Assignment of Rents— The Next Generation

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I. INTRODUCTION

If a debtor defaults on its real estate secured loan, a number of different interests come into play in enforcing an assignment of rents which may have been given in the transaction. The creditor may want to begin to collect the rents but not want to assume responsibility for the property. The debtor may want to collect and pocket the rents without applying them to the debt or, in some cases, without using them to maintain the property. If the debtor files bankruptcy, the creditor would like to argue that the rents are no longer the property of the debtor and must be handed over to the creditor to be applied to the creditor's loan. The debtor, however, will want to assert that, not only are the rents part of the debtor's bankruptcy estate, but they also are unencumbered by any lien in favor of the creditor.

Meanwhile, tenants want to ensure that the person to whom they are paying rent is legally entitled to it. They also have an interest in the proper care and maintenance of the property. Proper care and maintenance of a property often means that third parties supplying goods and services to the property must be paid, at the very least on a current basis, if not on invoices that may be many months old when the debtor's default occurs.

California courts and bankruptcy courts have hitherto been unsuccessful in creating a principled framework for handling the conflicting interests and desires of the various parties affected by the enforcement of an assignment of rents. To compound the problem, most modern practitioners and judges have little understanding of the arcane rules of real property law and their implications on who receives the rents after the owner defaults, who has responsibility for maintaining the property if the creditor receives the rents, and when the tenant becomes obligated to ignore the requirements of its lease and pay rent to the landlord's creditor.

The California Legislature has enacted a new statute, effective January 1, 1997, that addresses the issues on rent assignments that have baffled courts, practitioners and legal scholars. The statute is codified at Civil Code Section 2938 (the "Rents Statute"). The Rents Statute is the work of a committee (the "Rents Committee") of the California State Bar's Real Property Law Section, the publishers of this *Journal*.[1] All of the authors of this article serve on the Rents Committee and had a hand in drafting the Rents Statute. This article will, therefore, serve both as an explanation of the Rents Statute and as a defense of our work.

The Rents Statute eliminates the well-known and little justified distinction between absolute assignments and assignments for security in the context of a real property secured transaction. The Rents Committee viewed the absolute assignment as a legal fiction that had come to conceal the complex relationship among lenders, landlords, tenants, and property and service providers. The Rents Statute treats all assignments that are intended to secure the repayment or performance of an obligation as creating a "lien" on the rents, that is, an assignment for additional security.

The Rents Statute makes clear the distinction between enforcement and perfection, which both the California judiciary and the bankruptcy courts have only recently begun to acknowledge. For the creditor, the Rents Statute specifies the types of actions that, when taken, will give rise to the creditor's right to rents. For the debtor, the Rents Statute fixes the rents that the debtor is entitled to keep and the responsibilities that the creditor has for the care and maintenance of the real property from rents the creditor has collected. For the tenant, the Rents Statute affords protection against being obligated to pay rent more than once when confronted with the conflicting demands of a desperate landlord and one or more insistent creditors. This article discusses each of these aspects of the new Rents Statute and the impact of each on the day-to-day practice of counsel for both creditors and debtors.

The Rents Statute repeals Civil Code Sections 2938 and 2938.1 as they existed prior to January 1, 1997. The Rents Statute, however, applies only to contracts entered into after its January 1, 1997 effective date. Prior Civil Code Sections 2938 and 2938.1 govern contracts entered into prior to that effective date.

This article will discuss the historical treatment of assignment of rents, including the deficiencies in the prior law, and then will analyze each aspect of the Rents Statute.

II. AN OVERVIEW OF THE RENTS STATUTE

The Rents Statute addresses four assignment of rents issues: creation, perfection, enforcement, and entitlement. First, how does a creditor create an interest in rents and how is such interest to be characterized (subdivision (a))? Of particular significance in this regard is the abolition of the absolute assignment by the Rents Statute. Second, how does a creditor perfect its interest in rents (subdivision (b))? Third, how does the creditor enforce its rights in the rents when the debtor defaults (subdivision (c))? Finally, once the creditor enforces its rights, to what rents is the creditor entitled as against the borrower (subdivision (c)), tenants of the borrower (subdivision (d)), and competing creditors (subdivision (h)), and how is such entitlement to be treated if, despite the creditor's enforcement, the borrower or other third parties nevertheless obtain possession of the rent proceeds (subdivision(f))? The Rents Statute also addresses whether the creditor who collects rents has any corresponding obligations with respect to the mortgaged property (subdivision (g)) and the effect of the actions taken by the lender under the Rents Statute on California's one-action, antideficiency, and reinstatement statutes (subdivision (e)).

A. Historical Background

An examination of the historical treatment of the assignment of rents issues of creation, perfection, enforcement, and entitlement is in order, including the specific creation issue of charac-

terization of an assignment as absolute or as for additional security. This examination serves not only as a refresher course on the many knotty problems posed by current law, but also as a background for understanding the provisions of the Rents Statute.

1. *Creation and Characterization: Kinnison v. Guaranty Liquidating Corporation*

The leading California case to address the issues of creation and characterization is *Kinnison v. Guaranty Liquidating Corporation.*[2]

In *Kinnison*, two competing creditors of the debtor, Bartlett Syndicate Building Corporation, were engaged in a dispute over the right to rents which had been deposited into a bank account. The defendant and appellant, Guaranty Liquidating Corporation, was a judgment creditor of Bartlett. The plaintiff and respondent Kinnison was an assignee of the rights of Pacific Mutual Life Insurance Company ("Pacific Mutual"), as lender to Bartlett.

Pacific Mutual had lent funds to Bartlett secured by a deed of trust and an assignment of rents as additional security. After the loan went into default, Pacific Mutual and Bartlett entered into a loan workout arrangement consisting of a separate assignment of rents, together with, what we would call today, a "cash collateral agreement" providing that Bartlett would collect all of the rental income assigned, but specifying that such income was deemed to have been collected for the account and benefit of Pacific Mutual. It was this latter assignment which the court was called upon to characterize as either absolute or as additional security. Bartlett collected the rents pursuant to the loan workout arrangement and deposited them into Bartlett's general account with Farmers & Merchants National Bank. The case arose when Guaranty Liquidating Corporation levied upon that account.

The court found that the parties intended that the assignment made in connection with the loan workout transaction transferred the debtor's entire interest in the rents to Pacific Mutual such that the debtor no longer had any interest that was subject to a levy of execution by the defendant judgment creditor. The court stated that "the rents were relinquished completely, to be applied by Pacific Mutual in satisfaction of the total outstanding indebtedness" and that the assignment was an "attempt to liquidate the debt upon which Bartlett Corporation had been in default for at least eight months...."[3]

Because the assignment of rents in *Kinnison* was part of a loan workout agreement signed after the borrower's default, it was relatively easy for the court to find that the parties had intended to create an absolute assignment at the time of the execution of the assignment. However, that scenario is entirely different from that which exists at loan origination, the point at which most assignments of rents are given.

In eventually finding for Kinnison as the assignee of Pacific Mutual, the California Supreme Court initially explained that California has adopted the modern or "lien" theory of mortgages. Under this theory, the borrower retains title to, and the right to possession of, the property until a foreclosure is completed. The court held that the lien theory applies equally to mortgages and to deeds of trust. By implication, the court in *Kinnison* rejected the older title theory of mortgages pursuant to which title to property would be vested in the creditor until repayment.[4]

Although the court in *Kinnison* held that, in California the lien theory is the only theory of mortgages, the court nevertheless found that both a lien theory and a title theory of assignments of rents concurrently exist in this state. Under the lien theory, an assignment of rents is a security interest, and the assignee has no immediate right to the rents, just as a mortgagee has no immediate right to the real property. If an assignment of rents is a mere lien, the assignee lender must "perfect" its right to the rents by acquiring possession of the property or by obtaining the appointment of a receiver. Under the title theory, an assignment of rents is an absolute transfer of title to the rents to the creditor. No further "perfection" is necessary in this instance because title to the rents has already vested in the creditor. *Kinnison* stated that "...the decisive question is whether the parties contemplated an assignment of the rentals or merely a pledge of the rentals for security purposes."[5]

The court noted that indicia of a security interest in the rents would be continued enjoyment of the rents by the debtor as long as no default exists[6] and the debtor's ability to regain its right to receive the rents by paying the obligations which were due.[7] Because neither of these factors existed in *Kinnison*, and to the contrary, because the court found that the parties intended that the assignment be a complete relinquishment of the debtor's interest in satisfaction of the debt, the court found that the parties did not intend an assignment as additional security but rather an absolute assignment.

2. *Perfection/Enforcement*

In addition to its discussion of what must exist to create an interest in rents and how such interest should be characterized, the *Kinnison* court discussed the action that must be taken by the creditor in order to obtain the rents upon default. The court held that if an assignment of rents is for security, the lender has a mere lien and must "perfect" its right to the rents by acquiring possession of the property or by obtaining the appointment of a receiver. The creditor with an assignment as additional security has no immediate right to the rents, just as a mortgagee has no immediate right to the real property.[8] On the other hand, under the title theory, an absolute assignment of rents is an absolute transfer of title to the rents to the creditor. No further "perfection" is necessary because title to the rents has already vested in the creditor.

It was one of the unfortunate developments in the terminology of the jurisprudence of assignments of rents that the *Kinnison* court, as have courts before and after it, referred to the acts that a creditor had to take to obtain a right to specific rents as "perfection." The *Kinnison* court's analysis regarding the assignment as additional security resonates with old real property law doctrines, such as the requirement that an assignment of rents for security be "perfected" by obtaining possession of the property or appointment of a receiver. Clearly, the court in *Kinnison* was not using the term "perfection" in its modern sense as defined under the Uniform Commercial Code.[9] By contrast, the *Kinnison* court was referring to an older real property concept of "perfection" as the step necessary for the creditor to enforce the lien against the debtor. Until such "perfection" is achieved by the creditor, the debtor is entitled to keep any rents it is able to collect. The more accurate term for what *Kinnison* described as perfection in fact is "enforcement."

The *Kinnison* court spoke of the appointment of a receiver or obtaining possession of the property as "perfection." Earlier cases had also addressed these issues.

a. Receivership Appointment

The California courts were first confronted with an assignment of rents in *Mines v. Superior Court*,[10] in which the court had to address whether the enforcement of an assignment of rents was a violation of the lien theory of mortgages and prohibited in California by Code of Civil Procedure Section 744. In that case, the deed of trust gave the trustee (not the beneficiary) the power on default to "take possession, manage and care for the property and collect rents, issues and profits thereof." The trustee brought an action for specific performance of the rent assignment and to have a receiver appointed. The trustor argued that the trustee's action for specific performance was essentially "a legal action of ejectment to secure possession of the property" and that the trial court had no jurisdiction to appoint a receiver in a legal action. The California Supreme Court responded that the action was in fact an equitable action for specific performance of covenants in the deed of trust and not an action at law in ejectment and that a court of equity did have the power to appoint a receiver in an action for specific performance.[11]

b. Possession Versus the Right to Possession

The appointment of a receiver is a method for the creditor to obtain possession. Obtaining possession this way can be time-consuming and expensive; however, debtors seldom voluntarily give the creditor the right to possession. An early case which addressed the issue of the creditor's right to rents even though it had not obtained possession was *Title Guarantee and Trust Co. v. Monson*,[12] a case that pre-dated *Kinnison*. In *Monson*, the California Supreme Court held that a creditor's demand for possession of the property, even if unsuccessful, would be sufficient to "perfect" an assignment of rents for security. *Monson* was followed by *Mortgage Guarantee Co. v. Sampsell*,[13] which effectively held that demand on the borrower was the event that would give rise to a creditor's right to specific rents. The creditor had a right to the rents even if the borrower did not comply with the demand.

3. Entitlement

The entitlement issue has two components. First, as of what date does the lender have a right to rents and second, is the lender entitled to net rents or gross rents?

a. Date of Entitlement

The *Sampsell* case referred to above held that a trust deed beneficiary was entitled to rents accruing after the date of its demand.[14]

In *Childs v. Shelburne Realty Co.*,[15] the court shifted the date upon which the lender becomes entitled to rents to the date the lender obtains actual possession. However, the court did not consider or specifically overrule *Monson*'s holding that the date of demand establishes the date of the lender's entitlement to rents. In *Childs*, the court was faced with a dispute between a ground lessor who was the senior creditor under the ground lease, and Bank of America NT&SA which was the junior creditor under a trust agreement. Each creditor had a lien on the subrents payable to the ground tenant. After the ground tenant had defaulted on its trust agreement with the bank, the bank appointed the ground tenant as the bank's agent to collect the subrents and manage the property. Subsequently, the ground tenant defaulted under the ground lease, and the ground lessor took possession of the property after having served notice of termination of the ground lease on the ground tenant and the bank.

In connection with its quiet title action, the ground lessor, who was the senior lienor, requested recovery of the subrents that had been collected by the bank. The court in *Childs* rejected the ground lessor's argument that it had an absolute assignment of rents, finding there to be no indication in the record that anything more than an ordinary security interest had been contemplated. The court then held that the bank had been the first to "perfect" its lien by taking possession of the property through the appointment of the ground tenant as the agent of the bank to collect the subrents and manage the property. Therefore, the bank, even though it was the junior creditor, was nevertheless entitled to keep the subrents collected by the ground tenant while acting as the bank's agent.

Kinnison, *Childs*, and more recent cases have neither followed, distinguished, nor disapproved the rule set forth in *Monson* that a demand for possession as opposed to actual possession was effective "perfection" and that the lender's entitlement commenced as of that date. The validity of the *Monson* rule, therefore, remains untested.

b. Amount of Rents

(i) Net Rents: The *Monson* Case and Assignments for Additional Security

In the opinion of the *Monson* court, the creditor had a right to possession from the date of demand and should have been given possession on that date. If, however, the creditor had obtained possession of the property on the date of demand, the creditor would have collected the rents, but the creditor would also have been obligated to maintain the mortgaged property as a mortgagee in possession. This latter fact was not lost on the *Monson* court. In determining the amount of damages to be awarded to the creditor, the *Monson* court upheld the trial court's admission of evidence concerning the expenses incurred and paid by the debtor during the period prior to the creditor's taking possession. The creditor may have been entitled to rents from the date of its demand, but the rents to which the creditor was entitled were net of expenses of the property. In *Monson*, as in *Mines* and all other cases on the rent pledge, the creditor's right to rents is inextricably linked to the right of possession and, arguably, to the obligations that accompany possession. Those obligations may be discharged by a receiver or by the creditor as mortgagee in possession, but they must be discharged.

(ii) Gross Rents: The Absolute Assignment

The court in *Kinnison* does not expressly address the issue of net rents versus gross rents. However, the case holds open the possibility that the creditor with an absolute assignment is entitled to all rents from the property but would not have to assume the responsibilities of a mortgagee in possession in order to obtain the right to rents. The court makes several references to the assignment of the totality of the debtor's interest.[16]

4. The Move to Absolute Assignments

After *Kinnison*, creditors tried to convince courts that their

loan documents contained absolute assignments of rents. The creditor then would not need to prove that it had complied with *Kinnison's* requirement that an assignment of rents for security must be "perfected" by obtaining possession of the property or the appointment of a receiver. Moreover, the creditor would not need to argue whether *Monson* in fact was good law, because, with an absolute assignment, a creditor could establish entitlement as of the date of execution or the date of default rather than the date of demand. Cases have nevertheless rejected the creditor's attempts to find an absolute assignment.[17]

Finally in 1974, the Ninth Circuit Court of Appeals made new law in the area of assignments of rents. In the case of *In re Ventura-Louise Properties*,[18] the Ninth Circuit, applying California law, found that the creditor's original loan documents contained an absolute assignment of rents. The facts in *Ventura-Louise* contrast with those in *Kinnison*, whose holding depended upon the interpretation of a loan workout agreement signed following the borrower's default. Citing *Kinnison*, the court in *Ventura-Louise* stated that the parties' intent governs in determining whether an assignment of rents is to be construed as an absolute assignment or an assignment for security only.

Ironically, the Ninth Circuit made "new law" in *Ventura-Louise* based on old law kept alive by *Kinnison*—the title theory of assignments of rents. In applying this old theory, the court held that the borrower had intended to transfer actual title to the rents to the lender at the time of loan origination. No "perfection" was necessary because legal title to the rents had been vested in the lender since loan inception. The Ninth Circuit thus avoided the "perfection" question and all of its accompanying old doctrine regarding possession and receivership.

The lender in *Ventura-Louise* could have lost the right to a considerable sum of rents collected by the trustee in bankruptcy if the court had found the loan documents contained an assignment for security only. Such an assignment would have had to have been "perfected" by the lender's demand for possession of the property. Footnote 1 of the *Ventura-Louise* opinion states, in pertinent part, "Although we need not meet the perfection issue we do note that a demand for possession would have been sufficient for the Lender to perfect its security interest."[19] However, the lender had only made demand on the tenants for the rents and had merely begun a non-judicial foreclosure which was automatically stayed by the debtor's bankruptcy filing. Accordingly, the lender had neither made explicit demand for possession of the property, nor obtained actual possession of the property or the appointment of a receiver prior to bankruptcy. Therefore, if the lien theory had applied, the lender's lien would have remained "unperfected."

The Ninth Circuit's decision in *Ventura-Louise* continues to influence lending practices throughout California. Twenty-three years after *Ventura-Louise*, real estate secured lenders still rely upon that case for drafting guidance. As a result, virtually every California lender's form loan documents contain both an assignment of rents for security and a present, absolute assignment of rents. The assignment for security appears in the granting clause of the deed of trust, making the rents part of the trust estate. The present, absolute assignment of rents can be a separate document or it can appear in a separate section of the deed of trust. In this form of documentation, the lender under the absolute assignment usually grants a license back to the borrower to collect the rents until a default under the loan.

Lenders have had only partial success in court using documents drafted according to the formula based upon *Ventura-Louise*. For example, in a bankruptcy case entitled *In re Oak Glen R-Vee*,[20] the bankruptcy court was required to interpret a deed of trust purportedly containing both an assignment of rents for security and an absolute assignment of rents. The alleged absolute assignment was mixed in with twenty-seven other covenants of the borrower under the heading, "To protect the security of this Deed of Trust, Trustor agrees...." The bankruptcy court acknowledged that the purported absolute assignment language, "if considered alone, might be construed as an absolute assignment." But, when considering the document as a whole, including the heading and the assignment for security contained in the granting clause, the bankruptcy court concluded that the parties intended to create an assignment of rents for security only.

Practitioners reacted to *Oak Glen R-Vee* as a drafting challenge and refined their form of absolute assignments of rent, isolating them either as separate documents or as separate sections in their form deeds of trust. Despite the holding in *Oak Glen R-Vee*, lenders were reluctant to omit the assignments for security in the granting clauses of their deeds of trust because they worried that their assignments of rents were actually liens, not absolute transfers of title to the rents. Consistent with the lenders' concerns, some attorneys queried whether an assignment of rents for security was really the same thing and served the same economic function as an absolute assignment of rents granting a license back to the borrower to collect the rents until a default. Based on these and other observations by courts, practitioners, and commentators, it had become clear by 1991 that California case law on assignments of rents was a "Dead Man Walking" that the California Legislature sought to inter by the enactment of Civil Code Section 2938.

5. *The Previous California Statutory Attempts to Deal with Creation, Perfection, and Enforcement—Civil Code Sections 2938 and 2938.1*

In 1991 and 1992, California enacted two statutes to address the absolute assignment and the assignment as additional security, respectively. While the goal of the enactments was to set forth clearly the lender's rights to rents, the motivation was not clarity for clarity's sake. Rather it was to set forth a California law of assignment of rents for bankruptcy courts who were called upon to interpret that law.[21] These statutes expressly addressed the issues of creation and perfection. The characterization issue was implicitly addressed based on the very existence of the two different statutes, dealing with the two types of assignments. However, the statutes were ambiguous on the issue of enforcement and did not address the issue of entitlement.[22]

a. Prior Civil Code Section 2938

Prior Civil Code Section 2938 codified the use of absolute assignments, including absolute assignments conditional upon default. An absolute assignment was deemed to constitute a present transfer of existing and future rents and was deemed "perfected" upon and as of the date of recordation of the assignment, even if enforcement of the assignment had been precluded until the occurrence of a subsequent event, including, but not limited to, a default.

Because prior Section 2938 was stated to be "declaratory of existing law," the statute was apparently intended to apply retroactively. The existing law apparently referred to *Kinnison* and *In re Ventura-Louise*.

b. Prior Civil Code Section 2938.1

Prior Civil Code Section 2938.1 applied to assignments that state that they are given as additional security. Security assignments were deemed "perfected" by recordation. Thus, the statute did for the assignment as additional security what prior Section 2938 had done for the absolute assignment: it established that recordation is perfection. The statute specifically eliminated the need to obtain possession of the real property by appointment of a receiver or otherwise in order to perfect the assignment. Prior Section 2938.1 prohibited the collection of rents until the debtor was in default. The section applied only to assignments made on or after January 1, 1993.

The former statutes make it clear that recordation of the assignment is sufficient for perfection under Civil Code Section 2938 for any existing or future absolute or absolute conditional assignment, and under Section 2938.1 for assignments of rents for security purposes executed on or after January 1, 1993. The statutes do not address whether any enforcement action is necessary after the borrower's default in order for the lender to obtain a right to specific rents.

c. Case Law Interpretations

The only cases interpreting the pre-1997 California assignments of rents statutes in this area were *In re Goco*[23] and *MDFC v. Greenbrier Plaza Partners,*[24] both of which interpreted prior Section 2938. Both cases highlight the difficulties raised by the failure of that former statute to clearly address the issue of whether enforcement was required.

(i) *In re Goco*

In *Goco*, the creditor sought to recover retainers paid to the borrower's legal counsel *prior* to the bankruptcy filing from cash subject to the creditor's conditional absolute assignment of rents. The creditor had not made a demand on the debtor to turn over the rents and had only moved to sequester the rents when its foreclosure action was filed. The issue considered was whether the creditor's interest in the rents continued after the debtor transferred the proceeds from rents to third parties to pay legal retainers and if so, whether that interest prevailed over counsel's interest in the retainers.

The court held that the creditor was *not* entitled to the rents collected by the debtor until the creditor made demand for the rents or took other affirmative enforcement actions, even though the creditor had an absolute assignment and its interest in the rents was perfected under prior Civil Code Section 2938 upon recordation of the assignment. Enforcement was necessary, according to the court, to "bring an inchoate interest to fruition." The court stated that Civil Code Section 2938 may obviate the need for a further perfection step, but it does not obviate the need for a further enforcement step and that Section 2938 "on its face" clearly contemplates a separate enforcement action. Thus, the court held that the creditor acquired priority in rents arising only after enforcement actions were taken by the lender. Otherwise, the court felt that there would be confusion in the marketplace regarding entitlement to monies commingled or transferred to third parties.

The court was clearly critical of the *Ventura-Louise* decision and did not think *Ventura-Louise* should have been codified in former Civil Code Section 2938, but the court distinguished *Ventura-Louise,* in which the lender had initially made demand on the tenants for the rents and thus had taken steps to *enforce* its absolute assignment.

Goco suggests that perhaps mere demand on the debtor to turn over the rents would have been a sufficient enforcement step and that the creditor would be entitled to rents from the time of the demand on the debtor. If the debtor refuses to honor the creditor's request, however, it is unclear whether additional enforcement actions are necessary. *Goco* clearly held, however, that a creditor must take enforcement actions and cannot rest on its laurels merely because it has an absolute assignment that was deemed perfected by statute under California law upon recordation.

It is not clear whether the court in *Goco* would have reached a different result if the funds in question had not already been transferred to third parties. The court focused on the confusion that would have been created by trying to trace these funds and recover them from third parties.

(ii) *MDFC v. Greenbrier Plaza Partners*

The only California Court of Appeal case to date construing former Civil Code Section 2938 is *MDFC Loan Corporation v. Greenbrier Plaza Partners*. In *MDFC*, a bankruptcy filing occurred three days after the creditor obtained an order appointing a receiver. The receiver never went into possession. The bankruptcy was later dismissed at which time the receiver took possession of the property. While the bankruptcy was pending, however, the debtor collected over $320,000 in rents. These funds were eventually deposited with the receiver while the parties litigated who was entitled to them. A nonjudicial foreclosure sale was held, and the parties later filed conflicting requests for the funds held by the receiver. The trial judge ordered the funds to be disbursed to the debtor on the basis that (1) they were prior rents, and (2) the judge disagreed with the literal interpretation of former Civil Code Section 2938, which the judge apparently interpreted as allowing the lender the right to recover specific rents after default without the necessity of enforcement action. The appellate court reversed. The debtor argued that under *Goco*, an absolute assignment does not entitle the creditor to receive rents prior to the time the creditor or receiver takes possession of the property. The court rejected the debtor's reliance on *Goco* because, unlike the creditor in *Goco* who failed to take any steps to enforce its interest, the creditor in *MDFC* had done so by seeking appointment of a receiver. In addition, the debtor did not claim that the creditor failed to demand the rents on a timely basis.

Citing *Kinnison* and *Ventura-Louise*, the *MDFC* court stated that under the terms of the parties' agreement, the earliest date the creditor could demand to receive the property's income was the date the debtor was in default. Moreover, the creditor was only seeking funds received after the receiver's appointment (*i.e.*, after the creditor had sought to enforce its assignment). As a result, the issue in *Goco* was not presented.

For the court of appeal, the issue in *MDFC* was whether a lender had a right to rents before the lender took possession of the real property security, whether by appointment of a receiver or on its own. The *MDFC* court seized upon the absolute assignment to justify its decision that the lender was entitled to the rents from the date the receiver was appointed, even though the receiver had not taken possession.

In support of its decision that possession of the property was unnecessary to entitle a lender with an absolute assignment to

rents, the *MDFC* court cited former Civil Code Section 2938. That section stated that an absolute assignment of rents is "perfected" on recordation, even if by the terms of the assignment, the creditor has no right to the rents until after a default.

The *MDFC* court concluded that the term "perfection" as used in former Section 2938 meant that a creditor with an absolute assignment was entitled to rents without having to take possession of the property or any other action beyond recordation of the assignment in the recorder's office. Since the assignment was denominated as absolute conditioned upon default, the court found that the lender became entitled to rents upon default.

The court's holding appears to be in error because clause (b) of prior Section 2938 distinguishes between enforcement and perfection. Recordation gives the mortgagee a perfected interest, *i.e.*, an interest good against third party claimants, but the creditor's right to specific rents may still require another action beyond recordation, an action to enforce its rights. When the debtor in *MDFC* raised this argument, citing *Goco*, the court of appeal responded that, in this case, the creditor had taken its enforcement action by seeking the appointment of a receiver and demanding possession of the property. The *MDFC* court, therefore, did not have to address whether former Section 2938 would permit a creditor to obtain a right to rents immediately upon a default without having to take any action whatsoever if the assignment provided that the creditor had such a right.

For all its talk about absolute assignment, the true holding in *MDFC* is consistent with *Monson*: If the lender with an assignment for security has a contractual right to possession of the property following a default and, upon default, demands possession, the lender has a right to rents from the date the debtor refused to surrender possession. This is only fair. The *MDFC* court noted that it would be inequitable to allow a debtor to avoid its obligations under the deed of trust by merely filing a bankruptcy petition, that would have the effect of barring the receiver from assuming control of the property.[25] *Monson* made clear that equity would not tolerate a debtor refusing a creditor possession if the creditor had the right to possession and made a demand for it. *Monson* also made clear that the creditor is only entitled to recover from the debtor an amount equal to what the creditor would have received had the creditor taken possession: an amount net of reasonable property expenses.[26] If the court had relied on *Monson*, the outcome would have been the same, although the decision would not have been based on the interpretation of a purported absolute assignment.

B. The Rents Statute

1. Subdivision (a): Creation of an Assignment of Rents; Abolition of the Absolute Assignment Characterization

Subdivision (a) of the Rents Statute addresses two issues: (1) the required elements in order to create a binding assignment of rents and (2) the characterization of all assignments as assignments for additional security. Subdivision (a) also contains a definition of "leases, rents, issues, and profits" which includes the cash proceeds of such items. This definition is discussed in Section II. B. 4 (d) of this article.

a. Necessary Elements of an Assignment

Under subdivision 2938(a), a "present security interest in existing and future leases, rents, issues, or profits of real property" is created upon the assignor's execution and delivery of a written assignment. This follows the prescription contained in the version of Civil Code Section 2938 in effect prior to January 1, 1997.

The provisions of subdivision 2938(a) apply only to assignments of rents given in connection with *obligations* secured by real property. Thus, the law does not apply in the somewhat rare transaction where rents only are the collateral for a loan and not the underlying real property. The new law, in its reference to "obligations secured by real property" is broader than the prior Section 2938, which applied to assignments given in connection with "loans secured by real property."

b. All Assignments Create Security Interests

Subdivision 2938(a) provides that when an assignment of rents is "made in connection with an obligation secured by real property," it is deemed to create a security interest, "irrespective of whether the assignment is denoted as absolute, absolute conditioned upon default, additional security for an obligation, or otherwise." Thus, all assignments of rents created after January 1, 1997 constitute security interests in rents (that is, the rents are additional security for the loan), and any contrary designation by the parties will not be honored.

In this respect, the new law represents a departure from prior case and statutory law. However, as discussed above, the prior law was schizophrenic on this issue. The characterization made by the Rents Statute is that which most accurately reflects the intent of a lender and borrower at loan origination because, in the words of *Kinnison*, it is intended at that time the debtor would be able to have continued enjoyment of the rents as long as no default exists and the debtor would regain its right to receive the rents by paying the obligations due.

The Rents Committee decided to reiterate a fundamental principle in Anglo-American jurisprudence: If the parties intend an assignment of rents to be security for a mortgage debt, whether they denominate the assignment as absolute or for security, the assignment will be conclusively deemed to be for security and governed by the rules set forth in the Rents Statute on perfection and enforcement.[27]

2. Subdivision (b): Perfection

Subdivision 2938(b) provides for perfection of an assignment of rents by recordation in the office of the county recorder in the county in which the underlying real property is located. The text of this subsection mirrors the text of Section 2938 as it existed prior to January 1, 1997, with changes that do not affect its substance with regard to the effect of recording.[28]

New subdivision 2938(b) further notes that perfection is not altered by any provision of law or of the assignment that would preclude or defer enforcement until the occurrence of a subsequent event, including a default of the assignor, the assignee's obtaining possession of the property, or the appointment of a receiver. This provision of new subdivision 2938(b) consolidates the provisions of former Sections 2938 and 2938.1 regarding events that do not affect perfection.[29]

The intent of subdivision (b) is to establish that recordation is perfection for purposes of (1) establishing priority between lien claimants, and (2) any bankruptcy law requirement, which grants a lender a right in rents upon "perfection" for purposes of Sections 552(b)(2) and 363 of the Bankruptcy Code.[30] However, perfection is not an event which gives a lender a right to

specific rents in the non-bankruptcy (state law) context. In order to obtain a right to specific rents, the lender would need to enforce under the Rents Statute.

3. Subdivision (c): Enforcement

a. Methods of Enforcement

The Rents Statute, consistent with the characterization of all assignments as being for additional security, requires enforcement after the default of the debtor in order for the lender to obtain a right to specific rents.[31] The Rents Statute clarifies the acts that the creditor must take in order to activate its right to collect rents, the rents to which the lender is entitled and the time at which the creditor becomes entitled to the rents, from the real property security.

Under subdivision 2938(c), a creditor has four means of enforcing its right to rents, issues and profits from the real property security following a default by the debtor under the secured obligation. The creditor can use any one or more of the following enforcement tools:

(i) The appointment of a receiver.

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

(iii) Delivery to any one or more of the tenants of a written demand for turnover of rents, issues and profits in the form specified in subdivision 2938(k).[32] The creditor must also deliver a copy to the debtor and mail a copy to all those having recorded junior interests in the rents.

(iv) Delivery to the debtor of a written demand for the rents, issues and profits. The creditor must also mail a copy of the demand to all those having recorded junior interests in the rents.

b. Historical Background: Are the Methods of Enforcement New?

(i) Receivership Appointment.
As set forth in Section II. A. 2a above, in the past, the courts have recognized appointment of a receiver as a permissible method of enforcing an assignment of rents.

(ii) Obtaining Possession of the Rents

Obtaining possession of the rents, issues, and profits has also always been a recognized method of enforcement[33] although it has been disfavored because of the exposure to the mortgagee in possession status which such action creates. Such status would obligate the lender to act in a businesslike way with respect to the property and to account for its management of the property.[34] While the case law has held that mere collection of rents does not make the lender a mortgagee in possession but that greater acts of possession are necessary to impose such status,[35] lenders have nevertheless been concerned such that it is uncommon for lenders with an interest in rents to take such action upon the default of the tenant.

(iii) Demand for Payment of Rents

Under prior law, whether or not demand on the borrower or on tenants was effective enforcement depended in large part upon the consent of the borrower or the cooperation of the tenants. In *Johns v. Moore*,[36] it was held that the beneficiary could perfect the lien by making a demand on the tenants to pay future rents to the beneficiary. However, in that case, the borrower agreed that the beneficiary was entitled to receive the rents from the tenants. Effective enforcement may also occur if the defaulting trustor is appointed as agent to collect the rents for the beneficiary's account.[37] However, under California case law, a demand on the borrower or on the tenants does not constitute adequate enforcement if the borrower or the tenants fail to cooperate.[38] As set forth above in the discussion of the *Monson* case, for many practitioners and commentators, it was decidedly unclear whether a demand made upon the debtor was sufficient to entitle the creditor to the rents under an assignment for security.

Under the Rents Statute, demand alone is sufficient enforcement. Such demand may be on either the tenant or the borrower and, in order to be effective, it is not required that there be compliance with the demand.

(iv) A Compromise

The subdivision 2938(c) enforcement mechanisms represent a compromise. On the one hand, the new law gives the creditor certain and easy-to-follow procedures for activating its right to rents. But, the creditor loses two things. First, the creditor can no longer argue that it has an absolute assignment when the only function of its rent assignment is as additional security for the debtor's obligation to the creditor. Second, as the creditor has lost the ability to argue that its rent assignment is absolute, the creditor can no longer lay claim to rents collected by the debtor following a default (or some other event specified in the loan documents) and before the creditor takes some action to collect the rents.

4. Entitlement

a. As Against the Debtor—Subdivision (c)

The Rents Statute demarcates the dollars belonging to the debtor and the dollars belonging to the creditor after the creditor takes one or more of the enforcement actions mentioned in subdivision 2938(c). The creditor is "entitled to collect and receive all rents, issues, and profits that have accrued but remain unpaid and uncollected by the assignor [debtor] or its agent or for the assignor's [debtor's] benefit" on the date that any one of the actions is taken, as well as "all rents, issues, and profits that accrue on or after" that date. This provision reflects the intent of the parties in lender-borrower transactions but has a moderate amount of uncertainty with respect to exactly when certain events referred to in subdivision (c) occur.

Subdivision 2938(c)(1) clearly provides that the creditor is entitled to rents that have accrued and remain unpaid on the date of the "appointment of a receiver" and those accruing thereafter. However, under the Rents Statute, it is doubtful that a creditor's first act of enforcement would be to seek the appointment of a receiver; the creditor will most likely send a notice under subdivision 2938(c)(3) to the debtor or under subdivision 2938(c)(4) to the tenants, or both.

Subdivisions 2938(c)(2), (3), and (4) of the Rents Statute may be somewhat unclear with respect to the scope of the necessary enforcement in multi-tenant situations. Subdivision 2938(c)(2), for example, says that the creditor has enforced its right to rents upon "obtaining possession of the rents, issues, or profits." This paragraph would normally apply to rents obtained directly from the debtor. It may, however, also apply if the funds are received from the tenants directly and, in that sense, may be ambiguous. The paragraph could mean that the creditor is entitled to all rents when the creditor induces some but not all the tenants to pay the creditor. On the other hand, it could mean that the creditor is entitled to only those rents actually collected by the creditor. The linguistic dilemma posed by paragraph 2938(c)(2) is probably moot because the creditor will doubtless have made demand for the rents under paragraph 2938(c)(3) before the creditor will induce any tenants to pay rents to it, and only a very foolish creditor will make demand on some, but not all, of the tenants.

Under subdivision 2938(c)(3), the creditor is entitled to rents after delivery of a written demand to "any one or more tenants" to pay the rents to the creditor. Subdivision 2938(c)(3) embodies an ambiguity similar to that found in subdivision 2938(c)(2). For example, is the creditor entitled to all rents even though the creditor made demand on less than all? Or is the creditor entitled only to the rents from the tenants on whom demand was made? The former reading is closer to the grammatical structure of the Section and was the intent of the Rents Committee. The operative act is the demand itself, and the lender's right is not dependent on whether or not there is compliance by the tenants.

Subdivision 2938(c)(3) and (4) both provide that the creditor's right to rents begins on the date on which the following two events occur: (1) "delivery" of the demand to certain persons and (2) the "mailing" of a copy of the demand to certain other persons.

Delivery in subparagraphs 3 and 4 means delivery and not some other method of communication. If the intent had been that all communications were to be mailed, the verb "mail" would have been used throughout. A prudent lender may mail the written demands but the statute requires courier or hand-delivery for effective enforcement to have occurred.

Since these paragraphs tie enforcement to the delivery and mailing of a demand, they raise the question of what the effective date of the delivery and mailing would be. Both "delivery" and "mailing" generally connote the date as of which correspondence is placed into the post box or into the hands of a courier service, whether or not it is actually received, and this was the intent, with respect to rights as between the lender and the borrower. As to rights against the tenant, subdivision 2938(d) provides that the tenant's obligation to pay rent over to the creditor arises only after the tenant has actually "received" the written demand. Section 2938 clearly distinguishes between receipt and delivery. Paragraphs 2938(c)(3) and (4) require only delivery, not receipt.[39]

b. Entitlement as Against Tenants—Subdivisions (d) and (k)

One of the goals of a lender seeking to enforce its remedies following a default is to secure its entitlement to the actual payment of the rents. Under subdivisions (c)(3), (d) and (k), all of which concern the ability of the lender to notify tenants to send the rents to the lender, a lender is no longer required to be concerned about the potential adverse consequences of interfacing directly with tenants after a default. Upon default, the lender may immediately demand that the tenant deliver the rents to it. Under the law applicable to pre-1997 assignments, there was little guidance to the lender regarding its ability to demand payment of the rents from the tenants, even though most assignments granted such a right to the lender.

The procedure for the lender to effect its rights and obligations under subparagraph (c)(3) is relatively straightforward. The lender simply delivers a written demand to the tenants in the form specified by subdivision (k).

The demand must be in connection with the enforcement of the assignment, and the lender must state under penalty of perjury that it is the holder of a recorded assignment.[40] The notice must be sent to the address specified in the lease or other occupancy agreement. If no address is specified, it must be delivered to the property address. This can create considerable problems for the lender who may not have copies of the leases or subsequent amendments or assignments which may have changed the notice address. However, due to the dual liability placed on the tenant who receives a conforming notice and continues to pay the borrower, the Rents Committee decided to place the onus on the lender to monitor the leasing activity at the secured property to assure itself that it possesses current information on the tenants and their notice addresses.[41]

In addition, subdivisions (d) and (k) of the Rents Statute give rights and impose obligations on the tenant. These subdivisions set forth what a tenant must do in response to receipt of a demand notice and subsequent notices, and they describe the liability incurred by a tenant that fails to comply with such a notice.

A tenant that receives a valid and conforming subdivision (k) notice will generally be obligated to pay "past due and unpaid" rents, issues and profits, (and all rents, issues and profits which accrue thereafter,) to the lender who delivered the demand notice.[42] The form of the notice and the responsibilities of the tenant upon receipt of the notice may not be modified by a contract between the tenant and the lender. The tenant must continue to pay the rents to the lender until it receives a court order directing that the rents be paid in some other manner, or until the lender delivers a notice to the tenant canceling the original demand.[43]

There are two exceptions to the tenant's statutory obligation. If a tenant has previously received a notice that is valid on its face from a lender with a recorded assignment, regardless of the priority of that assignment, the tenant is not obligated to pay the rents to the lender who sent the subsequent notice.[44] Therefore, as between the tenant and the various lenders with recorded assignments, the "first to deliver" will always be the lender to whom the tenant is obligated to pay the rents.[45]

The second exception was designed to protect a tenant in light of operational realities inherent in the receipt and handling of notices.[46] The tenant has a ten-day grace period following receipt of the demand notice to redirect the rents to the lender before the tenant will suffer any adverse consequences. Any payment made to the borrower during this grace period must, however, be in "good faith" for the tenant to be protected.[47] This exception also protects the lender from any collusion between the borrower and its tenants during the grace period, since not only must the tenant meet the good faith requirement, the payment must also not be "inconsistent with the lease."[48]

If neither exception is applicable, and a tenant pays the rents to the borrower and not the lender, the tenant remains liable to the lender for the amount of the rents paid to the borrower.[49] If

the lender ultimately secures the appointment of a receiver, the receiver may recover these amounts and the tenant is subject to an unlawful detainer and other lease remedies for its failure to pay the receiver.

An important consumer-oriented exception was included in the statute. If a tenant occupies its leased premises for "residential purposes," the tenant will not be liable to the lender for subsequent payments made to the borrower after the lender's demand, and the lender's only recourse will be against the borrower under subparagraph (f)(1). The Rents Committee believed that for the most part, residential tenants would not be sophisticated enough to comprehend the obligations required by the statute, and they should not be obligated to incur the expense required in consulting with an attorney and possible double exposure for rent.

c. Entitlement as Against Other Lienors—Subdivision (h)

Subdivision 2938(h) of the Rents Statute continues the general rule borrowed from the receivership context that any lender, even one with a junior priority, may enforce its rights under an assignment of rents and be entitled to rents collected pursuant to that enforcement. However, a lender with a senior priority may "displace" that junior lender and thereafter have a prior right to the rents.[50] The senior perfected assignee, as against a junior assignee, is entitled only to rents collected after taking one of the prescribed enforcement actions, notwithstanding its senior priority, and cannot recover from the junior creditor, rents collected by the junior before the senior took its "pre-emptive" enforcement action.[51]

In order to further the pre-emptive aspect of the rule set forth above and to minimize the confusion that tenants may have when in receipt of conflicting demands, subdivision 2938(h) requires a junior assignee who receives notice of a senior assignee's enforcement action to notify tenants immediately that the junior's rent payment demand is canceled.

Finally, although implicitly required by the covenant of good faith and fair dealing in every assignment, subdivision 2938(h) should be read to require every assignee to send a notice of cancellation to all parties to whom a rent demand has been made (including junior assignors), immediately upon termination of the enforcement action (*e.g.*, due to cure, workout, or satisfaction of the secured obligation).

d. Entitlement as Against the Debtor and Competing Creditors When the Rents Have Gone Astray—Subdivision (f)

Subdivision (f) of the Rents Statute adds a proceeds doctrine to the law of real estate rents. This subdivision addresses the right of a lender to recover from the assignor, or other third parties, rent proceeds received by them despite the assignee's enforcement of its interest in the rents by notification to tenants or to the assignor. The subdivision also addresses the right of a senior lender to rent proceeds once it has taken its enforcement action after a junior lender has enforced.[52]

The necessity of including such a doctrine in the law was raised by cases such as *In re Goco,*[53] discussed in Section II. A. 5. c (i) above, in which the court held that a lender holding a conditional absolute assignment had to enforce such an assignment after default in order to collect specific rents. The court also stated in *dicta* that even if the lender had enforced its assignment, it might still be denied the right to the proceeds because of its inability to trace the proceeds.[54]

(i) What Are Rents Proceeds?

Some courts and commentators have made a distinction between the lender's interest in rents and in proceeds.[55] The term "rents" is used to describe the collateral before it is collected and "proceeds" is used to describe the actual amounts collected, whether in the form of cash, checks or deposit accounts into which those items are deposited. Establishing a right to proceeds may also require tracing the funds, since even if a right to proceeds is established, such right may be meaningless if the proceeds are commingled with other funds of the debtor.

(ii) Governing Law

A significant conceptual issue which arises in connection with the distinction between rents and the proceeds of rents is the characterization of each as real or as personal property. This characterization dictates the body of law which governs a lender's rights to such funds. Generally, the Uniform Commercial Code governs security interests in personal property.[56] The Uniform Commercial Code expressly excludes coverage for the creation or transfer of an interest in or lien on real estate, including a lease or rents thereunder and any interest of a lessor and lessee in any such lease or rents.[57] No significant issue is raised by the security interest in leases since that interest is recognized as an interest in real property.[58]

The issue with respect to rents is if rents (the original collateral) are real property excluded from the Commercial Code and proceeds are personal property covered by the Commercial Code, how does the creditor obtain an interest in the proceeds and what body of law governs the lender's rights?

Courts which have addressed this issue have reached different conclusions. The *Goco* court, in footnote 8, stated "(a)lthough an assignment of rents is outside the scope of the U.C.C., the proceeds of the rents are cash, which would be personal property governed by the U.C.C." *In re Scottsdale Medical Pavilion*[59] rejected such a distinction, holding that the finding of such a distinction would render all assignments of rents illusory since, upon payment, rents would always be converted to items which would be covered by the Commercial Code.[60] That Bankruptcy appellate panel opinion was affirmed by the Ninth Circuit.[61]

The Rents Committee ultimately took a position in accordance with the cases which define the interest in real property rents to include the cash proceeds thereof and codified this in the last two sentences of subdivision (a).[62] This characterization is supported conceptually by a number of the cases which have addressed this issue, including *Scottsdale Medical.*

Having established the characterization of rents and proceeds of rents, subdivision (f) of the Rents Statute then addresses the entitlement of the assignee to proceed as against the debtor and as against third parties.

(iii) Paragraph (f)(1)

Paragraph (1) of subdivision (f) of the Rents Statute addresses rights in rents proceeds as between (1) the assignee lender and the assignor borrower, and (2) the assignee lender and any junior assignee who has first enforced its interest. Subparagraph (f)(1) provides for a right of immediate turnover of the proceeds to the assignee where the assignee has enforced by

demand on tenants or on the assignor, but when the rents are nevertheless received by the borrower/assignor or its agent for collection or any other person who has collected such rents for the assignor's benefit. The lender also has a right of immediate turnover where a junior lender has enforced and a senior lender subsequently enforces and sends a copy of such demand to the junior, but the junior nevertheless continues to receive rents, presumably, but not necessarily, because of the failure of the junior to deliver the notice required by subdivision (h) canceling its previous demand.

(iv) Paragraph (f)(2)

Subparagraph (2) of subdivision (f) addresses the rights to proceeds as between the assignee who has enforced by demand on tenants or on the assignor and any third party other than those covered in subparagraph (f)(1). As between the assignee and any such third party, the lender has priority to the extent that the proceeds are identifiable. Proceeds are identifiable either if they are segregated or, if commingled, they can be traced using the lowest intermediate balance principle, unless the assignor or other party claiming an interest in the proceeds shows that some other method of tracing would be more just. The paragraph therefore allows tracing to establish identifiability rather than always requiring true identifiability. However, as is suggested by *Scottsdale Medical* and a number of other cases which have found in favor of a real property characterization for rent proceeds,[63] identifiability is enhanced if the rents are deposited in a segregated account containing rents proceeds only pursuant to a blocked account and lockbox agreement and, if, in addition, a security interest is taken in the account.[64]

(a) Lowest Intermediate Balance Principle

If the issue of tracing is reached, subparagraph (f)(2) directs use of a tracing principle borrowed from the trust arena. The lowest intermediate balance principle in explained in *Universal C.I.T. Corporation v. Farmer's Bank*[65] and *Chrysler Credit Corp. v. Superior Court*[66] referred to and explained in Code of Civil Procedure Section 703.080, which describes the method of tracing exempt funds for judgment execution purposes.[67] The lowest intermediate balance principle is also presently included in the proposed Section 9306 of the Article 9 revisions of the Uniform Commercial Code. The lowest intermediate balance principle does not always result in the ability to recover the exact amount of funds deposited and does not assume that funds deposited by the assignor/borrower after withdrawing the funds in which the lender had an interest were deposited with an intent to replenish the withdrawn funds. The doctrine results in recovery of an amount equal to the lowest balance which existed between the date of deposit and the date the lender's interest in the account is established.

(b) Payments in Operation of Debtor's Business

The last sentence of subparagraph (f)(2) of the Rents Statute, stating that the provisions of that paragraph are subject to any generally applicable law with respect to payments made in the operation of the assignor's business, incorporates a concept that exists in comment 2(c) of the Uniform Commercial Code Comments to Section 9306. Comment 2(c) provides that the assignee has no rights to proceeds transferred in the operation of the assignor's business, subject to fraudulent conveyance law and other applicable law.[68]

5. Subdivision (g): Of Rents and Responsibilities: Possession and Rents Decoupled

Subparagraph 2938(g) provides that if the creditor enforces its rent assignment by any means other than the appointment of a receiver and collects rents pursuant to that enforcement, the debtor or any junior lienor on the real property security can make written demand on the creditor to use the rents for the reasonable cost of "protecting and preserving the property," which includes the "payment of taxes and insurance and compliance with building and housing codes."[69] If no demand is received, the creditor may apply the rents to amounts owed by the debtor under the loan documents or otherwise in accordance with the loan documents.[70] Upon receipt of such a demand, the creditor must comply with it "to the extent of any rents, issues, or profits actually received" by the creditor.[71] If the creditor wants to avoid the administrative burden of making such payments, the creditor can seek the appointment of a receiver.[72] Subparagraph 2938(g)(2), however, makes clear that even though the creditor is obligated to use rents to protect and preserve the property under subparagraph (g), the debtor remains responsible for the management of the property. Moreover, the mere act of paying the costs of protecting and preserving the property will not make the creditor a dreaded "mortgagee in possession."[73]

Subparagraph 2938(g) represents an acknowledgment that without rent money, the debtor is unlikely to be able to preserve and protect the real property security. If the creditor does not use at least some of the rents to maintain the real property, the real property could rapidly diminish in value.

Subparagraph 2938(g) is, however, a compromise. The creditor must pay costs and expenses of maintenance (if so directed), but the creditor need no longer worry that collection of rents and payment of expenses by the creditor without the intervention of a receiver will make the creditor a mortgagee in possession.[74]

6. Interaction with California's One Action, Antideficiency and Reinstatement Statutes

Subparagraph (e) of the Rents Statute addresses the effect of California's one action, antideficiency, and reinstatement statutes on the lender's interest in rents.

a. One-Action Rule

California's one-action rule, codified in Code of Civil Procedure Section 726 ("Section 726"), provides that there shall be but one action for the enforcement of a lien on real property, and that action is foreclosure. Section 726 has a sanction effect which prevents a creditor who has taken some other enforcement action from thereafter foreclosing.

There have been many cases over the years regarding what activity can be engaged in by a creditor with a lien on real property without its losing the right to foreclose on the real property. One case decided under Section 726 that caused lenders much anxiety was *Great American First Savings Bank v. Bayside Developers*, a depublished case holding that the application of rents to the debt before foreclosure on the real property was a violation of the one-action rule.[75]

Pursuant to the opinion of the district court interpreting California state law,[76] a receiver who turns over to the lender sales proceeds which were part of the security for the debt to the lender does not violate Section 726. On appeal, the Ninth Circuit affirmed this holding.[77] These federal court opinions overruled the California state court decision in *Great American First Savings Bank v. Bayside Developers*[78] and were greeted favorably by the lending community, but were not binding on California state courts.

The Rents Statute specifically abrogates the *Bayside* decision. Subdivision 2938(c) provides in the unnumbered paragraph at the end of that subdivision:

> [N]either the application nor the failure to so apply the rents, issues, or profits shall result in a loss of any lien or security interest which the assignee may have in the underlying real property or any other collateral, render the obligation unenforceable, constitute a violation of Section 726 of the Code of Civil Procedure, or otherwise limit any right available to the assignee with respect to its security.

With these words, the restless ghost of *Bayside* can finally expire for once and for all.

b. Reinstatement

Under California Civil Code Section 2924(c), a defaulting debtor as to whom a Notice of Default has been filed has until five business days before the foreclosure sale to reinstate the loan by paying the delinquent amount owing plus certain allowed fees and costs. The relationship between the reinstatement right and rents collected by a receiver generally focused on the fact that a receiver must retain possession of rents until it is ordered by the court to pay them out.[79]

Neither Civil Code Section 2924(c) nor prior case or statutory law specifically answered the question of whether rents collected by a receiver or by a lender had to be applied to amounts which would reinstate after recordation of a Notice of Default. In addition, because of issues specifically raised by the *Bayside* case and the general uneasiness of California lenders with the extensions of the one action rule, it became the general lending practice not to apply rent to debt but rather (1) to have amounts collected held by the receiver, (2) to conduct a foreclosure sale at which the lender's bid was reduced by the amount of rents collected, and then (3) to have the rent proceeds paid over to the lender after the foreclosure. While this practice allayed the lenders' concerns about violating the one-action rule, it was unfair to debtors who argued that the debtor should be able to use the rents as a "credit" to the amount needed to reinstate instead of having the lender hold them. The Rents Committee agreed with this position, and subdivision (e) of the Rents Statute specifically states that amounts collected by the lender or on its behalf will be credited to amounts necessary to reinstate under subdivision 2924(c).

c. Antideficiency Laws

As stated immediately above, it became the customary practice of conservative lenders to apply collected rents to debt after the nonjudicial foreclosure sale. Whether or not this practice violated California's antideficiency prohibition set forth in Code of Civil Procedure Section 580d was raised *In re 500 Ygnacio*.[80] In that case, the lender made a direct demand on tenants for rents, collected approximately $200,000, and apparently did not use the rents to pay operating expenses. The case is not clear as to whether the rents were applied to the debt.

The court, in *dicta*, suggested *sua sponte* that a 580(d) problem might have been raised if the assignment of rents created a chattel mortgage in the rents assigned and application of such rents to debt constituted a nonjudicial foreclosure and thus waived the creditor's right to a deficiency claim. This *dicta* of the courts was peculiar in view of the fact that rents are not chattel. Further, even if they were, there is no antideficiency prohibition in the law which would apply following a nonjudicial foreclosure of a chattel mortgage. Since the loan had been nonrecourse, this issue had not even been addressed by the parties. The *In re 500 Ygnacio* case is also troubling because of the characterization of real property rents as personal property and the resulting comparison of the application of rents to the debt to a nonjudicial foreclosure.

The Rents Statute specifically states that application of rents to debt does not result in a loss of a right to a deficiency judgment.[81]

Conclusion

The law of assignment of rents has been described by one author as a mystery wrapped in an enigma. The goal of the Rents Committee was to set forth a comprehensive treatment of this area of law which was consistent with the intent of the parties and appropriately protective of the interests of all of the parties affected by the transactions.

Endnotes

1. The members of the Committee were Norma J. Williams, Chair; Dennis Arnold, Advisor; Pat Frobes, Advisor; Roy Geiger, Advisor; E. Manuel (Manny) Fishman; Paul Meyer; Jack Hindmarsh; Sylvia O'Neill; Sara Reynolds; Glenn Snyder; and Ira Waldman.
2. 18 Cal. 2d 256 (1941) [herein *Kinnison*].
3. *Id.* at 263.
4. The "lien" theory of mortgages is adopted in California pursuant to Code of Civil Procedure Section 744 and Civil Code Section 2927, both of which were enacted in 1872. Code of Civil Procedure Section 744 provides: "A mortgage of real property shall not be deemed a conveyance, whatever its terms, so as to enable the owner of the mortgage to recover possession of the real property without a foreclosure and sale." Civil Code Section 2927 provides: "A mortgage does not entitle the mortgagee to the possession of the property, unless authorized by the express terms of the mortgage; but after the execution of the mortgage the mortgagor may agree to such change of possession without a new consideration."

   As stated in the text, the lien theory of mortgages is a rejection of the older "title" theory of mortgages which had originated in medieval England. Under the title theory, fee simple title to the property was vested in the creditor, subject to a condition subsequent that if the borrower repaid, the condition would be satisfied and the land would re-vest in the mortgagor. If the lender permitted the borrower to stay in possession after the execution of the mortgage, the creditor could dispossess the debtor if it failed to pay by an action in ejectment in one of the common law courts. By the eighteenth century, the courts realized that a mortgage is actually a security agreement, notwithstanding the fact that legal title is vested in the lender. In the United States, a plurality of states, including California, have adopted the lien theory.

   Under the two theories of mortgages, whoever has title to the property has the right to possession. Thus, in jurisdictions that adhere to the title theory of mortgages, the mortgagee has the right to possession and in lien theory states, the mortgagor has the right to possession. It has been further held that whoever has the right to possession has the right to collect rents. *Gilman v. Telegraph Co.*, 91 U.S. 603, 616 (1876).

As a corollary, in order to obtain rents, the creditor must obtain possession. Normally, this is done by foreclosure and sale. As recognized by the court in *Kinnison*, however, the possessory rights of the mortgagor and the mortgagor's right to collect rents can be the subject of a special agreement between the mortgagor and the mortgagee.

5. *Kinnison*, 18 Cal. 2d at 262.
6. *Id.* at 263.
7. *Id.*
8. *Id.* at 261.
9. Under Article 9, a security interest is enforceable between the secured party and the debtor without the necessity of perfection. Cal.Com. Code § 9201. The effect of perfection under Article 9 is to put third parties on notice of the secured party's lien and to enable the secured party to gain priority over certain third parties, including junior secured parties. *Id.* 9301.
10. 216 Cal. 776 (1932).
11. The *Mines* case remains authority for creditors seeking receivership appointment under Code of Civil Procedure Section 564(b)(8), which authorizes appointment of a receiver as specific performance of a rents and profits clause, thus allowing creditors to avoid the burden of proving that the property is insufficient to discharge the debt, the showing required under Code of Civil Procedure Section 564(b)(2). As in other cases where the courts exercise their equitable powers, a California court can exercise its discretion whether to appoint a receiver. *See Barclays Bank of California v. Superior Court*, 69 Cal. App. 3d 593, 137 Cal. Rptr. 743 (1977).

    An amendment to Code of Civil Procedure Section 564 became effective on January 1, 1996 and was re-enacted as a part of the Rents Statute. That section expressly provides the courts with the equitable power to appoint a receiver to specifically enforce an assignment of rents. Section 564(b)(10) provides as follows:

    > (10) In an action by a secured lender for specified [sic] performance of an assignment of rents provision in a deed of trust, mortgage, or separate assignment document. In addition, that appointment may be continued after entry of a judgment for specific performance in that action, if appropriate to protect, operate, or maintain real property encumbered by the deed of trust or mortgage or to collect the rents therefrom while a pending nonjudicial foreclosure under power of sale in the deed of trust or mortgage is being completed.

    Before the addition of Section 564(b)(10), the custom and practice of most lenders was to commence a judicial foreclosure action and join a cause of action for specific performance of the rents clause.

    Section 564(b)(10) contemplates both a final judgment in the action for specific performance and the continuing jurisdiction of the court over the receivership until the nonjudicial foreclosure is consummated. The purpose of the statute was to address a problem often confronted by practitioners in the field. Overburdened judges, anxious to move along a judicial foreclosure case or an action for specific performance of an assignment of rents, often would compel the parties to choose between preparing for trial before the nonjudicial foreclosure was final or dismissing the case. Section 564(b)(10) permits the filing of an action for specific performance of an assignment of rents without joining it to a judicial foreclosure action, and it allows the court to enter a judgment on the specific performance action without compelling an immediate accounting of the rents by the receiver. The court, therefore, does not enter a judgment disposing of money or property in which the debtor has an interest until after the nonjudicial foreclosure sale takes place and the receivership is wound up.

    The addition of Code of Civil Procedure Section 564(b)(10) also appears to have resolved the issue of whether an action to appoint a receiver was an "action" under Code of Civil Procedure Section 726 inasmuch as Code of Civil Procedure Section 564(b)(10) contemplates the entry of a judgment in a specific performance action before the consummation of a nonjudicial foreclosure sale. If the appointment of a receiver and the rendering of a final judgment in the specific performance action were to be a violation of the one action rule, Section 564(b)(10) would make no sense. This conclusion is also consistent with 1991 legislative amendments adding Code of Civil Procedure Section 564(d) that stated, in addressing the issue of environmentally impaired properties, any action by a secured lender to appoint a receiver pursuant to that section would not constitute an action within the meaning of subdivision (a) of Section 726.

    Further, nothing in Section 564(b)(10) violates the twin goals of the one-action rule: to compel the creditor to realize on its collateral, both real and personal, before obtaining a judgment lien against the property of the debtor over which the creditor has no security interest and to compel the creditor in a single action to test the value of all its security before the creditor obtains a personal deficiency judgment against the debtor.
12. 11 Cal. 2d 621 (1938).
13. 51 Cal. App. 2d 180 (1942).
14. *Id.* at 189.
15. 23 Cal.2d 263 (1943).
16. The court stated, "It follows that the cases relied upon by defendant in seeking a reversal are not controlling. They deal with the requirements of possession necessary to constitute the mortgagee a "mortgagee in possession" where he holds only a security interest in the rentals. In the present case, on the other hand, the plaintiff's assignor, Pacific Mutual, held not merely a security interest in the rentals but an absolute assignment of Bartlett Corporation's interest therein." *Kinnison*, 18 Cal. 2d. at 263. The court also states that "[t]he instrument is phrased as a complete transfer of Bartlett Corporation's interest in the rentals." *Id.*
17. *See, e.g., Malsman v. Brandler*, 230 Cal.App.2d 922 (1964), (California appellate court rejected the lender's argument that the loan documents contained an absolute assignment of rents). *In re 500 Ygnacio Associates, Ltd.*, the court stated that: "The Court must conclude that, whether or not the assignment of rents is absolute, the creditor has nothing more than a security interest in the rents".
18. 490 F.2d 1141 (1974).
19. It is odd that the court in *Ventura-Louise* cited to *Sampsell* and other cases, but did not cite to *Monson*, the leading California Supreme Court case holding that demand on tenants constituted perfection.
20. 8 B.R. 213 (Bankr. C.D.Cal. 1981).
21. The U.S. Supreme Court case of *Butner v. United States*, 440 U.S. 48 (1979), dictated that state law be looked to in order to determine a lender's interest in rents. The basis of the Supreme Court decision was that, because Congress had chosen not to exercise its constitutional authority to enact federal bankruptcy statutes that would define a mortgagee's interest in rents and profits, state law would govern. The court did, however, caution that bankruptcy courts should take whatever steps are necessary to ensure that a mortgagee is afforded the same protection in bankruptcy court as it would have had under state law.

    The analysis of a lender's rights in rents in bankruptcy, before reaching the issue of the applicable state law, requires a review of several sections of the Bankruptcy Code. Under 11 U.S.C. Section 541(a)(6), a borrower's interest in rents from its real property is property of the estate. As to rents acquired after the bankruptcy case is filed, Section 552(a) provides that a security interest is eliminated in such after-acquired property as of the date of filing of the petition. Under Section 552(b), as it existed prior to the Bankruptcy Reform Act of 1994, a security interest created pre-bankruptcy in proceeds, products, rents, or profits of secured property continued to be valid to the extent enforcement of such security interest was permitted by state law. After the Bankruptcy Reform Act, however, state law is no longer defined as governing the creditor's rights. Under *Butner*, decided under the bankruptcy law prior to the Reform Act, it was necessary to look to the laws of the various states. If a lender was deemed to have an interest in the post-petition rents, then such rents would be treated as "cash collateral" under 11 U.S.C. Section 363, prohibiting the debtor from using such rents without providing "adequate protection" to the creditor.

    Because of the differences in the laws of the various states, the lower federal courts adopted conflicting positions on both the necessity and effect of pre-petition enforcement action by a secured creditor and the availability of post-petition relief.
22. Prior Civil Code Section 2938(a)(2) governing assignments that are expressly stated to be "absolute," provided in part:

    > "(2) the interest granted by the assignment shall be deemed perfected as of the date of recordation, notwithstanding any provision of the assignment or of any other provision of law that would otherwise preclude or defer enforcement of the rights granted the assignee under the assignment until the occurrence of a subsequent event, including, but not limited to, a subsequent default of the assignor."

    It is noted that this statute, in accordance with the more modern law on assignment of rents, moves toward the U.C.C. definition of perfection as recordation. The statute is ambiguous, however, as to whether enforcement is required to accomplish perfection.

The last sentence of prior Civil Code Section 2938.1(a) governing assignments that are expressly stated to be as "additional security," provided in part:

> "Recordation shall perfect that assignment without the necessity of the beneficiary or mortgagee obtaining possession of the real property, appointing a receiver, or taking any other action."

The same defect exists here as with prior Section 2938. It is even more curious when it is considered that Section 2938.1 dealt with assignments as additional security. Any rule that enforcement was not required for such assignments would be contrary to the entire jurisprudence of assignments as additional security as described in this article.

23. 151 B.R. 241 (Bankr. N.D. Cal. 1993).
24. 21 Cal. App. 4th 1045 (1994).
25. *Id.* at 1054–55.
26. We do not know for certain, but it is probably safe to assume that the amounts recovered by the lender in *MDFC* were net of expenses paid by the debtor while the debtor was in possession of the property collecting rents.
27. The absolute assignment is not dead. It is merely put in the place where *Kinnison* says it belongs. It can be a means of satisfying the debt, but is not a means of securing it. If a creditor wants an absolute assignment conditioned on default, and the debtor is willing to give it to the creditor, the creditor should be aware that upon the occurrence of the condition, the absolute assignment will reduce the amount of the indebtedness secured by the deed of trust by an amount equal to the present value of the future income stream. A creditor with an absolute assignment, one that is truly intended to be an absolute assignment, faces a risk of not being able to foreclose on the real property for the amount which the creditor considers to be the delinquency based purely on the unpaid amount of the debt as reflected by payments until the date of default. For the debtor, the absolute assignment may mean the loss of the benefits of the mortgaged property, while retaining ownership and the obligation to maintain the property. For the courts, the absolute assignment will raise issues that have always been present but never addressed: Is the absolute assignment consistent with the prohibition in this state against strict foreclosure? Is it good public policy to permit a creditor to collect all the income from a property without any responsibility to maintain it? If a lender has a right to collect rents, but no right to possession of the property, who has the right to evict the tenants and the responsibility to lease up the property?
28. New subdivision (b) states that the interest granted by the assignment shall be deemed "fully" perfected as of the time of recordation or with "the same force and effect as any other duly recorded conveyance of an interest in real property." The previous section did not contain the word "fully" and did not contain the last quoted clause.
29. See *supra* Note 22.
30. See *supra* Note 21.
31. *See Lee v. Ski Run Apartments Assocs.*, 249 Cal. App. 2d 293 (1967) (referring to enforcement as "perfection").
32. The statute erroneously refers to a demand in the form specified in subdivision "(j)".
33. *Snyder v. Western Loan & Bldg. Co.*, 1 Cal. 2d 697 (1934); *Nelson v. Bowen*, 124 Cal. App. 662 (1932); *Johns v. Moore*, 168 Cal. App. 2d 709 (1959).
34. *Murdock v. Clarke*, 90 Cal. 427(1891); *Anglo-Californian Bank v. Field*, 154 Cal. 513 (1908); *Davis v. Stewart*, 67 Cal. App. 2d 415 (1944).

    There is a paucity of California cases on the doctrine of mortgagee in possession, in large part probably due to the fact that most modern lenders view the status as a fate worse than death and try in all cases to avoid it. A short history lesson is, therefore, necessary to obtain a solid understanding of the mortgagee in possession and the judicial learning that surrounds it.

    The doctrine arose in England amidst the struggle between the Chancellor and the common law courts over the nature of the mortgage, with the initial common law view characterizing it as a transfer of title, and equity, characterizing it as a hypothecation or security transaction. *See supra* Note 4. The Equity Chancellor, who viewed the mortgage as a hypothecation, which is a non-possessory security interest, developed the doctrine of mortgagee in possession to underscore the non-possessory nature of the mortgage. The mortgagee in possession was, in the Court of Equity, required to account to the debtor for the profits from the land during the time the mortgagee was in possession.

    The courts of equity in both the United States and England imposed a burden on the mortgagee in possession that doubtless is the source of the almost irrational fear of modern lenders. The mortgagee in possession must use reasonable diligence in collecting rents and profits and will be charged for all rents and profits it could have collected had reasonable diligence been used. The courts are, however, quick to point out that the mortgagee in possession is not answerable for the profitability of the mortgaged property. The mortgagee in possession is only "chargeable for rents and profits not actually received where, and only where, he has failed to use reasonable diligence, or where he is guilty of fraud, gross negligence or willful default." *Johns v. Moore*, 168 Cal. App. 2d 709, 713 (1959). Lenders go to great lengths to avoid this onerous responsibility, which is perhaps one of the reasons for the widespread use of a receiver.
35. *Bank of America Natl Trust & Savis. Ass'n v. Bank of Amador County*, 135 Cal. App. 714 (1933); *Strutt v. Ontario Savings & Loan Ass'n*, 28 Cal. App. 3d 866 (1972). [Hereinafter *Strutt*].

    The case most often quoted for the proposition in the text is *Strutt*, in which the court expressed its belief that if the mortgagee "does no more than collect rents by means of a letter request to the tenants and does not undertake management of the property," the mortgagee does not thereby become a mortgagee in possession. The court in *Strutt* had no authority for its pronouncement, which has been interpreted by at least one commentator to mean that "even if the beneficiary personally collects rents from the tenants under [a rent assignment], it does not thereby become a mortgagee in possession." Bernhardt, California Mortgage and Deed of Trust Practice, § 5.6, at 243 (CEB, 1990). Moreover, the *Strutt* holding is *dicta*. After making its sweeping generalization, the court in *Strutt* goes on to point out that the mortgagee who had collected the rents had fulfilled all the obligations of a mortgagee in possession. *Strutt* 28 Cal. App. 3d at 880-81.

    Strutt is the only case to hold that a mortgagee who "merely" collects rents is not a mortgagee in possession for purposes of holding the mortgagee liable for the care of the mortgaged property and the collection of rents. Possession may entitle a mortgagee to collect rents, but collection of rents, according to *Strutt*, does not mean that the mortgagee is in possession. On the other hand, the courts have never faced the issue whether a creditor who has managed to convince all tenants to pay rent to it can refuse to use any of the sums collected for the care and maintenance of the property or may be held accountable for rents that the creditor could have collected had the creditor used reasonable diligence, which are the two obligations of a mortgagee-in-possession.
36. 168 Cal. App. 2d 709 (1959).
37. *Snyder v. Western Loan & Bldg. Co.*, 1 Cal. 2d 697 (1934).
38. *Childs Real Estate Co. v. Shelburne Realty Co.*, 23 Cal. 2d 263 (1943) [hereinfater *Childs*]; *Lee v. Ski Run Apartments Associates*, 249 Cal. App. 2d 293 (1967); *Malsman v. Brandler*, 230 Cal. App. 2d 922 (1964). *Dicta* in *In re Ventura Louise Properties*, a federal bankruptcy case, implied that demand may be sufficient for perfection purposes under bankruptcy law.
39. Both subparagraphs (3) and (4) of subdivision 2938(c) require that notices be given to those with recorded interests in the rents. A creditor contemplating taking an enforcement action under one of these two subsections would be wise to involve the title company that will be conducting the foreclosure to do a record search to make certain that holders of all recorded interests are given proper notice. This statute may create the need for a new title product.
40. There was considerable concern expressed to the Rents Committee about the bona fides of an assignee issuing a demand notice. The perjury penalty is designed to address this so that the lender must have a recorded assignment before it sends the demand or it will be subject to criminal prosecution. Note that the perjury penalty relates only to the lender's status as the holder of a recorded assignment, and it does not relate to whether or not the lender is entitled to enforce the assignment.
41. It may be somewhat unrealistic to expect lenders to monitor the leasing activity to this degree. Appropriate documentation can help minimize the problem and provide incentives to the borrower to provide the lender with periodic updates. Appropriate covenants should always be considered, along with a nonrecourse exception, for any loss suffered by the lender not having the correct addresses due to the failure of the borrower to provide the updates.
42. As tenants become knowledgeable about this procedure, they will want to confirm that the notice is valid and conforming on its face. If it is not conforming, for example, if it is in the wrong format, the notice would

not be valid and the tenant would not be obligated to deliver the rents, issues, and profits to the lender. In fact, if the tenant honors a nonconforming notice and it turns out that the lender was not entitled to the rents, issues, and profits as against the borrower, the tenant could be exposed to liability to the borrower and remedies under its lease, unless the borrower ultimately receives the rents, issues, and profits from the lender.

43. The subdivision (k) notice provides that the tenant may request a copy of the assignment from the lender; however, no sanction is provided for the failure of the lender to provide a copy of the assignment to the tenant and the failure to do so would not absolve the tenant from compliance with the statute.

44. The subdivision (k) notice states: "YOU WILL NOT BE SUBJECT TO DAMAGES OR OBLIGATED TO PAY RENT TO THE SECURED PARTY IF YOU HAVE PREVIOUSLY RECEIVED A DEMAND OF THIS TYPE FROM A DIFFERENT SECURED PARTY."

45. Once a lender with an earlier recorded assignment delivers a copy of its notice to the subordinate lender who issued a subdivision (k) demand notice to tenants, the subordinate lender is obligated to cancel its notice. (See subdivision (h) of the Rents Statute). The cancellation notice will not be effective until it is received by the tenant; until then, the tenant must continue to pay the rents, issues, and profits to the sender of the first demand notice. The superior lender's remedies with respect to rents, issues and profits paid to the subordinate lender will be governed by subdivision (f)(1) until delivery of the cancellation notice by the subordinate lender.

46. The Rents Committee recognized that there are small tenants with one location, major corporations with multiple locations, and many other types of operations and tenants in between so that no single procedure could accommodate the needs of them all. The procedure and the statutory grace period for compliance will be more than sufficient for most tenants, but not enough for some. The result was a compromise.

47. For example, if the tenant has received the notice, and could have changed its procedure prior to the expiration of the ten-day grace period, but sent the rents, issues, and profits to the borrower anyway, the tenant would not receive the benefit of the good faith exception.

48. For example, if the tenant prepaid more than the amount actually due under the lease in response to a request from the borrower, the payment would not be consistent with the lease and the tenant would remain liable to the lender for the prepaid amounts.

49. Subdivision (d) states that the tenant "shall not be discharged of the obligation to pay rent to the assignee." This rule imposing double liability is consistent with the general contract law regarding the effect of an assignment on the account debtor after notice, as set forth, for example, in California Commercial Code Section 9318. The lender should, therefore, be entitled to sue the tenant to recover these amounts. A lawsuit against the tenant is not clearly referenced in subdivision (e) as an extension of the enforcement action under subdivision (c), pursuant to which Section 726 of the Code of Civil Procedure would not apply. Nevertheless, CCP Section 726 would not apply to the litigation against the tenant as it would be an action ancillary to the subdivision (c) enforcement actions.

50. *Childs,* 23 Cal. 2d 263; *Baumann v. Bedford.* 18 Cal. 2d 366 (1941); *Carlon v. Superior Court,* 2 Cal. 2d 17 (1934).

51. *Childs,* 23 Cal. 2d at 268. Under the *Childs* holding, the senior lien of the ground lessor attached to any subrents which had accrued and remained uncollected as of the time when the ground lessor obtained possession of the property and all subrents accruing and collected thereafter. The senior lienholder could not recover rents that had previously been collected by the junior lienholder pursuant to the junior's enforcement efforts.

52. See discussion in Section II. B. 4(c) of the text.

53. 151 B.R. 241 (Banker N.D. Cal. 1993).

54. *Id.* at 250. The court stated, "Even if New West had successfully established that it was entitled to the rents before GOCO paid the retainers to the Law Firms, it nonetheless cannot prevail because it failed to meet its burden of tracing the proceeds. Declarations state that GOCO's rental income was commingled in an operating account pre-petition with income from other sources. New West has neither identified the other sources of income nor accounted for the amounts deposited into GOCO's pre-petition operating account along with rental income."

55. See Note 57, *infra*; Sheneman, Faughman, Hirsch *et al.*, California Foreclosure, § 7.11 (Shepard's McGraw-Hill 1995).

56. Cal. Comm. Code § 9102(a).

57. Commercial Code Section 9104(j) excludes from the coverage of Article 9 of the Commercial Code the creation or transfer of an interest in or lien on real estate, including a lease or rents thereunder and any interest of a lessor and lessee in any such lease or rents. *In re Bristol Associates, Inc.,* 505 F.2d 1056 (3d Cir. 1974); *In re Standard Conveyor Co.,* 773 F.2d 198 (8th Cir. 1985).

58. Consistent with rules holding that a security interest can be taken in an interest less than a fee (*Commercial Bank of Santa Ana v. Pritchard,* 126 Cal. 600 (1899); *McLeod v. Barnum,* 131 Cal. 605 (1901)) and the language of Commercial Code Section 9104(j), most lenders have treated leaseholds as interests in real property and created security interests in leaseholds in the manner in which security interests in real property are created. *See* Bernhardt, *California Mortgage and Deed of Trust Practice* § 1.32, at 40-41 (CEB, 1990, 1994); 4 Miller & Starr, California Real Estate 2d, § 9:14, at 43-45 (Bancroft-Whitney Co., 1989, 1993). The case of *Taylor v. Bouissiere,* 195 Cal. App. 3d 1197 (1987), held that the security first provision of Code of Civil Procedure Section 726 did not prevent an action to collect on a promissory note secured by the tenant's leasehold interest since that interest was personal property. Legislation enacted in 1989 (SB 1598), abrogating the holding in *Taylor v. Bouissiere,* expressly made Civil Code Sections 1212-1213, 2898, 2920, 2924b, 2924c, 2924.3, 2931a-b and 2954.10 and Code of Civil Procedure Sections 580b, 580d and 726 applicable to "real property or any estate or interest therein." This legislation should also discredit the case of *Placer Savings & Loan Association v. Walsh (In re Marino),* 813 F.2d 1562 (9th Cir. 1987). The 1994 case of *Lovelady v. Bryson,* 27 Cal. App. 4th 25 (1994), does not change this result. The *Lovelady* case confirmed that the customary method to encumber a leasehold was by a deed of trust, but that a UCC-1 which was recorded and which met all of the requirements of a leasehold mortgage would be sufficient as a leasehold mortgage.

59. 159 B.R. 295 (9th Cir. B.A.P. 1993), *aff'd,* 52 F.3d 244 (9th Cir 1995)[hereinafter *Scottsdale Medical*].

60. *Id.* at 298. Other cases addressing the characterization of rents or proceeds of rents include: *In re SLC Ltd. V,* 152 B.R. 755 (Bankr. D. Utah 1993) (funds from settlement of litigation involving lease and held in separate escrow account were rents, not general intangibles); *In re Kurth Ranch,* 110 B.R. 501 (Bankr. D. Mont. 1990) (failure to file a UCC financing statement covering rents did not deprive bank of right to rents under post-petition lease); *In re Valley Liquors, Inc.,* 103 B.R. 961 (Bankr. N.D. Ill. 1989) (proceeds of option to purchase deposited in segregated escrow account were realty, and thus not covered by UCC security interest in general intangibles); *Matter of Hollinrake,* 93 B.R. 183 (Bankr. S.D. Iowa 1988) (royalties in exchange for right to mine coal were rents in which bank with recorded mortgage with assignment of rents had superior interest over bank with financing statement covering assignment of royalties); *Matter of Spears,* 83 B.R. 621 (Bankr. S.D. Iowa 1987) (cash rents collected by the debtor were not cash collateral because the creditor with a mortgage on the underlying real estate did not take sufficient action to acquire an interest in rents; nor did UCC filing give creditor an interest in lease proceeds); *In re Patterson,* 64 B.R. 189 (Bankr. N.D. Ill. 1986) (payment of cash rents to a creditor with a UCC filing covering accounts, contract rights, and general intangibles was a preferential transfer as creditor did not have a security interest in rents and therefore received more than it was entitled to in Chapter 7 case); *In re Standard Conveyor Co.,* 773 F.2d 198 (8th Cir. 1985) (UCC security interest in contract rights, general intangibles, accounts, and receivables did not extend to prepaid rents deposited in escrow account pre-bankruptcy, because Minnesota Uniform Commercial Code Section 9104(j) excluded interest in leases and rents).

61. In a two paragraph opinion, the Ninth Circuit stated, "We have carefully reviewed the record, the law and the BAP's excellent opinion. We affirm for the reasons set forth in the BAP's opinion, which we adopt as our own." *Scottsdale Medical,* 52 F. 3d at 245.

62. Those sentences read as follows: "As used in this section 'leases, rents, issues, and profits of real property' include the cash proceeds thereof. The terms 'cash proceeds' means cash, checks, deposit accounts and the like."

63. See *supra* Note 57.

64. Under California Commercial Code Section 9302(1)(g), a security interest may be taken in a deposit account.

65. 358 F. Supp. 317 (E.D. Mo. 1973).

66. 17 Cal. App. 4th 1303 (1993).

67. The doctrine is explained as follows in *Chrysler Credit Corporation*: "If the trustee withdraws money and dissipates it, the trust funds are only those which remain on deposit. Subsequent deposits ordinarily do not inure to the benefit of the trust. Hence, the beneficiary can have his prior lien only upon the lowest intermediate balance left in the account. And if at any time the trustee withdraws and dissipates the entire fund, the beneficiary loses all prior claim and is merely a general creditor of the trustee."
68. It has been held that the term "ordinary course" in comment 2(c) should be given a fairly broad interpretation. *Harley-Davidson Motor Co., Inc. v. Bank of New England—Old Colony, N.A.*, 897 F. 2d 611, 622 (1st Cir. 1990); *J.I. Case Credit Corp. v. First National Bank of Madison County*, 991 F. 2d 1272, 1277 (7th Cir. 1993).
69. Cal. Civ. Code § 2938(g)(1).
70. *Id.* § 2938(c).
71. *Id.* § 2938(g)(2).
72. *Id.* § 2938(g)(4) and Cal. Civ. Proc. § 564(b)(11).
73. See discussion *supra* at Note 31.
74. *Id.*
75. 232 Cal. App. 3d 1546 (1991), *decertified,* 92 C.D.O.S. 2217 (Cal. 1992).
76. *RTC v. Bayside Developers*, 817 F. Supp. 822 (N.D. Cal. 1993).
77. *RTC v. Bayside Developers*, 43 F. 3d 1230 (9th Cir. 1994).
78. *Great American First Savings Bank v. Bayside Developers*, 232 Cal. App. 3d 1546, 284 Cal. Rptr. 194 (1991), *decertified,* 92 C.D.O.S. 2217 (Cal. 1992), had held that a receiver who turns over to the lender sales proceeds that were part of the security for the debt violates the one-action rule of Code of Civil Procedure Section 726. The court held that there was a primary security doctrine in California and that the real property was the primary security whereas the sales proceeds were secondary security. The state court decision cited *Turner v. Superior Court of Kern County*, 72 Cal. App. 3d 804 (1977), as authority for a "primary security" doctrine—that there is a risk of loss of security under Section 726 unless some types of security are exhausted before resorting to other types. *Turner* implied that rents collected by a receiver are a secondary source of collateral, and it relied for support on the United States Supreme Court case of *DuParquet Huot & Moneuse Co. v. Evans*, 297 U.S. 216, 56 S.Ct. 412 (1936), in which the court stated that a receivership in a foreclosure suit is limited and special. The rents and profits are impounded for the benefit of a particular mortgagee to be applied upon the debt in the event of a deficiency.
79. *Garretson Investment Co. v. Arndt.*, 144 Cal. 64 (1904).
80. 141 B.R. 191 (Bankr. N.D. Ca. 1992). The applicability of the antideficiency prohibition in Code of Civil Procedure Section 580b had been considered by the court in *Mortgage Guarantee Co. v. Sampsell*, 51 Cal. App. 2d 180 (1942). The case of *Hatch v. Security-First National Bank*, 19 Cal. 2d 254 (1942), considered the antideficiency prohibitions of Section 580a.
81. Cal. Civ. Code § 2938(e).

Senior Housing Laws: The Legislature Strikes Again! *The Riverside County Boondoggle*

By Jeffrey G. Wagner

An article appearing in the Spring, 1996 issue of the *Journal* (Vol. 14, No. 2) entitled *Senior Housing Laws: Recipes for Heartburn* described the complexities of the federal and state laws regulating senior housing and pleaded for legislative relief. Surprisingly, the California Legislature *did* act in 1996 and modified state laws to bring them into closer conformance with federal laws. That's the good news. The bad news—you must live in Riverside County, to take advantage of the new laws. Yes, the legislature in its wisdom carved out a separate set of laws applicable only to senior housing projects in Riverside County. Civil Code Sections 51.2, 51.3 and 51.4 were amended at Sections 51.2 (c), 51.3 (k), and 51.4 (e) to provide that they did not apply in Riverside County and Civil Code Sections 51.10, 51.11, and 51.12 were added to enact senior housing laws applicable only in Riverside County.

This unprecedented statutory gerrymandering means that a Riverside County senior housing project no longer must be designed to meet the physical and social needs of senior citizens. This change parallels a recent federal law change eliminating the requirement that projects contain significant senior facilities and services. Furthermore, if the project sets the minimum age requirement at the lowest-allowable level (age 55), it need not meet any minimum size requirements as long as the project is characterized as a senior community in the governing documents or qualifies as a senior community under federal law. This change also eliminated requirements not applicable under federal law. California Civil Code Sections 51.11 (b)(1) and (4).

The legislature justified Riverside County's special treatment stating "there is an unusually large concentration of senior communities and... an unusually large number of civil enforcement actions and litigation by private parties, notwithstanding the good faith beliefs of these communities that were in compliance with the law." (1995–96 Regular Session, ch. 1147, § 8.)

Presumably, good faith confusion and resulting litigation in counties with moderate or small (or even large but not "unusually" large) senior communities do not warrant legislative relief. Left out in the cold, senior communities in the other 57 counties remain subject to the more stringent requirements of Civil Code Sections 51.2 and 51.3 and their inherent conflicts with federal law.