

When Should Bankruptcy Courts Recognize Lenders' Rents Interests?

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INTRODUCTION

Most commercial real estate financing arrangements grant lenders the right to collect rents that the real estate generates and to apply these rents to reduce the mortgage¹ debt. A lender would prefer to collect rents generated by the security right from the loan's inception. A lender could use these rents to pay operating expenses and to apply the balance to loan payments, or keep the balance as a reserve for future payments.² Market realities, however, preclude lenders from making such arrangements with most private borrowers. Borrowers view control of rents as a vital aspect of their investments and remain reluctant to surrender such control prior to default.³

Consequently, lenders must settle for provisions in their loan instru-

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¹ This Article uses the term "mortgage" in the generic sense to denote either a true mortgage, with or without power of sale, or a deed of trust mortgage. Similarly, the terms "mortgagee" or "lender" denote the beneficiary under a deed of trust. The terms "mortgagor" or "borrower" denote the trustor under a deed of trust.

² Public revenue bond financing arrangements, for instance, typically use this scheme.

³ Even if lenders could get access to rents prior to default, they might think twice about doing so because of potential subordination or lender liability for "overcontrol" of the borrower's business. See *In re Clark Pipe & Supply*, 870 F.2d 1022, 1027 (5th Cir. 1989) (subordinating secured creditor's claim because of that creditor's acts of control detrimental to other creditors). See generally Schechter, *The Principal Principle: Controlling Creditors Should Be Held Liable for Their Debtors' Obligations*, 19 U.C. DAVIS L. REV. 875 (1986) (proposing lender liability for debtor's obligation when control affects payments made or costs incurred by debtor). The lender's mere seizure of rents would not render the lender liable. Nevertheless, the seizure may be a factor in determining liability.

ments⁴ that give them the right to collect rents⁵ only if the borrower defaults. Such provisions usually include an assignment of rents as well as a pledge of rent proceeds as security.⁶ On default, lenders typically appoint a receiver⁷ who collects rents and accumulates income over op-

⁴ In California, the lender's right to receive rents must arise by explicit agreement in the loan instrument. This is not true in some eastern states, sometimes called *title theory* states, where legal theory provides that the mortgagee, at least as of the instant of the debtor's default, has automatic right to possess the security, including the right to collect rents. California and most western states, called *lien theory* states, view the mortgage interest as a mere lien that does not give possessory rights of any kind until foreclosure. See CAL. CIV. PROC. CODE § 774 (West 1980). For a survey and analysis of laws pertaining to security interests in rents, see Randolph, *The Mortgagee's Interest in Rents; Some Policy Considerations and Proposals*, 29 U. KAN. L. REV. 1 (1980).

⁵ Frequently the rents interest arises both under the language of the mortgage itself and in a second document, usually denominated an "Assignment of Rents and Leases." The second document is used to accomplish an assignment directly to the lender, rather than to the trustee under a deed of trust. Frequently this second document will have extensive provisions controlling the borrower's flexibility in executing new leases on the property. The issue remains whether such an assignment is a real estate interest which would achieve priority by recordation in the real property records or is a personal property interest which must be recorded pursuant to the provisions of the Uniform Commercial Code (U.C.C.). Several jurisdictions have held that the interest is real estate. See *In re American Continental Corp.*, 105 Bankr. 564, 569 (Bankr. D. Ariz. 1989); *In re Standard Conveyor*, 773 F.2d 198, 204 (8th Cir. 1985); *In re Mears*, 88 Bankr. 19 (Bankr. S.D. Fla. 1988); *In re Cook*, 63 Bankr. 789 (Bankr. D.N.D. 1986). On the other hand, *Taylor v. Bouissiere*, 195 Cal. App. 3d 1197, 241 Cal. Rptr. 253 (1987), held that an assignment for security of a tenant's interest in a lease is a personal property security interest for purposes of California foreclosure laws. Consequently, the U.C.C. recording rules applied, and the one form of action rule in CAL. CIV. PROC. CODE § 726 *did not apply*. For a discussion of the one form of action rule see *infra* note 10.

⁶ In theory, in California the lender could reach rents following default simply by demanding that the tenants pay the rents over. See *Title Guarantee & Trust v. Monson*, 11 Cal. 2d 621, 81 P.2d 944 (1938); *Mortgage Guarantee Co. v. Sampsell*, 51 Cal. App. 2d 180, 188, 124 P.2d 353, 357 (1942). Uncertainty remains whether an assignment of rents, when activated by demand on tenants, should be viewed as taking "possession" of the premises or rather as a nonpossessory receipt of income, without any of the responsibilities of a possessor. These responsibilities could include, for example, liability on any real covenants in the lease. See Randolph, *supra* note 4, at 20-22. A full discussion of this issue under California law is beyond the scope of this Article. After bankruptcy, apparently a rent assignee will be able to reach, at most, the net rentals. See cases cited *infra* note 104.

⁷ Although the receivership remedy usually is more expensive than if the lender just commenced collecting the rents, receivership provides a number of tactical advantages. These include insulation from potential liability as a possessor of the premises, lower likelihood of exposure on lease covenants, and greater ability to preserve desirable junior leases. See *generally* Randolph, *supra* note 4, at 36 (discussing receivership option

erating expenses,⁸ as additional security,⁹ pending foreclosure.¹⁰

for creditors). Normally the mortgage instrument provides not only for a present assignment of the rents, with activation of the assignment conditioned on the borrower's default, but also a stipulation for the appointment of a receiver to collect the rents.

In California, the appointment of a receiver is subject to the equitable discretion of the court under CAL. CIV. PROC. CODE § 564 (West Supp. 1990). Lenders often seek to appoint a receiver through an action for specific performance of the rents-and-profits clause in the mortgage instrument. This is done under the general provisions of § 564(7), rather than as ancillary to a foreclosure action under § 564(2). *Id.* §§ 564(2)-(7). Arguably, this permits the court to avoid evaluating whether the real property security is adequate or in danger of being lost — issues raised by the language of § 564(2) but not present in the language of § 564(7). *Id.*; see *Title Guarantee & Trust Co.*, 11 Cal. 2d at 631, 81 P.2d at 949-50.

Stipulations in the mortgage instrument for the appointment of a receiver state a prima facie, but rebuttable, evidentiary showing of the mortgagee's entitlement to such appointment. *Barclay's Bank v. Superior Court*, 69 Cal. App. 3d 593, 137 Cal. Rptr. 743 (1977). It is unclear, however, what the court should take into account in deciding whether to appoint a receiver under § 564(7) other than the stipulation and the fact of default. See CAL. CIV. PROC. CODE § 564 (West Supp. 1990).

⁸ Courts have not yet resolved whether the receiver is a receiver of the *property* or just of the *rents*. If the receiver collects only rents, it conceivably could collect the gross rents and have no responsibility for the property's maintenance. This deprives the mortgagor of rental income that might be necessary for maintenance responsibilities. Therefore, it injures the tenants and endangers the value of the security. As the court has equitable discretion in the matter, it would seem appropriate for the court to place the receiver in possession and give the receiver the responsibility to maintain the property and to perform the leases to the extent that rent flow will allow.

⁹ Because the rents assignment is "additional security," the lender can foreclose on the real estate and still recover the rents (as needed) without concern about the antideficiency requirements of § 580b or § 580d. See CAL. CIV. PROC. CODE §§ 580(b) & (d) (West Supp. 1990); *Mortgage Guarantee Co.*, 51 Cal. App. 2d at 180, 124 P.2d at 353. Although the rents assignment obviously acts as security, lenders still commonly state in the instrument that the assignment is given as security. This insures against antideficiency problems and clarifies that the lender's right to the rents does not go beyond those necessary to collect the debt.

¹⁰ California lawyers have some concern that a lender who seeks to apply the rents to the mortgage debt prior to foreclosure might be viewed as having undertaken an "action" under the "one action rule." See CAL. CIV. PROC. CODE § 726 (West Supp. 1990). For a discussion of this possibility, see Leipziger, *Deficiency Judgments in California, the California Supreme Court Tries Again*, 22 UCLA L. REV. 753, 805 (1975). Consequently, the mortgagee could be deemed to have waived the security in the mortgaged property itself. *Walker v. Community Bank*, 10 Cal. 3d 729, 518 P.2d 329, 111 Cal. Rptr. 897 (1974). See Leipziger, *supra*, at 803.

In California, it might be possible to reach the rents without undertaking a formal legal action. See *infra* note 47. This, however, might not be the lender's wisest course of action for reasons unrelated to § 726. See *supra* note 6. A strong argument can be made that simply mailing a letter to tenants directing that rents be paid over to the mortgagee does not constitute an "action" within the meaning of § 726. A recent Ninth

A mortgagor's bankruptcy ultimately tests such a security interest's efficacy. Bankruptcy courts focus on rehabilitating the debtor or, failing that, maximizing the debtor's available assets for all creditors. Federal law, through the automatic stay provisions,¹¹ freezes state law debt collection remedies. A mortgagee may not obtain a priority interest in rents over other creditors, as established by the loan instrument, if a debtor files a bankruptcy petition after defaulting on the mortgage but before the lender appoints a rents receiver.

This Article discusses when and how a lender can gain recognition of such rights after a mortgagee declares bankruptcy. Section I provides a brief background of bankruptcy law for context. Section II analyzes the conditional present assignment fiction some courts use to recognize these rents interests. Section III discusses the bankruptcy courts' mandate to follow state law, and the various courts' divergent application and rejection of that mandate. Finally, Section IV proposes a new approach to encourage bankruptcy courts to recognize these rents interests in real estate financing arrangements.

Circuit opinion has pointed this out. *Trident Center v. Connecticut Gen. Life Ins. Co.*, 847 F.2d 564, 567-68 (9th Cir. 1988). Nevertheless, some California lawyers are concerned about the implications of *Bank of America v. Daily*, 152 Cal. App. 3d 767, 199 Cal. Rptr. 557 (1984), where a bank's exercise of its set-off right against a debtor's bank account was held to be an "action." The lender in *Daily* did not have a contract right of set-off. The lender relied on its statutory powers. Arguably this is distinct from a situation in which a bank has a contractual assignment of rents and relies on this private right to reach the security, rather than relying on a statutorily recognized "self-help" claim (even though the statute only codifies the common law). But *Daily* is just murky enough to leave lawyers concerned.

Further, if a lender sends a letter demanding rents to be paid over to the lender, additional legal action might be necessary to collect these rents, again triggering concerns that an "action" has been brought. An action by the mortgagee against the tenants should not really be viewed as an "action" against the mortgagor. The mortgagee or the tenants may find it necessary to bring the mortgagor in as a party, however, thus raising the specter that an "action" has been brought.

The simple appointment of the receiver may constitute an action, even when the rents are not applied to the debt until the foreclosure is completed. Clearly the danger decreases here. *Mortgage Guarantee Co.*, 51 Cal. App. 2d at 186, 124 P.2d at 356 (holding no "action" in such a case). See Leipziger, *supra*, at 805.

¹¹ See *infra* notes 16-21 and accompanying text.

I. A BRIEF BACKGROUND OF BANKRUPTCY LAW

A. *Bankruptcy Overview*

The United States Constitution mandates a federal bankruptcy process.¹² Theoretically, the bankruptcy process is procedural. Bankruptcy courts must respect state law unless a federal principle overrides state law.¹³

In 1978, Congress enacted the Bankruptcy Code.¹⁴ Under the Code, an entity can file a bankruptcy petition under Chapter 7, 9, 11, 12, or 13. The entity thereby becomes a "debtor." The filing of the petition creates an estate comprised of all the debtor's legal and equitable interests in property.¹⁵

The filing of a bankruptcy petition also serves as an automatic stay.¹⁶ This automatic stay prohibits creditors from taking virtually any collection action against the debtor.¹⁷ The automatic stay freezes a creditor's position at the time of the petition. Thus, the bankruptcy court can determine all creditors' rights and distribute the property in the estate according to the Code.

The court may grant some creditors, most of which are secured creditors, relief from the automatic stay.¹⁸ The court may grant such relief "for cause, including lack of adequate protection."¹⁹ If a creditor shows that its security is inadequately protected, the trustee may provide adequate protection for its security.²⁰ Thus the court may allow the estate to retain the property while protecting the creditor.²¹

¹² U.S. CONST. art. I, § 8, cl. 4. The goals of bankruptcy are to provide the debtor with a fresh start through the discharge and to orchestrate creditors' claims. *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).

¹³ *Butner v. United States*, 440 U.S. 48 (1979).

¹⁴ Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, tit. IV, § 402, 92 Stat. 2682 (1978) (codified as amended at 11 U.S.C. §§ 101-1329 (1988)). The Code replaced the Bankruptcy Act of 1898. Congress amended the Code in 1984 and again in 1986.

¹⁵ 11 U.S.C. § 541(a) (1988).

¹⁶ *Id.* § 362(a).

¹⁷ *Id.* The automatic stay prohibits litigation for pre-bankruptcy debts, enforcement of judgments against the debtor, any action against the debtor or the estate's property (the action prohibited includes obtaining liens, perfecting liens or enforcing liens), and any act to collect from the debtor. *Id.* § 362(a)1-6. Section 362(b) provides exceptions from the stay.

¹⁸ *Id.* § 362(d)(1).

¹⁹ *Id.*

²⁰ *Id.* § 361(1)-(3) (giving examples of adequate protection).

²¹ This is true even if the creditor has a perfected security interest in the property. Ordinarily, in nonbankruptcy law, the secured creditor may foreclose on the secured property upon the debtor's default. *See, e.g., CAL. COM. CODE* § 9501 (West Supp.

When a debtor files a bankruptcy petition under Chapter 7, a trustee is appointed.²² The trustee collects the estate's assets and liquidates the estate. The trustee either distributes assets, or sells the assets and distributes the proceeds to the creditors.²³ Chapters 11 and 13 attempt to reorganize the debtor²⁴ rather than liquidating the debtor's assets. In Chapters 11 and 13, the debtor performs the function of a trustee,²⁵ and in such cases, is termed a "debtor in possession." The Code provides the trustee with powers unavailable to debtors outside of bankruptcy.²⁶ These powers include avoiding powers.²⁷ The trustee may avoid certain transactions that the debtor made before filing for bankruptcy relief.²⁸ Specifically, section 544(a) makes the trustee a hypothetical lien creditor as of the day the debtor filed for bankruptcy relief.²⁹ Thus, the trustee will prevail over any of the debtor's pre-bankruptcy transactions that would be ineffective against a lien creditor in nonbankruptcy law.

Although secured creditors enjoy protection in bankruptcy, they rarely retain all rights that their secured status gave them under state law. A creditor with a secured rents interest can only hope that the bankruptcy court will *recognize* a rents claim. After bankruptcy, a creditor with a rents interest does not have an absolute right to receive rents or to force the trustee to create a cash reserve, from the rents collected, for added protection.³⁰ Bankruptcy permits the trustee³¹ to manage the assets for efficient disposition of all the debtor's affairs, including spending the rents that the debtor's property generates. If the court recognizes the security interest in rents as valid in bankruptcy, however, the secured creditor enjoys some protection. The trustee can-

1990).

²² 11 U.S.C. § 701 (1988).

²³ *Id.* The priority rights of competing secured creditors are usually determined by state law. The rights of competing unsecured creditors are determined by the priority provisions of *Id.* § 726.

²⁴ The debtor in possession reorganizes under a plan of reorganization. *Id.* § 1123.

²⁵ *Id.* § 1101(1).

²⁶ Congress vested the trustee with these powers so that the trustee may further enhance the estate.

²⁷ The trustee's avoiding powers are limited by the provisions in 11 U.S.C. § 546 (1988).

²⁸ *See id.* §§ 544, 546-548.

²⁹ *Id.*

³⁰ Rents are "cash collateral" which in theory cannot be expended by the debtor, but the court on petition may authorize the expenditure of such collateral if adequate protection is available. *Id.* §§ 363(c)(2) & (4).

³¹ This Article uses the term "trustee" to refer to both the bankruptcy trustee and the debtor in possession when discussing collection of rents.

not expend the rents unless the secured party has "adequate protection."³² A secured creditor is adequately protected if other security for the claim can adequately pay the claim, if the court provides liens on other property of the debtor, or if the court provides some other method of protection.

B. Rents Interests Under the Old Bankruptcy Act

The old Bankruptcy Act permitted most lenders to collect rents during bankruptcy if the lenders "perfected" their rents interests prior to the bankruptcy petition.³³ No clear definition of perfection exists, however, other than the redundant statement that perfection means that the bankruptcy court will recognize an interest as effective following a bankruptcy petition. A creditor held a perfected rents claim if the creditor had begun lawfully collecting rents, under state law, prior to the bankruptcy petition.³⁴ If, however, a lender had not yet begun collecting rents, the court often found the interest "unperfected," at least until the lender took some further action in bankruptcy.³⁵ Under the general rubric, state law determined the appropriate method to reach rents post-

³² For a collection of cases discussing "adequate protection" in this context, see *infra* note 106.

³³ The Bankruptcy Act of 1898, ch. 541, 30 Stat. 544, § 75s(2) (repealed 1979); see *In re Rider*, 40 F. Supp. 882, 886 (S.D. Iowa 1941). See generally Comment, *The Mortgagee's Rights to Rents and Profits Following Petition in Bankruptcy*, 60 IOWA L. REV. 1388 (1975) (outlining development of bankruptcy law and validity of mortgagee's interest in rents and profits).

³⁴ See Comment, *supra* note 33, at 1391.

³⁵ *Central States Life Ins. Co. v. Carlson*, 98 F.2d 102 (10th Cir. 1938) (viewing lender as having done everything possible to establish its rents claim under the circumstances and recognizing claim as to rents accruing during bankruptcy). In several appellate cases, lenders believed they had perfected their rents interests, but the courts held otherwise. Some lenders even lost rents that they had already collected. See, e.g., *In re American Fuel & Power Co.*, 151 F.2d 470 (6th Cir. 1945); *Central States Life Ins. Co. v. Carlson*, 98 F.2d 102 (10th Cir. 1938); *In re Hotel St. James Co.*, 65 F.2d 82 (9th Cir. 1933); *In re Clark Realty Co.*, 253 F. 938 (7th Cir. 1918); *In re Von Rooy*, 21 F. Supp. 431 (N.D. Ohio 1937); *In re Dole*, 110 F. 926 (D. Vt. 1901). The Seventh Circuit Court of Appeals ignored the *Clark* case and permitted a lender access to the rents in *In re Wakey*, 50 F.2d 869 (7th Cir. 1931). In *Tower Grove Bank & Trust Co. v. Weinstein*, 119 F.2d 120 (8th Cir. 1941), the Eighth Circuit denied the lender access to the rents in a title theory jurisdiction and pointed out that, even though the mortgagee needed no explicit assignment to reach the rents, it was still required to take possession to perfect its title theory interest. *But see In re Stackenberg*, 374 F. Supp. 15 (E.D. Mo.), *aff'd*, 505 F.2d 1250 (8th Cir. 1974) (stating prepetition attornment by tenants not necessary for bankruptcy recognition of rents interest in title theory jurisdiction).

bankruptcy when the interest was unperfected.³⁶ Some courts, however, adopted a "federal rule of equity"³⁷ to determine how lenders should perfect such rents interests.

II. THE CONDITIONAL PRESENT ASSIGNMENT FICTION

A. *The Fiction*

By finding rents interests unperfected, bankruptcy courts stripped lenders of protection at the critical moment of default (the very event for which the lender sought protection). To avoid depriving lenders of the protection for which they bargained, some courts have come to view rents interests as immediately perfected under a conditional present assignment theory. Under this theory, a borrower, on execution of the loan instruments, immediately assigns to a mortgagee any rents generated by the property. Thus, the mortgagee immediately has a perfected security interest in rents for bankruptcy court protection in the event the borrower defaults. Because borrowers will not relinquish control of rents until default, however, lenders have attempted to create these present assignments conditionally. Under such an assignment, a borrower immediately assigns rents to the lender, but retains the right to receive those rents unless and until the borrower defaults.³⁸ Thus, although the lender's rights arise immediately, the assignment defers the lender's enjoyment of those rights by conditioning their enjoyment on the bor-

³⁶ See, e.g., *Hotel St. James Co.*, 65 F.2d at 82.

³⁷ In a few circuits, the courts have given the lender access to the rents through a "federal rule of equity." This rule has utilized different standards than would have been available in state courts before the bankruptcy stay began. See *In re Pittsburgh-Duguesne Dev. Co.*, 482 F.2d 243 (3d Cir. 1973); *Associated Co. v. Greenhurt*, 66 F.2d 428 (3d Cir. 1933); *Wakey*, 50 F.2d at 869; *Bindseil v. Liberty Trust Co.*, 248 F.2d 112 (3d Cir. 1917). See generally Comment, *supra* note 33 (discussing federal courts' application of general rule to rents-and-profits clause in bankruptcy cases). These latter cases may have gone beyond the state court rules and have been criticized on that basis. In fact, these cases largely arose in title theory jurisdictions in which the mortgagee automatically had the right to rents upon default as a matter of state common law, even absent an assignment in the mortgage.

³⁸ The concept of the conditional present assignment exists in commercial finance law. Commercial financing often involves a present assignment, conditioned on default, of the debtor's receivables. Whether the typical mortgagor/mortgagee relationship ought to be so characterized is another question. Based on personal experience in real estate practice, this author believes that the parties, in the typical mortgage relationship, expect that the mortgagor will continue to have free access to the rents at least until the borrower defaults *and* the mortgagee takes some action to "activate" its rents interest. This is true regardless of the phrasing of the mortgage instrument. See *infra* notes 63-64 and accompanying text.

rower's default.

The conditional present assignment is a fiction. Borrowers and lenders do not intend that the lender will begin collecting rents at the very moment the borrower defaults. Rather, the parties expect that the lender will take some step to "activate" the rents claim. Otherwise, even after minor defaults, borrowers would unlawfully be taking and using their lenders' funds when the borrowers collected rent.³⁹

Secured real estate lenders typically continue to bargain with borrowers following default. Lenders will not resort to such dramatic remedies as cutting off the borrowers' rental income flow until the lenders conclude that the situation is hopeless or that continued delay may harm the lenders. The conditional present assignment fiction suggests that the parties intend the lender to have a legal claim on rents that the borrower receives during this period of negotiation. Regardless of what the documents provide, the parties rarely intend this. Nevertheless, lenders require borrowers to sign documents purporting to create such rights specifically so the lender will enjoy greater protection in the event of bankruptcy.

The Ninth Circuit adopted this conditional present assignment theory to find a rents interest perfected in *In re Ventura Louise Properties*.⁴⁰ In *Ventura Louise*, decided under the old Act, the loan documents purported to assign the rents to the lender, but provided that the borrower could collect rents until default. The borrower defaulted on the loan and filed bankruptcy before the lender took any action to collect the rents. Nevertheless, the court ruled that the lender had perfected the rents interest. The court held the rents interest perfected because, under state law, the interest would be valid against competing creditors (with notice of the lender's claim) who had seized the rents after default. The court indicated that, under state law, the lender perfected a "present assignment" in rents upon execution of the documents. Consequently, the court protected the lender's interest in the rents, even though the agreement postponed the lender's enjoyment of the rents until default, and even though the lender had not attempted to collect the rents following default.⁴¹

In characterizing the rents interest as a "perfected" present assignment, the *Ventura Louise* court had little California precedent on

³⁹ Likewise, tenants who paid rent to the borrower/landlord would not technically be paying the rent. Thus, the tenants might be held to have breached their leases.

⁴⁰ 490 F.2d 1141 (9th Cir. 1974).

⁴¹ No California case has adopted this view, although there was suggestive dicta in a few cases. See *infra* note 43.

which to rely. The court emphasized *Kinnison v. Guaranty Liquidating Corp.*,⁴² which recognized a mortgagee's priority claim in rents collected under an assignment.⁴³ In *Kinnison*, however, the mortgagee collected the rents immediately after executing the assignment, even prior to default. The *Kinnison* court characterized the interest as a "present assignment," stating the controlling test as whether the parties contemplated an assignment of rents or merely a pledge of rents for security purposes.⁴⁴ The court further indicated the possibility for a "present

⁴² 18 Cal. 2d 256, 115 P.2d 450 (1941).

⁴³ *Kinnison* exemplifies the confused thinking of courts and practitioners concerning rents interests. It is difficult to see how a borrower can pledge a fund that is not yet in existence, such as unaccrued rents. Thus, the concept that rents are pledged in itself is anomalous. Nevertheless, practitioners routinely use pledge language in their documents, and courts routinely refer to it. Apparently, any interest which is activated on default and is intended to insure payment of that obligation is given "for security." Thus, when *Kinnison* distinguishes the assignment before it from "merely a pledge of rentals," one is hard pressed to understand just what the court has in mind. See *Kinnison*, 18 Cal. 2d at 262, 115 P.2d at 453.

It is easier to accept the simple holding of *Kinnison* — that the assignment in that case was "perfected" as a present assignment. *Id.* at 263, 115 P.2d at 454. The *Kinnison* assignment was not contingent upon default. The mortgagee collected rents from the moment of the assignment and held all the landlord's rights to enforce collection. In essence, the mortgagee had the tenant's possessory interest. *Id.* at 263-64, 115 P.2d at 454. This was a continuing collection device *in addition to* a security device.

Despite the court's protestations to the contrary, the *Kinnison* assignment was still an assignment for security. It did not survive the note and was simply a method of applying revenues for the payment of the debt. The mortgagee obtained no interest other than as a mortgagee. Indeed, had the mortgagee done so, this almost certainly would have been viewed as a clog on the equity of redemption. Thus, it might be fairer to say that when the court differentiated between present "active" assignments and future "inchoate" assignments, the court characterized the former as established both as collection devices *and security devices*, and the latter as *solely* devices for security.

Subsequent California cases cast little light on *Kinnison*. None of the cases represent a clear holding that an absolute assignment contingent on default gives the lender a priority right to collect the rents accruing after default. See, e.g., *Childs Real Estate Co. v. Shelburne Realty Co.*, 23 Cal. 2d 263, 143 P.2d 697 (1943); *Malsman v. Brandler*, 230 Cal. App. 2d 922, 41 Cal. Rptr. 438 (1964); *Santacrocce Bros. v. Edgewater-Santa Clara, Inc.*, 242 Cal. App. 2d 584, 51 Cal. Rptr. 613 (1966). For a full discussion of these cases, see Note, *Assignment of Rents Clauses Under California Law and in Bankruptcy: Strategy for the Secured Creditor*, 31 HASTINGS L.J. 1433, 1442-53 (1980).

A recent article suggests that *Kinnison* derives from a pre-U.C.C. view of security interests and made valid distinctions in that context. The article concludes that these distinctions are no longer valid following the adoption of the U.C.C.'s "unitary" concept of a security interest. McCafferty, *The Assignment of Rents in the Crucible of Bankruptcy*, 94 COM. L.J. 423, 442-45 (1989).

⁴⁴ *Kinnison*, 18 Cal. 2d at 263, 115 P.2d at 454.

assignment" contingent on default that would not constitute a "pledge . . . for security purposes."⁴⁵ The *Ventura Louise* court, building on the dictum in *Kinnison*, recognized as "perfected" this hybrid rents interest: ineffective until default and only available to satisfy the debt. The court characterized this interest as something other than "for security purposes."

The *Ventura Louise* doctrine has presented interpretation problems to subsequent courts because the court failed to describe clearly the elements of an effective conditional present assignment. The case appears to distinguish two types of clauses: (1) the "present assignment" which the bankruptcy court recognized as perfected even though the lender had not attempted collection before the bankruptcy petition, and (2) a mere "assignment for security" which the court indicated it would not recognize. The opinion states that the documents created a "present assignment" rather than "an assignment for security purposes only,"⁴⁶ even though the mortgagor clearly assigned the rents solely to secure the debt. The court apparently characterized the interest this way to fit within the poorly stated *Kinnison* rule.⁴⁷

⁴⁵ *Id.* at 262, 115 P.2d at 453.

⁴⁶ *In re Ventura Louise Properties*, 490 F.2d 1141, 1145 (1974).

⁴⁷ In light of the language in *Kinnison*, it is easy to see why the court chose to characterize the assignment in this way. Nevertheless it is impossible to see how the assignment in question, whatever else it might be, could be said not to be an assignment for security. *Ventura Louise*, however, should be understood in context. The court had few alternatives, in light of available precedent, if it wished to recognize the lender's security interest at all during bankruptcy.

Ventura Louise recognized that a mortgagee could "perfect" its rents interest in California merely by asserting a right to possession prior to bankruptcy. *Ventura Louise*, 490 F.2d at 1145 n.1. The court undoubtedly also recognized that a borrower could avoid such a right by filing a "preemptory strike" bankruptcy petition before the lender had decided to act. Lenders have a variety of additional concerns in relying on a request for possession as the means of exercising a rents claim. See *Randolph*, *supra* note 4, at 17-22.

As stated, the flaw in the *Kinnison* dictum is that it suggests that an assignment stated to be "for security purposes" is distinct from the "payment device" which the court approves as a present assignment. This rationale was not necessary to the result in *Kinnison*, and as indicated above, is inconsistent with the parties' objectives. All assignments of rents are for security. Some of these, however, may require some additional act for activation.

A subsequent California case compounds the problem. *Malsman v. Brandler*, 230 Cal. App. 2d 922, 41 Cal. Rptr. 438 (1964). *Malsman*, faced with *Kinnison* as precedent, acknowledged that case as good law, but then proceeded to restrict *Kinnison's* significance by finding a similar rent assignment "unperfected" (ineffective to give the creditor rights to accrued rents) until the creditor had taken a distinct act to invoke its rights. Because of the instrument's language, the court ruled that an action for posses-

The parties in *Ventura Louise*, however, clearly intended the assignment as a means of security — no more and no less than any other rents assignment. The lender had no right to the rents other than as security. Following foreclosure, rents collected in excess of any deficiency belonged to the borrower.⁴⁸ Further, the lender clearly relinquished any right to rents before default.⁴⁹ Thus, it is difficult to con-

sion through a receiver, rather than a simple demand for the rents, was the act necessary for activation. *Id.* at 925, 41 Cal. Rptr. at 440-41.

The *Malsman* court, finding that the assignment was not perfected upon execution, noted that the language of the rents clause stated that it was given “as additional security.” *Id.* However, this was only one of several defects that the court found in the clause. More significantly, the clause expressly stated that upon default the beneficiary could “take possession and collect the rents.” *Id.* This indicated to the court that the parties intended *some further action* by the mortgagee before the rents passed to the mortgagee. The court distinguished such arrangements from situations in which the assignment of rents “is in payment *pro tanto* of the obligation.” *Id.* *Malsman* perpetuates the notion that a conditional present assignment of rents is possible. The case also suggests that stating that an assignment is “for security” is relevant in differentiating between conditional absolute assignments and conditional inchoate assignments. The case suggests this while in fact limiting the reach of *Kinnison*. Arguably, the *Ventura Louise* clause, *see infra* note 49, would not have passed muster under *Malsman*, since the case appears to require a separate act of possession before the rents interest becomes effective.

Ventura Louise, and later *In re Stapp*, 641 F.2d 737 (9th Cir. 1981) (applying Nevada law), picked up the *Kinnison* dictum, differentiating between present assignments and assignments for security only. A student note also reiterated this dictum. *See Note, supra* note 43. This dictum suggests that the language “for security purposes” is a significant element in deciding whether an assignment is perfected or unperfected at the outset. This author disagrees with such reasoning. *See infra* notes 100-01 and accompanying text.

⁴⁸ In fact, *Ventura Louise* never contended that the rents assignment transferred any rights to the lender other than those necessary to pay the debt. Other courts have summarily dismissed arguments that the language of an assignment-of-rents clause gave the lender any right to rents beyond the amount of the secured debt. *See In re Stapp*, 641 F.2d at 737; *In re Dacey*, 80 Bankr. 206 (Bankr. D. Nev. 1987).

⁴⁹ The deed of trust set forth the beneficiary’s right to the rents in a provision which began as follows:

Should Trustor fail or refuse to make any payment or do any act which he is obligated hereunder to make or do, at the time and manner herein provided, then Trustee and/or Beneficiary each in its sole discretion, it being hereby made the sole judge of the legality thereof, may . . .

Ventura Louise, 490 F.2d at 1143.

The specific language granting a rents interest in the *Ventura Louise* documents does not grammatically follow this clause, although it apparently is subordinate to it.

Beneficiary is authorized either by itself or by its agent to be appointed by it for that purpose, to enter into and upon and take and hold possession of any or all property covered hereby and exclude the Trustor and all other

clude that the assignment was a method of arranging for payment of the debt in addition to a security interest.⁵⁰

The *Ventura Louise* court may have been suggesting a distinction between a present assignment provision, albeit for security, and a contingent, inchoate provision used *merely* for security. This distinction, however, is purely semantical. Any interest given solely to assure payment of a debt constitutes security. Moreover, although such an interpretation might make *Ventura Louise* more logical,⁵¹ later cases have not interpreted *Ventura Louise* this way.

B. Present Assignment/Security Purposes Dichotomy

Many bankruptcy courts have narrowly applied the *Ventura Louise* conditional present assignment doctrine. Courts have refused to protect lenders who fail to seize rents prepetition, even though the lenders phrased their loan documents to create a "present assignment." The decisions indicate that mortgage clauses stated to be "for security purposes" cannot qualify as conditional present assignments under the *Ventura Louise* rule.⁵²

persons therefrom; and may operate and manage the said property and rent and lease the same and collect any rents, issues, income and profits therefrom, . . . the same being hereby assigned and transferred for the benefit and protection of the Beneficiary.

Id.

⁵⁰ One California case has suggested that the real distinction between a "present assignment" and an inchoate (unperfected) assignment is that the present assignment is "payment *pro tanto* of the obligation." *Malsman v. Brandler*, 230 Cal. App. 2d 922, 925, 41 Cal. Rptr. 438, 440 (1964); *see supra* note 47. *Cf. In re Triplet*, 84 Bankr. 84 (Bankr. W.D. Tex. 1988) (making same distinction under Texas law).

⁵¹ 490 F.2d at 1141-45.

⁵² *See In re Stapp*, 641 F.2d 737 (9th Cir. 1981) (applying Nevada law). The court characterized an assignment of rents as a present assignment and indicated that the essential feature leading to that view was the fact that the instrument did not state that the assignment was "for additional security." *Id.* at 739; *see also Taylor v. Brennan*, 621 S.W.2d 592, 594 (Tex. 1981). In *Taylor*, the court indicated that characterizing the rents assignment as "additional security" was some evidence, although not dispositive, that the parties intended an inchoate interest and not an absolute assignment. *Id.* Courts distinguish these clauses notwithstanding the fact that such language simply states an obvious truism that applies as well to the interests protected in *Ventura Louise* as it does to any other rents interest in a mortgage. For a discussion of cases interpreting *Ventura Louise* in this manner, *see infra* notes 53-60 and accompanying text.

At least one bankruptcy decision in the Ninth Circuit has recognized an interest as within the ambit of *Ventura Louise* even though it purported to be for security purposes. *In re Gould*, 78 Bankr. 590 (Bankr. D. Idaho 1987). This case construed two rents clauses as "present assignments." *Id.* at 593. One specifically stated that the par-

The bankruptcy court decision in *In re Oak Glen R-Vee*,⁵³ illustrates this distinction. The *Oak Glenn* mortgage contained an assignment-of-rents clause clearly stating a present assignment.⁵⁴ The clause, however, appeared in a mortgage instrument creating all rights under it “for the purpose of securing”⁵⁵ the debt. Thus, the court refused to recognize the rents interest and held that the transfer failed to create a present assignment.

The 1988 bankruptcy court decision in *In re Association Center Ltd. Partnership*⁵⁶ further exemplifies this present assignment/security purposes dichotomy. The *Association Center* mortgage contained a rents clause clearly creating a present assignment. The deed of trust stated:

As further security . . . all Grantor’s rents and profits . . . and the right, title and interest of the Grantor entered under all leases now or hereafter affecting [the security property] *are hereby assigned and transferred to the Beneficiary*. So long as no default shall exist . . . the Grantor may collect assigned rents and profits as the same fall due, but upon the occurrence of any default . . . all right of the Grantor to collect or receive rents

ties intended “that this assignment of rents constitutes an absolute assignment and not an assignment for additional security only.” *Id.* at 591. Although the court set forth the entire rents clause, the court did not quote further from the instrument containing this rents clause. Thus, it is difficult to tell if another clause of the document characterized the rents right as security. The second clause that passed the court’s muster stated that it was given “as further security” and that upon default the assignment became absolute. *Id.* at 592.

See *In re El Patio Ltd.*, 6 Bankr. 518 (Bankr. C.D. Cal. 1980) (giving recognition to “absolute assignment” without stating language); *In re Dacey*, 80 Bankr. 206 (D. Nev. 1987). This court stated that the absolute nature of the assignment was not impugned when the clause indicated that the trustee would collect rents “for the account of [the borrower]” since obviously the parties only intended that the assignment be used only to satisfy the debt. *Id.* at 209-10; see also *In re Fluge*, 57 Bankr. 451 (Bankr. D.N.D. 1985) (holding present assignment of rents valid under North Dakota law).

⁵³ 8 Bankr. 213 (Bankr. C.D. Cal. 1981).

⁵⁴ The clause stated that:

Trustor further irrevocably grants, transfers and assigns to Beneficiary the rents, income, issues and profits from all [the mortgaged property] . . . Notwithstanding any other provisions hereof, Trustee and Beneficiary hereby grant permission to Trustor to collect and retain the rents, income issue and profits from such property as they become due and payable but Beneficiary reserves the right to revoke such permission as to Trustee and itself at any time with or without cause by notice in writing to Trustor. In any event, such permission to Trustor automatically shall be revoked upon default by Trustor in payment of any indebtedness secured hereby or in performance of any agreement hereunder.

8 Bankr. at 215, nn.1-2.

⁵⁵ *Id.*

⁵⁶ 87 Bankr. 142 (Bankr. W.D. Wash. 1988).

or profits shall wholly terminate. All rents or profits of Grantor receivable from or in respect to said property which it shall be permitted to collect hereunder shall be received in trust to pay the usual reasonable operating expenses of, and the taxes upon, said property and the sums owing the Beneficiary as they become due and payable.⁵⁷

This language declares more clearly than the language in *Ventura Louise* the parties' intent to presently assign the rents.⁵⁸ Nevertheless, the court refused to construe this as a present assignment. It held that the opening phrase, "as further security," made the interest a "pledge for security purposes only" and not a present assignment. Under the court's interpretation of *Ventura Louise*, the use of such language was a fatal flaw.

The rents clauses in both these cases, like the language in *Ventura Louise*, purported to create a present assignment of rents which the lender could not "activate" until default. In both cases, the interest simply acted as security. The lender had no interest in the rents other than to secure repayment of the obligation. In short, the interests appeared substantively identical to those created in *Ventura Louise*. Language indicating that the rents interest secured a debt was the only difference.⁵⁹

These bankruptcy court decisions have seized the ambiguous language of *Ventura Louise* to deny effect to contract language that the parties clearly intended to fall within the ambit of *Ventura Louise*. If the court decided *Ventura Louise* correctly, these cases are wrong. Including the words "for security purposes" in a clause otherwise expressing an intent to create a conditional present assignment should not deprive a lender of the *Ventura Louise* protection.

Although the *Oak Glen* and *Association Center* cases seem inconsistent with the apparent rationale of *Ventura Louise*, the problem may lie in the *Ventura Louise* decision. The *Ventura Louise* court distorted the transaction before it and created a puzzle for practitioners trying to fit within its terms. Taken together, *Ventura Louise* and its progeny create a semantic obstacle course for real estate lawyers in which form,

⁵⁷ *Id.* at 143 (emphasis added).

⁵⁸ For the *Ventura Louise* document's text, see *supra* note 49.

⁵⁹ See also *Taylor v. Brennan*, 621 S.W.2d 592 (Tex. 1981). *Taylor* makes the same analysis under Texas law, but indicates that the "for security" language is suggestive, but not dispositive, on whether the interest is "inchoate" (not a present assignment). *Id.* at 594. Cf. *In re Winslow Center Assocs.*, 50 Bankr. 679 (Bankr. E.D. Pa. 1985) (distinguishing between absolute assignment and "pledge for security," but failing to resolve whether mere phrasing of interest as "for security" would render interest a pledge).

and not substance, has the real meaning, and the necessary form is left unstated. Thus, real estate drafters, attempting to draft enforceable rents clauses, have little guidance or certainty.⁶⁰

Courts in other jurisdictions hold it impossible, under controlling state law, to create a present assignment contingent on default.⁶¹ These courts simply refuse to recognize immediately perfected contingent rents interests. These cases are irreconcilable with *Ventura Louise*, regardless of the controlling documents' subtle differences in phrasing. However phrased, all rents interests transferred to mortgagees that become effective on default basically state the same intent of the parties. Therefore, all should be construed alike.⁶²

The best uniform approach, however, is to interpret these clauses as *not* operating automatically. In virtually all private real estate secured transactions, the parties intend the borrower to retain access to the rents until the borrower defaults *and* the lender takes some step to activate that interest.⁶³ Typically, when financial difficulties arise, lenders and borrowers attempt to work things out informally, rather than

⁶⁰ Most recently, a bankruptcy court in Arizona affirmed the possibility of creating an "absolute assignment" in Arizona, but then held inadequate the lender's attempt to create such an assignment in the loan documents. See *In re American Continental Corp.*, 105 Bankr. 564 (Bankr. D. Ariz. 1989). The court relied on three factors that diluted the effect of the present assignment language. First, there were several references to the fact that the assignment was made "as further security." Second, the assignment would remain in effect only until the borrower paid the debt. Third, the lender would have had to notify the tenants before the tenants would be required to pay the rents to the lender. See *id.* at 569. If *Ventura Louise* applied factors such as these, it would not have recognized the "conditional present assignment" initially.

⁶¹ See *In re Johnson*, 62 Bankr. 24 (Bankr. 9th Cir. 1986) (applying Washington law); *In re Prichard Plaza Assocs.*, 84 Bankr. 289 (Bankr. D. Mass 1988); *In re Hamlin's Landing Joint Venture*, 77 Bankr. 916 (Bankr. M.D. Fla. 1987); *In re Zales*, 77 Bankr. 257 (Bankr. D. Haw. 1987); *In re Fluge*, 57 Bankr. 451 (Bankr. D.N.D. 1985); *Consolidated Capital Income Trust v. Colter, Inc.*, 47 Bankr. 1008 (Bankr. D. Colo. 1985).

⁶² For a further discussion of these issues, see Randolph, *supra* note 4, at 31.

⁶³ Judge Augustus Hand expressed this point in *Prudential Ins. Co. v. Liberdar Holding Corp.*, 74 F.2d 50 (2d Cir. 1934):

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

Id. at 51; see also *Taylor v. Brennan*, 621 S.W.2d 592 (Tex. 1981).

assuming that the lender will resort immediately to all of its security rights. Default alone should not trigger a major alteration in the parties' entitlements.⁶⁴ Thus, the Ninth Circuit should overrule *Ventura Louise* and hold that conditional present assignments *do not* operate automatically, but rather require the mortgagee to take some step to activate its rents interest.

Better still, lenders should not need conditional present assignments that operate automatically. As argued below, bankruptcy courts should recognize a lender's rents interest even if the lender has not taken steps to activate that interest before the borrower files a bankruptcy petition. Thus, courts would not need to strain to find a present assignment of rents that the parties never intended. Rather, bankruptcy courts should permit lenders to seek recognition of state law rents claims, by specific bankruptcy filings, except when the lender (or receiver) has already started collecting the rents prior to the borrower filing bankruptcy. Such a rule will avoid strained drafting. Moreover, it will avoid strained interpretation of loan instruments designed to facilitate a comfortable predefault environment for the borrower and reasonable postdefault protection for the lender.

III. *Butner*: BANKRUPTCY RECOGNITION OF "UNPERFECTED" RENTS INTERESTS

The need to create a contingent present assignment *apparently* dissipated soon after the court's decision in *Ventura Louise*. In *Butner v. United States*,⁶⁵ the United States Supreme Court instructed bank-

⁶⁴ This argument suffers from an obvious inconsistency in certain title theory states where, under state law, the mortgagee has the right to possession immediately on execution of the mortgage, or at least at the moment of default. Rents generally follow possession. For a full analysis of various state provisions, see Randolph, *supra* note 4, at 6-20. Even in title theory states, however, courts have found ways to require lender action before the rents interest is activated. See *In re Prichard Plaza Assocs.*, 84 Bankr. 289 (Bankr. D. Mass. 1988); see also text accompanying *infra* notes 84-86. California, like all western states, is a lien theory state. See CAL. CIV. PROC. CODE § 744 (West 1980). Whatever problems arise under the title theory should not affect judicial approaches in California.

⁶⁵ 440 U.S. 48 (1979). The case involved an appeal from a bankruptcy case concerning North Carolina property. The bankruptcy trustee had collected rents. The mortgagees argued that these rents should be applied to reduce their debt. The lower court denied any interest in the rents because the mortgagees had taken no prepetition action to reach them. The mortgagees argued that they had a state law right to the rents immediately upon default without their taking any further action and that the bankruptcy court should recognize such a right. The Supreme Court did not resolve the dispute between the lender and the bankruptcy trustee, but remanded to the lower

ruptcy courts to recognize state-created rents interests *even if "unperfected" at the time the mortgagee files bankruptcy*. Unfortunately for lenders, subsequent courts have not always carried out the Supreme Court's mandate.

A. *The Butner Holding*

Butner ended a long-standing circuit court division over which law bankruptcy courts should apply in determining the validity of rents interests postpetition.⁶⁶ The Court held that state law should apply and remanded for further proceedings. Writing for a unanimous court, Justice Stevens explicitly stated the Court's intent that bankruptcy judges administer parties' rights to rents by the same standards applicable in state courts *even if a creditor first seeks relief after a bankruptcy petition*. Justice Stevens stated that:

[T]he federal bankruptcy court should take whatever steps are necessary to ensure that the mortgagee is afforded in federal bankruptcy court the same protection he would have under state law if no bankruptcy had ensued. . . . [O]ur decision avoids the . . . inequity of depriving a mortgagee of his state-law security interest when bankruptcy intervenes. For while it is argued that bankruptcy may impair or delay the mortgagee's exercise of his right to foreclosure, and thus his acquisition of a security interest in rents according to the law of many States, a bankruptcy judge familiar with local practice should be able to avoid this potential loss by sequestering rents or authorizing immediate state-law foreclosures.⁶⁷

This language is certainly dicta. The Court did not need to order bankruptcy courts to recognize rents interests that lenders failed to perfect prior to the bankruptcy petition. The mortgagee in *Butner* had taken some action prior to bankruptcy to reach the rents, thus perfecting the security interest. Further, the Court addressed the narrow issue of what law to apply, not the broader issue of when the bankruptcy courts should apply that law.

The Court's specific language, however, is difficult to misunderstand. If bankruptcy must not impede the mortgagee's state law access to

court for resolution of this issue. Instead, the Court addressed a broader issue — whether federal or state law should control the disposition of rents in bankruptcy.

⁶⁶ See *id.* at 51-54. A rough majority of the circuits had concluded that state law should apply, but a number of others applied a "federal rule of equity" to determine whether to protect the creditor's rents interest. *Butner* characterized the Third Circuit and the Seventh Circuit as adopting a federal rule of equity, *id.* at 53, while it viewed the Second, Fourth, Sixth, Eighth, and Ninth Circuits as deferring to local law, *id.* at 52-53.

⁶⁷ *Id.* at 56-57.

rents, then bankruptcy courts must permit access to rents, during bankruptcy, by providing remedies equivalent to those available in state courts. Although lenders must take some further action before bankruptcy courts will recognize their security interests, courts should honor those interests from the time of the lender's action.

B. *Butner Under the Current Bankruptcy Code*

The Court decided *Butner* under the old Act. Nevertheless, the doctrine applies equally under the new Bankruptcy Code.⁶⁸ Several cases have ruled that petitions in bankruptcy court to sequester rents or otherwise to recognize contractual security interests, obligate bankruptcy courts to recognize security interests that state laws already recognize.⁶⁹

Bankruptcy Code Section 552(b) recognizes rents interests created before bankruptcy that state laws recognize.⁷⁰ This provision states

⁶⁸ *In re Village Properties, Ltd.*, 723 F.2d 441, 445 (5th Cir. 1984); see also *In re Prichard Plaza Assocs.*, 84 Bankr. 289, 293-94 (Bankr. D. Mass. 1988). The *Prichard Plaza* holding, however, is inconsistent with the notion that *Butner* is still the law. See *infra* notes 84-86 and accompanying text.

⁶⁹ A recent California bankruptcy case recognized that postpetition action can perfect a rents interest. *In re McCombs Properties VI, Ltd.*, 88 Bankr. 261 (Bankr. C.D. Cal. 1988).

The court in *Village Properties, Ltd.* denied relief on the facts before it, but set forth its views on what would be sufficient to perfect an inchoate interest in rents, postpetition, under Texas law:

The form of the action required to perfect the mortgagee's interest is not as important as its substantive thrust — diligent action by the mortgagee which demonstrates that he would probably have obtained the rents had bankruptcy not intervened.

Village Properties, Ltd., 723 F.2d at 446; see also *In re Casbeer*, 793 F.2d 1436 (5th Cir. 1986); *In re Gelwicks*, 81 Bankr. 445 (Bankr. N.D. Ill. 1987); *In re Hamlin's Landing Joint Venture*, 77 Bankr. 916 (Bankr. M.D. Fla. 1987) (denying protection to lender, but indicating properly phrased motion to set aside stay would result in protection under Florida law); *In re Morning Star Ranch Resorts*, 64 Bankr. 818 (Bankr. D. Colo. 1986) (holding § 546(b) motion sufficient to activate interest postpetition under Colorado law); *In re Sampson*, 57 Bankr. 304 (Bankr. E.D. Tenn. 1986); *In re Southern Gardens, Inc.*, 39 Bankr. 671 (Bankr. S.D. Ill. 1982) (holding postpetition demand on trustee to set aside rents sufficient to "activate" assignment under Illinois law).

⁷⁰ 11 U.S.C. § 552(b) (1988). The section states:

Except as provided in sections 353, 506(c), 522, 544, 545, 547, and 548 of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, product, offspring, rents or profits of such property, then such security interest extends to such proceeds, product, offspring, rents or profits acquired by the estate after the

that, for bankruptcy purposes, a secured creditor obtains a lien against the rents and proceeds of a debt's security to the same extent that state law and the security agreement grant such a lien. Other bankruptcy provisions designed to further the purposes of the bankruptcy proceeding (such as the automatic stay and equitable distribution powers) limit a creditor's right to actually receive the rents. Nevertheless, nothing in the new Code suggests that Congress intended to preempt a state law recognized security interest in rents.⁷¹ Thus, *Butner's* mandate that bankruptcy courts protect such interests remains valid. If state law permits lenders access to rents provided the lenders have recorded security interests and have taken steps to "activate" those interests, then bankruptcy courts should permit these lenders to activate their rents interests by action in the bankruptcy proceedings even though the lenders have not attempted to activate the interests before the bankruptcy petition.⁷²

commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

Id.

⁷¹ Some courts have held that the trustee's avoidance powers, set forth in § 544, preclude the court from applying *Butner* to rents interests that are unperfected at the time of petition. *See infra* notes 87-90 and accompanying text. Other courts have held these avoidance powers are limited by § 546(b), which permits secured creditors to "perfect" certain state-recognized security interests retroactively by a postpetition notice. *See infra* notes 91-95 and accompanying text. This Article takes the position that § 544 does not authorize departure from the *Butner* rationale and that rents interests are secure from avoidance if they are properly recorded, even though they are effective against the trustee only as to rents arising after activation of the interest. *See infra* notes 91-95 and accompanying text.

⁷² Courts have recognized a wide variety of postpetition actions as sufficient to "perfect." One court found an informal demand on the trustee sufficient. *See In re Southern Gardens, Inc.*, 39 Bankr. 671 (Bankr. S.D. Ill. 1982). Numerous courts have found filing a § 546(b) perfection notice sufficient to activate a right to rents. *See, e.g., In re Casbeer*, 793 F.2d 1436 (5th Cir. 1986); *In re McCombs Properties VI, Ltd.*, 88 Bankr. 261 (Bankr. N.D. Cal. 1988). However, courts frequently require further showings that the conditions for exercise of this right under state law existed. *See, e.g., Virginia Beach Fed. Sav. & Loan Assoc. v. Wood*, 97 Bankr. 71 (Bankr. N.D. Okla. 1988); *In re Morning Star Ranch Resorts*, 64 Bankr. 818 (Bankr. N.D. Colo. 1986); *In re Colter, Inc.*, 46 Bankr. 510 (Bankr. D. Colo. 1984).

Some courts have ruled that perfection simply requires some affirmative action to sequester, control, collect or take possession of rents. *See, e.g., In re American Continental Corp.*, 105 Bankr. 564 (Bankr. D. Ariz. 1989); *In re Village Properties, Ltd.*, 723 F.2d 441 (stating in dicta that no perfection had occurred). Most commonly such action involves either a motion for relief from the stay to pursue state court action, *see,*

C. Courts Rejecting the *Butner* Mandate

Although a clear split seems to be developing,⁷³ numerous cases have failed to follow the *Butner* mandate.⁷⁴ Some cases avert *Butner* by closely interpreting state law. Other cases hide behind the automatic stay provisions. Still other cases allow the trustee to avoid the rents interest.

1. State Law Interpretation Problems

Association Center,⁷⁵ illustrates bankruptcy courts sidestepping the *Butner* mandate, while purporting to follow it, by closely interpreting state law. The *Association Center* mortgagee filed a receivership action, to collect rents, after the borrower defaulted. The mortgagor responded by filing a bankruptcy petition. Although the mortgagee took the necessary state court action to activate the rents claim, the mortgagor's bankruptcy prevented the state court from acting. In the bankruptcy court, the mortgagee moved to sequester the rents. Under *Butner*, the court should have protected the mortgagee's rents interest by sequestering the rents or by providing "adequate protection." Instead, the court permitted the bankruptcy trustee to collect the rents and left the lender unprotected.

The court noted that no Washington state law provided for sequestration of rents and ruled that sequestering rents would expand the state law rights available to the mortgagee.⁷⁶ Washington law provides

e.g., *In re Johnson*, 62 Bankr. 24 (Bankr. 9th Cir. 1986) (ruling that lifting of stay only for pursuit of foreclosure did not perfect right to rents); *In re Rief*, 83 Bankr. 626 (Bankr. S.D. Iowa 1988) (lifting stay to allow pursuit of rents through prepetition motion for receiver in state court); *In re Gelwicks*, 81 Bankr. 445 (N.D. Ill. 1987) (motion to allow pursuit of rents); or a motion to sequester/segregate rents, *see, e.g.*, *In re Mears*, 88 Bankr. 419 (Bankr. S.D. Fla. 1988) (holding sequestration order perfects interest when state law requires seizure or commencement of action); *In re Anderson*, 50 Bankr. 728 (Bankr. D. Neb. 1985).

Finally, some courts use the filing of adversarial proceedings as the point of perfection. *See, e.g.*, *In re Oak Glen R-Vee*, 8 Bankr. 213 (Bankr. C.D. Cal. 1981) (finding filing of complaint sufficient to enable court to order sequestration); *In re Sampson*, 57 Bankr. 304 (Bankr. E.D. Tenn. 1986) (defining § 546(b) notice as adversarial proceeding against trustee to determine validity of lien; filing of proof of claim and demand for rents on mortgagor and trustee were insufficient).

⁷³ For cases recognizing postpetition perfection, see Section III D *infra*.

⁷⁴ In addition to the *Prichard* decision, see *Kearney Hotel Partners*, 92 Bankr. 95 (Bankr. S.D.N.Y. 1988); *In re Gotta*, 47 Bankr. 198 (Bankr. W.D. Wis. 1985).

⁷⁵ *See supra* notes 56-58 and accompanying text.

⁷⁶ The court based its decision on a close reading of the Ninth Circuit decision in *Investors Syndicate v. Smith*, 105 F.2d 611 (9th Cir. 1939). This case involved a mort-

for a receiver to collect rents.⁷⁷ Bankruptcy courts do not appoint receivers,⁷⁸ but sequestration would be the bankruptcy equivalent to a state court receivership appointment. The *Association Center* court apparently requires that state court remedies replicate available bankruptcy approaches, or the court cannot protect the mortgagee. The court points out, however, that the mortgagee made no request for relief from the stay. Thus, the case may suggest that in every case a lender must seek relief from the stay to reach the rents.⁷⁹

If the case suggests that a lender must seek relief from the stay with respect to the property itself, this seems unrealistic. Many circumstances might require the court to protect a lender's rents interest, while not requiring the court to lift the stay on foreclosure of the property. For instance, the property may be critical to a reorganization. Thus, even with an undersecured lender, the bankruptcy court would not lift the stay.⁸⁰ Under the *Association Center* reasoning, however, the court also would refuse to protect the mortgagee by sequestering the rents.

If the case simply suggests that, to gain recognition of a rents interest, a lender must seek relief from the stay to realize the rents via state court remedies, this seems more workable for lenders.⁸¹ Of course, in

gagee's right to reach rents following bankruptcy through sequestration. As the court construed applicable state law, the mortgagee would not have received access to the rents in the state courts. The court denied access to the rents, stating that sequestration should not be granted "in cases where the mortgagee would have greater rights in bankruptcy than he would have, had bankruptcy not intervened." *Id.* at 622.

⁷⁷ WASH. REV. CODE § 7.60.040 (1961).

⁷⁸ 11 U.S.C. § 105(b) (1988). A bankruptcy court's ability to appoint a receiver for general equity purposes remains uncertain. *In re Association Center Ltd. Partnership*, 87 Bankr. 142, 147 n.2 (Bankr. W.D. Wash. 1988) (citing *In re Cassidy Land & Cattle Co.*, 836 F.2d 1130 (8th Cir. 1988)) and *In re Memorial Estates, Inc.*, 797 F.2d 516 (7th Cir. 1986).

⁷⁹ *Association Center* is unusual, if not unique, in its reasoning. One other case which comes close to this reasoning is *In re Winzenberg*, 61 Bankr. 141 (Bankr. N.D. Iowa 1986). Iowa law permits a mortgagee to reach rents only through a receiver appointed in a foreclosure action. The court held that since bankruptcy stays the foreclosure action, the mortgagee cannot have the right to receive rents in bankruptcy. *Id.* at 145; see also *In re Reif*, 83 Bankr. 626 (Bankr. S.D. Iowa 1988); *In re Spears*, 83 Bankr. 621 (Bankr. S.D. Iowa 1987).

⁸⁰ See e.g., *In re Gaslight Village, Inc.*, 6 Bankr. 871 (Bankr. D. Conn. 1980); *In re El Patio, Ltd.*, 6 Bankr. 518 (Bankr. C.D. Cal. 1980).

⁸¹ See, e.g., *In re Hamlin's Landing Joint Venture*, 77 Bankr. 916 (Bankr. M.D. Fla. 1987) (requesting relief from stay on foreclosure not sufficient to raise issue of rents interest; lender must ask for relief from stay on realization of rents interest itself); *In re Oliver*, 66 Bankr. 426 (Bankr. N.D. Tex. 1986) (requiring motion for relief from

many circumstances the estate might need the "cash collateral" consisting of rents. Thus, the trustee properly could argue against relief from the stay if the court affords "adequate protection" to the secured party. Nevertheless, the court, by evaluating the question of adequate protection and ensuring protection when required, would have recognized the rents interest. The court fails to state why a lender must seek relief from the stay to gain such recognition of this interest.⁸²

2. Automatic Stay Problems

Other cases refuse to follow *Butner* because of the automatic stay. These cases read section 362(a)(4) as expressing Congress' intent that the automatic stay prevent creditors from obtaining recognition of rents interests through an action in bankruptcy court.⁸³ Under section 362(a)(4), the filing of a bankruptcy petition automatically stays "any act to create, perfect, or enforce any lien against property of the estate." If this precluded any creditor's action *in the bankruptcy court proceedings* to obtain recognition of its security interest, it apparently would prevent postpetition recognition of any rents interest. If read this way, however, the stay would prevent *any* activity by a creditor to protect a secured claim in bankruptcy. This would be an absurd result.

A leading case refusing to recognize "unperfected" rents interests postpetition, *In re Prichard Plaza Associate Ltd. Partnership*,⁸⁴ illustrates this "automatic stay" reasoning. *Prichard* simply holds that the automatic stay provisions of section 362 demonstrate Congress' intent to preempt state court recognition of security interests in rents, at least for the period of the stay.⁸⁵ The court states that a lender can seek relief from the stay if the lender lacks adequate protection. However, the court does not recognize the "unperfected" rents interest when determining the lender's protection.

The same Congressional intent argument might have been made under the old Bankruptcy Act, but *Butner* apparently resolved that argument in favor of the lender. On the one hand, the new Bankruptcy Code has adopted stay provisions more comprehensive than those existing before. The current provisions clearly set out an overall scheme

stay on realization of rents interest).

⁸² Some other action in bankruptcy might be just as appropriate. For cases recognizing actions other than petitions for relief from the stay as sufficient to perfect a rents interest postpetition, see *supra* note 72.

⁸³ See *infra* notes 84-86 and accompanying text.

⁸⁴ 84 Bankr. 289 (Bankr. D. Mass. 1988).

⁸⁵ See *id.* at 300.

to “freeze” the parties where they stand at the moment of bankruptcy. Thus, arguably it is appropriate, under the new Code, to stay any action by a creditor to activate a security interest. On the other hand, the current statute’s language permits recognition of rents interests following bankruptcy. This undercuts the contention that the Code establishes a new “stay philosophy” concerning rents. Rather, *Butner*, which compels recognition of state law rents interests, remains current.⁸⁶

Courts adopting the *Prichard* rationale state that they *are* deferring to the state law, as directed by *Butner*, in determining whether a lender perfected a rents interest prepetition. Common law requires specific action to “activate” a rents interest following default. Consequently, borrowers commonly declare bankruptcy before the secured lenders can take action to “activate” their rents interests. These courts analyze the rents interest as unperfected and simply view any further action to activate the interest as stayed. This analysis is consistent with a narrow reading of *Butner* because *Butner* simply remanded on the issue of how to interpret a state court interest. Nevertheless, the *Butner* dicta quoted above leaves little doubt that the court intended bankruptcy courts to recognize state-created rights activated in the bankruptcy proceeding itself.

3. Avoidance Problems

Several bankruptcy courts have stated that, even if section 552(b) does recognize rents interests, the trustee can avoid these interests under section 544.⁸⁷ Section 552(b) expressly subjects rents interests to the trustee’s section 544 avoidance powers.⁸⁸ Section 544(a) places the trustee in the shoes of a hypothetical lien creditor with respect to competing claims on the debtor’s estate. In most states, a lien creditor can reach rents, notwithstanding an assignment of rents in a mortgage, unless and until a mortgagee “activates” the rents claim. Standing in the shoes of this creditor, the trustee could assert a right, superior to a lender, in any rents accrued prior to the lender activating the rents interest. Further, if the stay provisions prevent any postpetition right to activate a rents claim, the trustee can avoid all of the secured creditor’s rights in the rents.

⁸⁶ For a thorough contextual and historical analysis of this argument, see McCafferty, *supra* note 43.

⁸⁷ See *Kearney Hotel Partners*, 92 Bankr. 95 (Bankr. S.D.N.Y. 1988); *In re Erickson*, 83 Bankr. 701 (Bankr. D. Neb. 1988); *In re Selden*, 62 Bankr. 954 (Bankr. D. Neb. 1986).

⁸⁸ 11 U.S.C. § 552(b) (1988); see also *id.* § 362(b)(3).

Cases using section 544 to avoid rents interests must contend with section 546, which authorizes secured parties to invoke security interests by postpetition notice even though they had not perfected those interests prior to bankruptcy. Section 546 is a specific exception to the section 544 avoidance powers. This section states that: (1) the bankruptcy trustee's avoidance powers are subject to rights that state law recognizes as having priority at the time of the petition even though perfected later, and (2) lenders may perfect such interests postpetition by notice within the time set by state law. Thus, if under section 546(b) a lender can activate a rents claim postpetition, neither the automatic stay nor the avoidance power would prevent the bankruptcy court from recognizing a rents interest.

The antiperfection cases claim that section 546(b) serves only to recognize interests "perfected" postpetition in the U.C.C. meaning of the term (usually this means recording).⁸⁹ These cases hold that section 546(b) is irrelevant to rents interests, because valid rents interests derive from prepetition "activation," rather than prepetition "recording." These cases rely on legislative history indicating that section 546(b) endeavors to protect mechanic's liens and similar interests that state law gives priority over other prior recorded claims.⁹⁰ The antiperfection cases then argue that, without this section 546(b) argument, no procedure exists to recognize unperfected interests. Thus, the Bankruptcy Code's stay provisions eliminate any possibility of the creditor gaining recognition postpetition. Consequently, a trustee can apply rents to the benefit of all creditors and can avoid any rents, under section 544, that the secured creditor might have already collected by postpetition action.

D. Courts that Recognize Postpetition Perfection

A number of courts have relied on section 546(b) to justify the recognition of a rents interest even though the mortgagee had not attempted to seize the rents before the bankruptcy petition.⁹¹

⁸⁹ See *In re Prichard Plaza Assocs.*, 84 Bankr. 289, 301 (Bankr. D. Mass. 1988).

⁹⁰ The legislative history yields only one example of the intended effect of § 546(b). This suggests that the primary thrust is toward security interests recorded during the "grace period" permitted by U.C.C. § 9-301(2). Other situations that more precisely fit the language of § 546(b) are mechanic's liens under state laws that take priority as of a time earlier than recording, and fixture liens under U.C.C. § 9-313.

⁹¹ *In re Casbeer*, 793 F.2d 1436 (5th Cir. 1986); *In re Mears*, 88 Bankr. 419 (Bankr. S.D. Fla. 1988); *In re McCombs Properties VI, Ltd.*, 88 Bankr. 261 (Bankr. C.D. Cal. 1988); *In re Gelwicks*, 81 Bankr. 445 (Bankr. N.D. Ill. 1987); *In re Morning Star Ranch Resorts*, 64 Bankr. 818 (Bankr. D. Colo. 1986); *In re Sampson*, 57 Bankr. 304 (Bankr. E.D. Tenn. 1986); *In re Southern Gardens, Inc.*, 39 Bankr. 671

The Fifth Circuit recently upheld an action to perfect a rents interest postpetition in *In re Casbeer*.⁹² *Casbeer* recognized a rents claim as perfected by postpetition notice under section 546(b). The court emphasized that section 552(b) protected the rents after the lender activated the rents interest. The court acknowledged that the lender could not protect rents arising before the section 546(b) notice. Nevertheless, the court stated that the lender's activation of the rents interest retroactively perfected the rents interest as of the pre-bankruptcy period.⁹³ As *Casbeer* characterized the situation, the lender perfected the interest prior to the petition, although activation did not occur until during bankruptcy.

A number of courts, agree with the *Casbeer* approach and recognize postpetition efforts to reach rents by viewing such efforts as section 546(b) actions.⁹⁴ The Supreme Court recently reaffirmed *Butner* and cited *Casbeer* with approval, in *United Savings Association of Texas v. Timbers of Inwood Forest*.⁹⁵ Although *Timbers* generally addressed the

(Bankr. S.D. Ill. 1982).

⁹² 793 F.2d 1436, 1442-43 (5th Cir. 1986); see also *In re Village Properties, Ltd.*, 723 F.2d 441, 447 (5th Cir. 1984) (perfecting mortgagee's interest on petition); *In re Sampson*, 57 Bankr. 304 (Bankr. E.D. Tenn. 1986) (perfecting security interest in rents on filing of adversary proceeding).

⁹³ 793 F.2d at 1443.

⁹⁴ See cases cited *supra* note 91. Probably the most thorough and explicit case on this issue is *In re American Continental Corp.*, 105 Bankr. 564 (Bankr. D. Ariz. 1989) (analyzing whether prior cases recognize necessity to adopt *Casbeer* "relation back" theory to recognize possibility of postpetition perfection).

⁹⁵ 484 U.S. 365 (1988). The Court stated that:

Section 552(a) states the general rule that a prepetition security interest does not reach property acquired by the estate or debtor postpetition. Section 552(b) sets forth an exception, allowing postpetition "proceeds, product, offspring, rents, or profits" of the collateral to be covered only if the security agreement expressly provides for an interest in such property, and the interest has been perfected under "applicable non-bankruptcy law." See, e.g., *In re Casbeer*, 793 F.2d 1436, 1442-44 (5th Cir. 1986); *In re Johnson*, 62 Bankr. 24, 28-30 (9th Cir. 1986); cf. *Butner v. United States*, 440 U.S. 48, 54-56 (1979) (same rule under former Bankruptcy Act). Section 552(b) therefore makes possession of a perfected security interest in postpetition rents or profits from collateral a condition of having them applied to satisfying the claim of the secured creditor ahead of the claims of unsecured creditors.

Id. at 370.

The *Johnson* case citation might appear more significant to Ninth Circuit practitioners than the *Casbeer* citation. Although it supports the notion that § 552 permits postpetition recognition of rents interests, the excerpt from *Johnson* gives very little detail of its reasoning.

"adequate protection" principle, the Court's selection of cases to illustrate its discussion may have been more than fortuitous. The Court may have confirmed that *Casbeer* truly reflects the balance of state and federal policies first established in *Butner*.

IV. A SUGGESTED ANALYSIS

Courts should view the rents interest as a security interest "owned" by the secured party prior to bankruptcy. Most security interests surviving bankruptcy are "reified" pre-bankruptcy more than an inactivated rents interest. Still, the rents interest is part and parcel of the mortgage, a greater security interest. Courts clearly recognize mortgages as existing pre-bankruptcy. Thus, courts should view rents as part of the mortgagee's possessory right deriving directly from the mortgage lien interest. In effect, rents compensate the mortgagee for the time delay in foreclosure.⁹⁶

Courts should recognize rents interests in mortgages and protect them under section 552(b). State law protects rents interest holders against other claimants when lenders record their mortgages. Whether lenders must take action to collect and apply the rents depends on controlling state law. Bankruptcy courts should permit lenders to take action in bankruptcy court that is equivalent to the state law required "activation" and should apply those factors that state law would apply in determining whether the rents interest should be enforced. Courts should protect such mortgagees' security interests in rents accruing thereafter. Moreover, such interests should be free from the trustee's avoidance powers.

Section 552(b) protects existing, state-recognized security interests, including the proceeds therefrom. It differentiates security interests in property already identified from security interests in "after-acquired property."⁹⁷ Secured parties cannot improve their positions by debtors obtaining, through postpetition efforts,⁹⁸ new assets technically falling

⁹⁶ The fact that lien theory states such as California require that the lender specifically bargain for such an interest does not detract from the function the interest plays in the security relationship. *See supra* note 4 (discussing difference between title theory and lien theory states).

⁹⁷ *See* 4 COLLIER ON BANKRUPTCY ¶ 552.01, at 552-54 (L. King 15th ed. 1987).

⁹⁸ Bankruptcy entitles the debtor to a "fresh start," and postpetition wages cannot be reached by prepetition security clauses. The Court originally set forth this principle in *Local Loan Co. v. Hunt*, 292 U.S. 234, 243 (1934). Bankruptcy courts view § 552 as embracing this concept. *See, e.g., In re Miranda Soto*, 667 F.2d 235 (1st Cir. 1981) (holding no lien on postpetition wages); *In re Lawrence*, 41 Bankr. 36 (Bankr. D. Minn. 1984) (holding that postpetition milk produced by cows subject to security inter-

within the security interest. Rents do not flow from a debtor's new effort.⁹⁹ A mortgagee's rents interest gives the mortgagee a right to reach rents, following default, as the security interest's "fruits of possession." The rents interest is not a new security, but part of the mortgage security that section 552(b) protects.¹⁰⁰ The word "rents" in section 552(b) acknowledges this fact.

The requirement that a mortgagee take formal action to activate a rents interest should not detract from this argument. Rents flow from possession of property in which a prepetition security interest existed. Consequently, rents interests deserve postpetition recognition. Courts analogizing "inactivated" rents interests to "after-acquired property," while viewing rents under "automatic activation" clauses as distinct, draw a distinction that section 552 will not support. The "property" (rents) is the same. The "perfection" of the interest (the mortgage instrument's recording) is also the same.¹⁰¹

Rents interests might be analogized to personal property security interests in equipment. Assume that a creditor had no immediate right to take and sell the equipment on default, but rather had to undertake a

est does not fall within § 552(b); evaluating time, labor, and funds relating to collateral to conclude that milk is product of postpetition investment).

⁹⁹ In those rare cases where income is the result of new effort (such as income generated by a hotel), there is general agreement that such income does not constitute rents for purposes of a general rents clause. This author has no quarrel with such cases.

¹⁰⁰ In an analogous context, a recent bankruptcy court decision held that a rents interest was not a separate security interest which would prevent a mortgagee in a Chapter 13 bankruptcy proceeding from arguing that the debtor's principal residence was secured "only" by a security interest in the real property. The court held that the rents interest was part of the mortgage security. *In re Hougland*, 93 Bankr. 718 (Bankr. D. Or. 1988).

¹⁰¹ For a similar argument, based upon Texas law, see Averch, *Revisitation of the Fifth Circuit Opinions of Village Properties and Casbeer: Is Post-Petition "Perfection" of an Assignment of Rents Necessary To Characterize Rental Income as Cash Collateral?*, 93 COM. L.J. 516 (1988). Averch suggests a distinction between security interests in rents contained in mortgage instruments and separate assignments. Section 552(b), he argues, should apply to the assignments contained in mortgages and such interests should be regarded as "perfected" as of recording regardless of when lenders activate them. This would result in virtually every security interest in rents being treated as perfected. Although secured real estate financing arrangements frequently contain a separate "assignment of rents document," these transactions almost universally include the rents security interest in the mortgage document itself. The primary reason for the separate documentation in deed of trust states is concern arising from the uncertainty of whether an assignment of rents should be recorded under the U.C.C. If states require U.C.C. recording, the secured party should be the creditor and not the trustee. This leads to parties documenting rents assignments separate from the deed of trust, to show the lender as the assignee.

notice procedure to establish that right. Prior to a creditor initiating this procedure, a debtor might file bankruptcy. Bankruptcy courts should recognize such a creditor's rights. "Perfection" (in this case filing the financing statement under the U.C.C.) would have fully protected the creditor, even though the creditor would have to act further to realize on the security. Prior to the creditor's realization, the debtor would have exclusive use of the equipment. Thereafter, outside of bankruptcy, the secured party has a superior claim to possession of the equipment. Upon activating the interest, the creditor would have the right to such equipment's "proceeds" if the debtor sold or leased the equipment to another. Bankruptcy courts also should provide the creditor such protection.

The personal property security interest analogy is theoretical. Typically, personal property security arrangements do not require further activation. Nevertheless, the analogy demonstrates that interpreting section 552(b) to favor late activation of rents interests is consistent with the Bankruptcy Act's general treatment of creditors. Moreover, the bankruptcy court has equitable power to recognize state-created rights. Thus, courts need not view a mortgagee's subsequent action to obtain recognition of a rents interest as a section 546(b) notice.¹⁰²

It is difficult to see why courts emphasize section 546(b). Section 552(b) instructs bankruptcy courts to recognize rents interests in security agreements signed prior to bankruptcy. Section 546(b) provides a method for "perfection," but uses that term differently than cases discussing rents interests. Further, the legislative history argument raised by courts refusing to effectuate section 546(b) in these cases is compelling. The statute's drafters did not intend section 546(b) to empower bankruptcy courts to recognize rents interests postpetition.

Even without section 546(b), however, courts can and should recognize such interests. Section 546(b) only helps creditors seeking recognition of rents claims if creditors must avert the section 544 avoidance powers. Section 544, however, should not impede postpetition recognition of rents claims. Section 552(b), which validates rents claims in bankruptcy if valid under state law, should permit creditors to activate rents claims. Once activated, courts should recognize such claims. Section 544 permits the trustee to avoid interests that lenders fail to "perfect," under state law, prior to bankruptcy. This section, however,

¹⁰² A few bankruptcy courts have recognized this fact. See *In re Pavillion Place*, 89 Bankr. 36 (Bankr. Minn. 1988); *In re Oliver*, 66 Bankr. 426 (Bankr. N.D. Tex. 1986); *In re Winslow Center Assocs.*, 50 Bankr. 679 (Bankr. E.D. Pa. 1985); *In re Anderson*, 50 Bankr. 728 (Bankr. D. Neb. 1985).

should not apply to rents interests in real estate mortgages if the lenders properly record the security agreements creating these interests and if state law gives these interests priority over competing creditors when activated. Courts reading section 552(b) and section 544 consistent with *Butner* will recognize rents claims when a creditor seeks such recognition in bankruptcy court. Thus, section 544 will have no impact. Accordingly, courts need not resort to section 546(b).

Furthermore, creditors should be able to activate rents interests in bankruptcy notwithstanding the automatic stay. The stay does not prevent creditors from seeking remedies by actions in the bankruptcy proceedings. This section merely prohibits state law proceedings involving the debtor's property for the period of the stay.

Finally, from a policy standpoint, courts should recognize the postpetition validity of a rents interest rather than adopting the approach taken by *Association Center* and *Prichard*. Those cases compel bankruptcy courts to make distinctions in state laws that were not written with the bankruptcy situation in mind. States that permit lenders access to rents really have no reason to restrict that access subsequent to a bankruptcy filing. Ultimately, most states will develop doctrines to permit postpetition recognition. Until then, however, lenders must guess at what loan document phrasing will satisfy bankruptcy courts that lenders have perfected their rents interests. Such a system will increase lenders' costs and produce further bizarre interpretations of parties' intent. Moreover, lenders might demand that borrowers pay rents to a trustee from the outset. This unduly restricts borrowers' business flexibility and increases costs *on all loans* simply to avoid a technical problem arising in the few loans that go into bankruptcy. This problem should not exist.

Section 552(b) compels the conclusion that bankruptcy courts should recognize *some* security interests in rents postpetition. This policy draws an intelligent distinction between security interests in asset value existing at the time of the petition and interests in income generated by the debtor's activity following the petition. If lenders receive any security interest protection at all, they should be able to look to these assets' intrinsic value in income as well as liquidation. Bankruptcy may forestall attempts to realize liquidation value. Thus, lenders and borrowers should be able to agree that the premises' continuing rental value will provide the lender protection from delay in foreclosure.

State courts increasingly view rents interest in real estate as "perfected" against subsequent parties by recording in the real estate

records.¹⁰³ Unsecured creditors, and others interested in a debtor's property, have notice of such recorded rents interests. Thus, these interested parties can claim no unfair surprise or reliance on rents as assets. Information about the secured creditor's claim is only a title report away. Bankruptcy courts, therefore, should not force cumbersome and expensive arrangements on all real estate secured loans merely to avoid a technical distinction in bankruptcy.

Currently, notice to the trustee *should* sufficiently activate a rents interest in California.¹⁰⁴ Prudent lenders should follow this demand on the trustee with a bankruptcy court motion for relief from stay to pursue the rents in state court.¹⁰⁵ Where appropriate, lenders should couple this motion with a motion for relief from the stay to foreclose. Lenders should ask for sequestration of rents, or alternatively, adequate protection of the rents interest.¹⁰⁶ Thus, lenders at least will have taken all

¹⁰³ See *supra* note 5.

¹⁰⁴ The court in *In re Ventura Louise Properties*, 490 F.2d 1141 (9th Cir. 1974), indicated in dicta that an "unperfected" rents assignment in California becomes perfected simply by notice to lessees. *Id.* at 1145 n.1. The court cited *Mortgage Guarantee Co. v. Sampsell*, 51 Cal. App. 2d 180, 124 P.2d 353 (1942), and *Bank of Am. Nat'l Trust & Sav. Ass'n v. Bank of Amador County*, 135 Cal. App. 714, 28 P.2d 86 (1933), both of which generally support the point. More direct authority, however, can be found in *Title Guarantee & Trust v. Monson*, 11 Cal. 2d 621, 81 P.2d 944 (1938), which holds specifically that a demand for possession sufficiently triggers a California mortgagee's interest in rents, provided such interest appears in the mortgage itself.

A bankruptcy petition notice to the lessees may be sufficient to "perfect." If the lessee actually paid the rent over to the mortgagee, however, this might violate § 362(a) of the Bankruptcy Act as an "attempt to exercise control over the property of the estate." Therefore, the functional equivalent of notice to the lessees under the Act would be notice to the trustee.

¹⁰⁵ See *In re Johnson*, 62 Bankr. 24 (9th Cir. 1986). The court applied Washington law and refused to follow the conditional present assignment approach. The court does not specifically state that a simple demand on the tenants would activate a rents interest. However, the court appears to require more affirmative action. A mere motion for relief from the stay to foreclose is not enough to activate the rents interest. The motion must address the rents directly. *Johnson* implies that the court would have entertained a motion to sequester, or even some motion for recognition of the rents interest, in connection with the motion for relief from stay.

¹⁰⁶ The lender subsequently may find itself arguing whether sequestration is necessary to give it "adequate protection." There is general agreement that the only interest of the mortgagee is in the *net rents* in most cases. Reinvesting the rents in the operation and maintenance of the property usually provides adequate protection, when required. The court in *In re Prichard Plaza Assocs.*, 84 Bankr. 289 (Bankr. D. Mass. 1988), although it refused to recognize the rents interest as valid, opined that adequate protection, if required, would be satisfied if the debtor applied rents entirely to the operation and maintenance of the property. *Id.* at 302.

steps currently recognized¹⁰⁷ to perfect their rents interests.

CONCLUSION

Bankruptcy court cases currently leave lenders uncertain as to whether a court will protect their rents interests. Lenders might attempt to draft rents clauses so close to the *Ventura Louise* phrasing that courts will view them as perfected on the mortgage's signing. If lenders fail, however, courts will not recognize the interests activated postpetition. Ironically, to reach a legitimate security position, lenders might need to draft imprecise documents that courts can twist to provide protection. This produces a result that the parties did not contemplate. Moreover, the Supreme Court rendered this practice unnecessary.

The Supreme Court recently indicated in *Timbers*, that *Butner* remains viable. Thus, bankruptcy courts should provide lenders the necessary postpetition recognition of rents interests. This protection will render *Ventura Louise* moot and, ultimately, forgotten. Lenders then can protect their rents interests as they and their borrowers intended.

See also, e.g., In re McCombs Properties VI, Ltd., 88 Bankr. 261 (Bankr. C.D. Cal. 1988) (holding equity cushion "adequate protection" and that rents could be spent to make repairs or renovations that would increase rent flow even without cushion); *In re Western Real Estate Fund*, 83 Bankr. 52 (Bankr. W.D. Okla. 1988) (allowing expenditures of postpetition rent revenues for upkeep); *In re Oak Glen R-Vee*, 8 Bankr. 213 (Bankr. C.D. Cal. 1981) (holding equity cushion made it unnecessary to sequester rents to protect lender); *In re El Patio, Ltd.*, 6 Bankr. 518 (Bankr. C.D. Cal. 1980) (refusing to lift stay on property critical to reorganization, but holding lender entitled to any rent proceeds in excess of amounts necessary to maintain property); *In re Gaslight Village, Inc.*, 6 Bankr. 871 (Bankr. D. Conn. 1980) (suggesting 100% sequestration of rents possible in appropriate case).

A full discussion of the "adequate protection" issue is beyond the scope of this Article. Note should be made, however, of *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365 (1988), which dealt with this issue and held that "adequate protection" of an undersecured creditor does not involve protecting the creditor from lost opportunity costs due to delay in payment, nor does it require periodic interest payments.

¹⁰⁷ See *supra* note 72 and accompanying text.