Mortgagee’s Rights in Leases and Rents (Continued)

- In most mortgage transactions today, it doesn’t make a practical difference whether a state is a “title” or “lien” theory state
- Reason: by executing an “Assignment of Leases and Rents,” the mortgagor expressly “assigns” leases and rents to the mortgagee (thus, the parties “contract” to an “intermediate” position)
  - Prior to default: mortgagor can collect rents, spend them as it wishes, even in “title theory” states
  - Post-default: mortgagee can take steps to enforce its security interest in rents, collect them, and apply them to the debt, even in “lien theory” states

Rents and Leases: Mortgagee Concerns

- 1) What rights does the mortgagee have versus the tenants, during and after foreclosure sale?
- 2) What rights does the mortgagee have in rents versus other creditors such as a junior mortgagee, a judgment lien creditor, or the trustee in bankruptcy (if borrower files for bankruptcy)?

“Mortgagee in Possession”

- Lender can become a “mortgagee in possession” of the mortgaged property prior to foreclosure, if either:
  - (1) Mortgagor consents; or
  - (2) Mortgagor abandons the property (putting property at risk of harm due to vandalism/lack of maintenance)
- Upon taking possession, mortgagee can operate property, collect rents from tenants, and apply them to mortgage debt
“Mortgagee in Possession”

- Problem: Mortgage lenders are very reluctant to take actual possession of land prior to foreclosure
  - Potential premises liability (in tort) to 3rd parties (e.g., Coleman v. Hoffman, p. 388)
  - Duty to account for rents collected (“in the quasi character of a trustee,” pp. 362-363)
  - Duty of care to mortgagor (lender can’t act solely to protect its own interest)
- Lenders want to collect rents and apply them to the debt without taking possession of land (and becoming a “mortgagee in possession”)

“Collection” of Rents

- The two most common methods for a lender to enforce an assignment of rents are:
  - Getting the appointment of a receiver (court-appointed manager of the property)
  - Notifying the tenants of the assignment and directing them to pay future rents directly to the lender/assignee
    - Once T receives that notice/direction, T can satisfy its rent obligation **ONLY by paying the lender/assignee, not by paying borrower/assignor landlord**

Problem 3(b)

- Uphoff (mortgagor/owner of Badger Shopping Center) collects January rents from all 10 tenants ($20,000 total)
- Instead of paying his mortgage payment, Uphoff uses the money to pay Lambert Paving to resurface the parking lot
- Mortgagee then sues Uphoff and Lambert Paving, claiming (a) the rents were property on which the mortgage lender had a valid lien and (b) Uphoff and Lambert Paving converted those rents, in violation of lender’s lien rights
- How would you rule in Mortgagee v. Lambert Paving?

“Collection” of Rents

- Once Ts paid the rents, they are cash (personalty)
- Common law: money is negotiable (someone who takes money for value in good faith takes it free of a conflicting interest in the money)
  - Mortgagee can’t enforce its lien on the money, once it has been paid to Lambert Paving (absent proof of collusion)
  - Rationale: ostensible ownership; how was Lambert Paving supposed to know that the cash was proceeds of rents? [We don’t expect people to investigate title to cash before accepting it in payment!]
**In re Millette** [p. 373]

- 8/92: Borrowers borrowed $445K from Bank, to whom they granted a mortgage on office building
  - Bank recorded mortgage and an assignment of rents
- 11/93: O'Neal Steel got $165K judgment against the Borrowers
- 5/94: Borrowers leased office space to the County; shortly thereafter, O'Neal Steel sued the County to garnish the lease payments due to Borrowers
  - Bank intervened in garnishment action
  - Before Bank could foreclose, Millette (one of Borrowers) filed for bankruptcy

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- Bank’s argument: we have first priority
  - Our mortgage/assignment of rents was recorded (“perfected”) before O'Neal Steel obtained its judgment lien
- O'Neal Steel: we have first priority
  - Bank’s lien on the rents was “inchoate” (Taylor v. Brennan), so it wasn’t enforceable until the Bank took affirmative steps to enforce it; by that time, our judgment lien had already attached
- Who has the better argument?

**Bankruptcy Code § 544(a)**

- In bankruptcy, the bankruptcy trustee can invalidate an unperfected security interest in the debtor’s property under its “strong-arm” power
  - Trustee is deemed to have the status of a “lien creditor” of debtor’s personal property (lien creditor has priority over an unperfected Article 9 security interest) [§ 9-317(a)(2)]
  - Trustee is deemed to have the status of a BFP of debtor’s land (BFP would take land free of an unrecorded mortgage, under a state’s recording act)

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- Millette properly rejected Taylor v. Brennan
  - An assignment of rents is designed to protect lender’s right to collect rents that accrue in the future
  - Bank’s lien on future rents (not yet accrued) was “perfected” by recording, and this established Bank’s priority as to future rents
  - O’Neal Steel may have priority as to collected rents already garnished, but not as to rents that will accrue in future months (and once Bank enforces its lien, it can collect those future rents)
By today, most states have rejected the *Taylor v. Brennan* view that an assignment of rents is “inchoate”
- Uniform Assignment of Rents Act (or comparable legislation) is in effect in several states (CA, NV, UT, NM, TX); Texas Act explicitly overrules *Taylor v. Brennan*
- Other states have narrower statutes that clearly equate recording with “perfected” status (NC and others)
- Others have rejected this view by court decision

**Missouri Law on Rent Assignments**
- No statute addressing enforcement of lien on rents
- Missouri case law provides that for an assignee of rents to be entitled to collect rents, it must have
  - 1) Proper documentation of the assignment;
  - 2) Proper recording of the assignment;
  - 3) Default by the mortgagor/assignor; and either
  - 4a) Possession of the premises by the mortgagee/assignee; or
  - 4b) Action equivalent to possession by the mortgagee/assignee
- If 4a or 4b hasn’t happened by the date borrower files bankruptcy petition, lender can enforce its right to rents by filing a motion w/bankruptcy court to “sequester” rents

**Appointment of a Receiver**
- Pro: gets the mortgagor out of possession of the land (and out of control of rents), but without making the lender a “mortgagee in possession”
  - No premises tort liability for mortgagee
  - Mortgagee has no duty re: operating and managing the mortgaged property (this power is vested in receiver by court order)
  - Receiver can manage property and enter into new leases pending foreclosure (if that power is vested in the receiver by court order) [mortgagee in possession can’t effectively enter leases w/out consent of mortgagor]
Appointment of a Receiver

- Con: receivership is costly, particularly by comparison to direct collection of rent (by notification to tenants)
  - Attorneys' fees for process (pleadings, hearing)
  - Receiver’s bond
  - Receiver’s fee (5-10% of gross rents)
- Note: in Missouri, receivership is very uncommon
  - Power of sale foreclosure happens very fast (45 days)
  - Small amount of rent that would accrue in such a short period of time may not justify expense of receivership

Receivership: Two Questions

- Should a lender be able to get a receiver appointed just because the borrower is in default and the mortgage says the lender is entitled to a receiver after default? Should freedom of contract go that far?
- Should a receiver be able to sell the property directly (i.e., in lieu of a foreclosure sale), or should receiver be purely a custodian?