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ASSIGNMENTS OF RENTS
Lenders Beware!

"How can you have any pudding, if you don't eat your meat?"
Pink Floyd

Assignments of Rents. Here's a topic that doesn't pop up in light conversation very often.

Assignments of Rents. Virtually every commercial real estate financing includes an assignment of rents – either as a separate instrument, or in the mortgage, or both. We think we know what it means, and what protection it provides. But do we?

Assignments of Rents. What could assignments of rents possibly have to do with *Pink Floyd*?

It has been suggested on occasion, only half-jokingly, that I don't like lenders. That is really not true. Lenders are valuable participants in the commercial real estate market. Without lenders, few of my clients could buy, develop or own commercial real estate projects. Commercial lenders provide valuable liquidity to the market (usually) and allow commercial real estate developers and investors to leverage available resources.

For years, I have described commercial lenders and their borrows as "friendly adversaries". Friendly, because they need each other. Adversarial, because their interests are not always completely aligned. They are each necessary complements to the other.

In good times, all typically works well, with lenders and borrowers sharing a common goal –financing a viable commercial project that makes each of them an attractive return.

In troubled times, like we have seen over the past several years, lenders and borrowers can find themselves at odds. The current economic downturn has been particularly brutal because the commercial real estate market has seen an unprecedented collapse in property values and tenant rental revenue. Lenders often blame the borrower, because the loan has ended up in default. Realistically, for most commercial real estate borrowers, there is little if anything they could have done to prevent a default, save not acquiring and financing the project in the first place – which, in hindsight, most borrows wish, as much as most lenders wish, had been the case. But neither borrowers nor lenders foresaw the dramatic financial debacle we have been experiencing since 2008.

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Still, we are where we are. Commercial real estate borrowers are holding projects with substantially lower values than existed five or six years ago, and may be in default of their mortgage loans. Not unreasonably, commercial real estate lenders want their money back.

Assuming the lender has properly documented and administered its commercial real estate loan, the lender should be in the driver's seat. All else being equal, with a properly documented and administered commercial loan, a lender has a powerful arsenal of enforcement tools at its disposal.

That said, lenders must still comply with the law. Assuming they can pass the test of having a properly documented loan that has been properly administered in a manner that does not violate the rights and interests of the borrower, the mere fact that a lender is owed millions of dollars and has a secured interest in the borrowers project (including, yes, an assignment of rents) does not mean a lender can do whatever it wishes to collect its loan without regard to applicable law.

Do I dislike lenders? No. What I abhor are lenders and their attorneys who ignore the law – which already wildly favors lenders – and take steps in direct contravention of the law to collect their loans. With the legal enforcement deck already stacked in their favor, there is no excuse for lenders to overreach and violate the law in their enforcement efforts. When they do, they should fully expect that I will object on behalf of my borrower clients and seek to hold them accountable. We will pursue compensatory and punitive damages, when appropriate, petition to have their unlawful actions reversed, and will press to have their equitable remedies, including their equitable remedy of foreclosure, curtailed or barred.

Follow the law, and a lender should expect to get what the law provides. Violate the law, and a lender should expect to suffer the consequences.

Enforcement of an Assignment of Rents is a case in point. The law in Illinois, and in most other states, is crystal clear. It is an extension of common law doctrine that has developed over centuries. If a lender is going to require an Assignment of Rents, and plans to enforce the Assignment of Rents, it is incumbent upon the lender to know the law governing Assignments of Rents.

The leading case in Illinois on the effect and enforceability of an Assignment of Rents provision, whether in the mortgage or in a separate document, is ***Comerica Bank—Illinois vs. Harris Bank Hinsdale, et al***, 284 Ill.App.3d 1030, 220 Ill.Dec. 468, 673 N.E.2d 380 (1st. Dist. 1996).

The *Comerica* case involved a dispute between a property owner/mortgagor and a first and second mortgagee as to who was entitled to collect the rents from shopping center tenants after the mortgagor's default in payment of the a first mortgage and second mortgage.

The assignment of rents provision in the mortgage provided that, after a default, Comerica could collect rents from the property without taking possession of the property, and without exercising other options under the mortgage.

Comerica, the first mortgagee, sent a notice to tenants that the mortgagor was in default under its mortgage and that under the assignment of rents provision in its mortgage Comerica was entitled to collect the rents. Thereupon Comerica began collecting rents.

The property owner/mortgagor and the second mortgagee objected.

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In summary, **the *Comerica* court held as follows**:

1. At common law, it was strictly held that the mortgagee must take actual possession before being entitled to rents.

2. A clause in a real estate mortgage pledging rents and profits creates an equitable lien upon such rents and profits of the land, which may be enforced by the mortgagee upon default *by taking possession* of the mortgaged property.

3. The *possession requirement reflects the public policy in Illinois* which seeks to prevent mortgagees from stripping the rents from the property and leaving the mortgagor and the tenants without resources for maintenance and repair.

4. Courts will *not* enforce private agreements that are contrary to public policy.

5. "To obtain the benefits of possession in the form of rents, the mortgagee must also accept the burdens associated with possession – the responsibilities and potential liability that follow whenever a mortgage goes into default. *The mortgagee's right to rents*, then, is not automatic but *arises only when the mortgagee has affirmatively sought possession with its attendant benefits and burdens*".

6. A mortgagee may be entitled to rents once a receiver is appointed as an incidence of being in "*constructive possession*", since having a receiver appointed constitutes affirmative action by the mortgagee, under court authorization.

7. In a foreclosure action, the mortgagee is not entitled to rents until judgment has actually been entered unless the mortgage agreement permits the mortgagee to obtain prejudgment possession.

8. A *mere filing of a foreclosure action or request for appointment of a receiver is not sufficient* to trigger a mortgagee's right to collect rents. The receiver must actually be appointed. "*The mortgagee is not entitled to the rents until the mortgagee or a receiver appointed on the mortgagee's behalf has taken actual possession of the real estate after default."*

9. *Where a mortgagee does not obtain prejudgment possession* of the property (through a court appointed receiver or as a mortgagee in possession), and where rents are collected during a time while the mortgagor remained in possession of the property, *the rents so collected belong to the mortgagor*.

In making its ruling, the *Comerica* court relied on Illinois case law, but, noting that the U.S. Supreme Court has required bankruptcy courts to apply State law in determining a mortgagee's entitlement to rents [*Butner v United States*, 440 U.S. 48, 99 S. Ct. 914 (1979)], the *Comerica* court also found relevant

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bankruptcy decisions and Federal case law to be thorough and persuasive. Among other cases, the Comerica court found persuasive the bankruptcy court opinion in In re. *J.D. Monarch Development Co*. 153 B.R.829 (Bankr. S.D.Ill 1993).

In the case of **In re. *J.D. Monarch Development Co***. 153 B.R.829 (Bankr. S.D.Ill 1993), the bankruptcy court, applying Illinois law, held as follows:

1. Illinois law recognizes the validity of an assignment of rents included in a mortgage of real estate.

2. Such an assignment creates a security interest in rents that is perfected as to third parties upon recording the mortgage in the real estate records.

3. *As between the mortgagee and the mortgagor*, however, *the mortgagee is not entitled to the rents until* the mortgagee or a receiver appointed on the mortgagee's behalf has taken actual *possession* of the real estate after default.

4. This is so even though the mortgage instrument contains a specific pledge of the rents.

5. The mortgage does not create a lien upon rents to the same extent that it creates a lien upon the land. Rather, the inclusion of rents in a mortgage merely gives the mortgagee the right to collect rents as an incident of possession of the mortgaged property, and the mortgagee, after default, must take affirmative action to be placed in possession of the property to receive such income.

6. The requirement that a mortgagee enforce its lien on rents by possession of the real estate renders *an assignment of rents different from security interests in other property*.

7. Typically, a perfected lien gives the creditor an interest in a specific piece of property, whereas *an assignment of rents allows the mortgagee to collect rents that come due after the mortgagee takes control of the property*. To obtain the benefits of possession in the form of rents, the mortgagee must also accept the burdens associated with possession.

Notwithstanding the clarity of the law on this topic, there are lenders, and lenders' counsel, and occasionally receivers, who ignore the law or choose to intentionally violate the law by seeking to take the benefits of rental projects by control of rents without accepting the burdens that come with possession. They want the good, but not the bad. The dessert, but not the main course. The pudding, but not the meat.

[Hence my opening reference to Pink Floyd: "*How can you have any pudding, if you don't eat your meat?*" Even *Pink Floyd* understood the public policy applicable to assignments of rents!]

So what is the property owning borrower's remedy for a lender violating the law by exercising dominion or control over rents payable to the borrower without first obtaining possession of the project?

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How about conversion/civil theft? Let's check-off the elements:

A proper complaint for conversion must allege the four elements of a cause of action for conversion:

(1) an unauthorized and wrongful assumption of control, dominion, or ownership by a lender over a borrower's personalty (identifiable "rents" count); **[√ check]**

(2) borrower's right to the rents; **[√ check]**

(3) borrower's right to immediate possession of the rents; **[√ check]**

(4) borrowers' demand for possession of the rents. [*easy to do*: **√ check]**

"*Punitive damages*" are available where a defendant willfully or wantonly converts the property of another. Is there any legitimate doubt – especially in Illinois – especially since the court's clear and unequivocal *Comerica* decision in 1996 – that a lender who unilaterally converts the rents of a borrower to its own use without taking lawful possession of the rental project does so "willfully or wantonly" in disregard of the project owners' rights to those rents?

If a lender is intentionally violating the law as it relates to the security for its loan, particularly as it relates to an assignment of rents executed within or in conjunction with a mortgage debt, might the lender also be guilty of "*unclean hands*" relative to the mortgage security, with the result that a lender might be equitably barred from foreclosing its mortgage in a court of equity? Stay tuned . . .

The point is *not* that I wish to prevent a lender from enforcing its legal rights under its loan documents. The point is, a lender must enforce its legal rights within the bounds of the law, just like everyone else.

I didn't make the rules, but I will enforce them. If a lender insists on violating the law vis-à-vis one of my borrower clients, it should expect to suffer the consequences.

This is *not* a threat – it is a promise.

Thanks for listening.
Kymn