee enforces its security interest in rents by notification/collection from the assignor or tenants. Where a subordinate assignee has enforced its security interest in rents by obtaining the appointment of a receiver, the receiver for the subordinate assignee may continue to collect the rents and apply the proceeds in accordance with the terms of the receivership order under Section 7 until such time as a senior assignee obtains the appointment of a receiver (or completes a foreclosure, thereby extinguishing the subordinate lien).

## **SECTION 15. PERFECTION AND PRIORITY OF ASSIGNEE’S SECURITY INTEREST IN PROCEEDS.**

(a) In this section:

(1) “Article 9” means [Article 9 of the Uniform Commercial Code as adopted in this state] or, to the extent applicable to any particular issue, Article 9 as adopted by the state whose laws govern that issue under the choice-of-laws rules contained in Article 9 as adopted by this state.

(2) “Conflicting interest” means an interest in proceeds, held by a person other than an assignee, that is:

(A) a security interest arising under Article 9; or

(B) any other interest if Article 9 resolves the priority conflict between that person and a secured party with a conflicting security interest in the proceeds.

(b) An assignee’s security interest in identifiable cash proceeds is perfected if its security interest in rents is perfected. An assignee’s security interest in identifiable noncash proceeds is perfected only if the assignee perfects that interest in accordance with Article 9.

(c) Except as otherwise provided in subsection (d), priority between an assignee’s security interest in identifiable proceeds and a conflicting interest is governed by the priority rules in Article 9.



(d) An assignee's perfected security interest in identifiable cash proceeds is subordinate to a conflicting interest that is perfected by control under Article 9 but has priority over a conflicting interest that is perfected other than by control.

### Comment

1. *"Conflicting interests."* If two or more persons claim a conflicting security interest in rents, the priority of those interests is generally resolved by the state's general priority rules as established by the state's recording act and by Section 5(c) of this Act. However, once rents are actually collected and held as "proceeds" as defined in this Act, conflicts may arise between an assignee of rents that holds a security interest in "proceeds" as recognized by this Act and certain third parties other than rents assignees. For example, these third parties might include persons who hold a security interest in the proceeds by virtue of Article 9 of the Uniform Commercial Code, persons who take transfers of cash proceeds from the assignor in the ordinary course, or a bank claiming a right of set-off against cash proceeds held in a deposit account maintained at that bank. Section 15 provides priority rules sufficient to govern such disputes. As discussed in the following comments, these rules generally incorporate the priority rules already in Article 9. References to the rules of priority in Article 9 include all of the rules in subpart 3 of part 3 of Article 9, whether the rules subordinate one interest to another or permit one interest to take free of the interest of another.

Section 15 applies to any priority conflict as to proceeds between an assignee of rents and the holder of a "conflicting interest." A "conflicting interest" is a security interest in the proceeds that arises under Article 9, or any other interest in the proceeds if Article 9's priority rules resolve a conflict between that interest and a conflicting Article 9 security interest.

2. *Perfection and priority of assignee's security interest in cash proceeds.* In the typical case, a tenant's payment of rent will result in cash proceeds. An assignee of rents would have a security interest in cash proceeds of rents as long as the assignee could satisfy the tracing burden imposed by Section 14's "identifiability" standard. See Sections 14(a), (b). Further, Section 15(b) makes clear that the assignee's security interest in cash proceeds is perfected so long as the assignee's security interest in rents was perfected. Cf. U.C.C. § 9-315(c), (d) (continuous perfection of Article 9 security interest in identifiable cash proceeds where security interest in original collateral was perfected).

Generally speaking, priority between an assignee's security interest in identifiable proceeds and a conflicting interest is governed by the priority rules expressed in Article 9. However, an assignee's perfected security interest in identifiable cash proceeds has priority over a conflicting interest that is perfected under Article 9 by a means other than by control.

This Act addresses only the perfection and priority of a security interest that an assignee claims in "proceeds" of rents under this Act. This Act does not prevent an assignee from entering into a security agreement with the assignor that would create an Article 9 security interest in those proceeds. For example, an assignee and assignor could enter into a security agreement granting assignee an Article 9 security interest in the deposit account into which

assignor's rent collections are deposited. If the assignee obtains such an Article 9 security interest, the perfection and priority of that interest are governed by Article 9.

3. *Perfection and priority of assignee's security interest in noncash proceeds.* It is possible — though not common — that a tenant's payment of rent could produce noncash proceeds. For example, a tenant might make payment of its rental obligation to assignor by transfer of a piece of equipment rather than a cash payment. Alternatively, a tenant might make payment in the form of cash, and the assignor might take the cash and use it to purchase a piece of equipment. Under Section 14, an assignee of rents would have a security interest in noncash proceeds of rents as long as the assignee could satisfy the tracing burden imposed by Section 14's "identifiability" standard. Section 15(b) makes clear, however, that the assignee's security interest in identifiable noncash proceeds will be perfected only if the assignee perfects that interest in accordance with Article 9. Thus, if the assignee claims a security interest in an item of equipment that the assignor received in satisfaction of a tenant's rental obligation (or that the assignor purchased using proceeds of rents), the assignee's security interest in that equipment will be unperfected unless the assignee files a financing statement covering the equipment in the proper Article 9 filing office. Likewise, any conflict between an assignee claiming a security interest in an item of personal property as noncash proceeds of rents and a secured party claiming an Article 9 security interest in the same item will be resolved by the appropriate Article 9 priority rules.

4. *Illustrations.* The application of the priority rules expressed in Section 15 is demonstrated in the following illustrations:

*Illustration 1.* In year 1, Debtor grants to Secured Party an effective security interest in all of Debtor's existing and after-acquired assets, and Secured Party perfects this security interest by filing. In year 2, Debtor makes an assignment of rents to Assignee, and Assignee promptly records. In year 3, Debtor receives a rent check from Tenant. Assignee has a perfected security interest in the check as identifiable cash proceeds of rents. Secured Party has a perfected security interest in the check, but Secured Party's security interest is perfected only by filing. Thus, Assignee has priority as to the check under subsection (d).

*Illustration 2.* Same as Illustration 1, except Debtor deposits the check into a deposit account maintained at Bank. Secured Party has not established control over the deposit account in accordance with U.C.C. § 9-104. Assignee has a perfected security interest in the deposited funds as identifiable cash proceeds of rents. Secured Party also has an Article 9 security interest in the deposited funds as proceeds of the check, but that security interest is perfected only by virtue of Article 9's continuous perfection as to identifiable cash proceeds under U.C.C. § 9-315(c), (d)(2). Thus, Assignee has priority as to the deposited funds under subsection (d).

*Illustration 3.* Same as Illustration 2, except that Secured Party has established control over the deposit account by virtue of a control agreement as provided in U.C.C. § 9-104(a)(2). Secured Party has priority as to the deposited funds under subsection (d).

*Illustration 4.* Same as Illustration 2, except that Bank attempts to exercise a right of set-off against Debtor after Debtor defaults to Bank in repayment of an unsecured line of credit. Bank's right of set-off has priority over Assignee's security interest in the deposited funds. *Cf.* § 9-340(a), (b) (bank's right of set-off generally not affected by existence of security interest in deposited funds).

*Illustration 5.* Same as Illustration 4, but assume that Assignee has achieved control by becoming Bank's customer with respect to the deposit account as described in U.C.C. § 9-104(a)(3). Bank's exercise of its set-off right would be ineffective against Assignee. *Cf.* U.C.C. § 9-340(c) (exercise of bank's set-off right ineffective against a person holding a security interest in the deposit account who becomes bank's customer with respect to that account).

*Illustration 6.* Assignor makes an assignment of rents to Assignee, and Assignee promptly records. The following month, Assignor receives a rent check from Tenant, and deposits the check into a bank account containing only proceeds of rents. Assignor then writes a check drawn on that bank account to Supplier in payment of an account incurred by Assignor to purchase office equipment and supplies. In good faith, Supplier accepts the check and presents it for payment and the check is paid. Even though Assignee had a perfected security interest in the proceeds of rents deposited into the bank account, Supplier takes the funds paid from the bank account free and clear of the Assignee's security interest in those funds. *Cf.* U.C.C. § 9-332(b) (transferee of funds from deposit account takes them free of a security interest in the deposit account unless the transferee acts in collusion with debtor in violating rights of secured party).

*Illustration 7.* Assignor makes an assignment of rents to Assignee, and Assignee promptly records. The following month, Assignor receives cash from Tenant in payment of Tenant's rent obligation. Assignor uses the cash to purchase cleaning equipment from Supplier in an ordinary course transaction. Assignor does not file an Article 9 financing statement covering the cleaning equipment. Even though Assignee had a perfected security interest in the cash collected from Tenant, Supplier took the cash free and clear of the Assignee's security interest. *Cf.* U.C.C. § 9-332(a) (transferee of money takes it free of a security interest unless the transferee acts in collusion with debtor in violating rights of secured party). Furthermore, while Assignee may have a security interest in the cleaning equipment as the identifiable noncash proceeds of rents, Assignee's security interest in the cleaning equipment is unperfected under subsection (b), and would be subordinate to any perfected Article 9 security interest in the cleaning equipment. *Cf.* U.C.C. § 9-322(a)(2) (perfected security interest has priority over conflicting unperfected security interest).

*Illustration 8.* Same as Illustration 7, but assume Assignee has filed an Article 9 financing statement sufficient to cover all of Assignor's assets. Assignee has a perfected security interest in the cleaning equipment. The priority of that security interest versus other conflicting interests will be governed by the priority rules expressed in Article 9. *Cf.* U.C.C. § 9-322(a)(1) (conflicting perfected security interests); U.C.C. § 9-317(b) (buyers other than in ordinary course).

**SECTION 16. PRIORITY SUBJECT TO SUBORDINATION.** This [act] does not preclude subordination by agreement as to rents or proceeds.

**Comment**

Section 16 makes it clear that a person entitled to priority under this Act may effectively agree to subordinate its claim. Contractual subordination of a security interest in rents and/or proceeds may occur in the context of an intercreditor agreement between persons holding conflicting security interests in rents. The enforceability of such agreements is governed by state law other than this Act.

**SECTION 17. UNIFORMITY OF APPLICATION AND CONSTRUCTION.** In applying and construing this uniform act, consideration must be given to the need to promote uniformity of the law with respect to its subject matter among states that enact it.

**SECTION 18. RELATION TO ELECTRONIC SIGNATURES IN GLOBAL AND NATIONAL COMMERCE ACT.** This [act] modifies, limits, and supersedes the federal Electronic Signatures in Global and National Commerce Act (15 U.S.C. Section 7001, et. seq.) but does not modify, limit, or supersede Section 101(c) of that act (15 U.S.C. Section 7001(c)) or authorize electronic delivery of any of the notices described in Section 103(b) of that act (15 U.S.C. Section 7003(b)).

**SECTION 19. APPLICATION TO EXISTING RELATIONSHIPS.**

(a) Except as otherwise provided in this section, this [act] governs the enforcement of an assignment of rents and the perfection and priority of a security interest in rents, even if the document creating the assignment was signed and delivered before the effective date of this [act].

(b) This [act] does not affect an action or proceeding commenced before the effective date of this [act].

(c) Section 4(a) of this [act] does not apply to any security instrument signed and delivered before the effective date of this [act].

(d) This [act] does not affect:

(1) the enforceability of an assignee's security interest in rents or proceeds if, immediately before the effective date of this [act], that security interest was enforceable;

(2) the perfection of an assignee's security interest in rents or proceeds if, immediately before the effective date of this [act], that security interest was perfected; or

(3) the priority of an assignee's security interest in rents or proceeds with respect to the interest of another person if, immediately before the effective date of this [act], the interest of the other person was enforceable and perfected, and that priority was established.

**SECTION 20. EFFECTIVE DATE.** This [act] takes effect on \_\_\_\_\_.

**[SECTION 21. REPEALS.** The following acts and parts of acts are repealed:

(1) .....

(2) .....

(3) .....]